EMBARGOED UNTIL 12.15 PM
FRIDAY 18 DECEMBER 1981

The Treasury and Civil Service Committee have agreed to the following report:

THE GOVERNMENT'S ECONOMIC POLICY: AUTUMN REVIEW

## A. INTRODUCTION

1. This report is the fourth in a series of short twice-yearly reviews of the Government's economic policy. As required by the Industry Act, the Treasury publish two economic forecasts a year - one at the time of the Budget and one in the autumn. At the same time as the autumn forecast is published, the Chancellor of the Exchequer makes a statement in the House. This affords us the opportunity to assess the economic situation and the Government's policy about half-way through the financial year.

2. This year we took the opportunity to hear oral evidence from the Chancellor of the Exchequer before he made his statement. We also took evidence from Treasury officials. As on previous occasions, we are indebted to our advisers, Dr Paul Neild, Mr Paul Ormerod, Dr Bill Robinson and Mr Terry Ward for their assistance in preparing the report.

3. The autumn statement is an event of growing importance in the Parliamentary and economic calendar. But it is unsatisfactory in two principal respects.

4. First, the Government now give a figure for the "planning total" of expenditure (which excludes debt interest) in the next financial year, but only give in summary form some of the changes inherent in that total figure. Furthermore, the Public Expenditure White Paper giving comprehensive information over the whole field - originally published in the autumn - is now delayed until the time of the Budget. There may well be a case for publishing the Public Expenditure White Paper and the Government's Budget proposals simultaneously and reforming the system so that they are produced on a comparable basis. At present they are not comparable and the two are only published together by delaying the White Paper until long after the Government have decided on its contents. This means that for several months Parliament is without information on substantial areas of public expenditure, both for the current

and next financial year, which it might wish to debate well in advance of the Budget - or even in certain cases before the publication of the Estimates for the forthcoming year.

5. Second, the statement - which is certainly not a Mini-Budget, whatever some commentators may say to the contrary - gives no indication of the Government's proposed budgetary policy for the next financial year. Still less does it foreshadow individual taxation changes which may be under consideration (except for National Insurance contributions, which have become regarded as a form of taxation). The Chancellor of the Exchequer can therefore state, with some justification, that it is not possible to pass judgment at this stage on the Government's overall economic posture, since only their expenditure plans are revealed and not their plans covering revenue.[1] This is unsatisfactory. Moreover, the effect of this is to extend the Chancellor's traditional state of 'purdah' prior to the Budget to a period of at least four months. This has created difficult problems for Parliament.

6. The relationship between expenditure and taxation is among the subjects dealt with in a wide-ranging study conducted by a Committee set up under the Chairmanship of the late Lord Armstrong of Sanderstead at the instigation of the Institute for Fiscal Studies in 1978. The Committee's report[2] contains a number of important recommendations. We propose, in line with a recommendation of the Select Committee on Procedure (Supply) of last Session, to follow up some of the matters dealt with in the Armstrong Report early next year. Other areas covered in the Report may be more appropriately considered by the proposed Select Committee on Procedure.

7. In 1979 the Government's forecast and the Chancellor's statement were made on 1 November and in 1980 on 24 November. This year they were delayed until 2 December which made it impossible for us to publish a report before the debate on 9 December. If the Select Committee are to have time to prepare

1. Official Report, 2 December 1981, Col 249
2. "Budgetary Reform in the UK". 1980

a report for the House it would be helpful if the Government's public expenditure statement and the Industry Act forecasts were made available by mid-November. We ask the Government to bear this in mind in future years.

Common Assumption Forecasts

8. In our Fifth Report last Session - on the 1981 Budget and the Government's Expenditure Plans 1981-82 to 1983-84 - we published a Table comparing the post-Budget Forecasts of the Treasury with those of the London Business School, the National Institute of Economic and Social Research, the Economist Intelligence Unit and Phillips and Drew. We summarised the main features brought out by the comparisons. It was apparent to us that in many important respects the assumptions fed into their economic models by the several forecasters were far from uniform. This made valid comparisons difficult.

9. We have expressed in Chapter 10 of our Third Report last Session - on Monetary Policy - our conviction that more work needs to be done in the field of inter-model comparisons.[3] On this occasion therefore three of the four institutions were asked as an experiment to feed into their models certain common assumptions.[4] In the Table of comparisons in the Annex these "common assumption" forecasts are set out alongside each institution's forecast based its preferred assumptions. Also included are the Treasury's own forecast and Phillips and Drew's forecast (which was produced immediately after the Chancellor's statement on 2 December and takes into account the impact of the measures then announced).

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3 HC(1980-81)163-I, pp lxxxix-xci
4 See Annex

## B - PUBLIC EXPENDITURE

10. This year the Chancellor's autumn economic statement included revised plans for public spending in the financial year ahead. Generally in previous years only a number of revisions to original plans for the coming financial year have been made known, and no revised estimate of overall spending plans given. We welcome this addition to the information previously provided.

11. On the other hand the revised plans contain gaps. In particular they contain no estimates for debt interest payments, and no information on asset sales. Full and proper discussion of the plans is hindered because they are expressed solely in cash terms; in order to make comparions possible it would have been helpful if the March Budget plans had been restated on a comparable basis.

### Expected Outturns and Revised Plans

#### (i) Cash Terms

12. The planning total for public expenditure (which excludes debt interest) for 1981-82 is now expected[5] to be around £107 billion in cash terms compared with a figure of £105 billion presented at the time of the March budget. The 1982-83 planning total has been raised from the £110 billion implied by the last Public Expenditure White Paper (Cmnd 8175) to £115 billion, again measured in cash terms.[6] This represents a rise of 7½% over 1981-82.

#### (ii) Volume terms

13. From the cash figures presented it is not possible to come to any firm view of the volume growth now expected for the present financial year. At the time of the budget a virtually unchanged level from 1980-81 was planned. We have not been told whether the likely outturn of £107 billion in cash terms compared with the original cash plan of £105 billion reflects

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5. Official Report, 2 December 1981, Col 242
6. Table 1. Summary of Public Expenditure Decisions for 1982-83, H M Treasury

unplanned increases in volume or unexpectedly higher prices. Treasury witnesses[7] informed us that the pay and price assumptions underlying the budget estimates had only been marginally revised, so much of the £2 billion extra presumably reflects an increase in the volume of public expenditure. We agree with the Treasury that measuring volume is sometimes difficult and that any estimates for 1981-82 must be tentative since the year has not ended. Nevertheless we feel that more could - and should - be said about volume.

14. Increases in public sector pay and in the price of goods and services purchased by the public sector of 4% and 9% respectively for 1982-83 over 1981-82 amount to a rise in projected public sector costs of 7½% overall. With planned cash spending also rising by 7½%, in theory neither an increase nor a decrease in overall volume terms is being planned; but if, as seems possible, public sector costs rise more than projected, there will be a decrease. The flat path now planned compares with the plans at the time of the Budget to reduce the volume of 1982-83 expenditure from the 1981-82 level by 2%.[8] The upward revision illustrates the difficulty the Government have had in holding to the key elements of their Medium Term Financial Strategy.

(iii) Cost terms

15. To assess the tax implications of public spending the relevant measure is public expenditure in "cost" terms.[9] The Treasury now estimate that pay and price increases will raise the cost of the public sector by 7½% in the financial year 1982-83. General cost increases as measured by retail prices are

7. Q172
8. Table 1. Summary of Public Expenditure Decisions for 1982-3, H M Treasury, March 1981
9. The various wages and prices paid by the public sector change at different rates from those of the private sector and this affects the relative cost of the public service as a whole to the economy generally. (See "The Government's Expenditure Plans 1981-82 to 1983-84", Cmnd 8175, pages 232-233.)

expected to be 10%.[10] The Table below shows changes in public expenditure in cost terms since 1978-79.

Planned Changes in Public Expenditure Planning Total Compared with Outturn, 1979-80 to 1982-3. % changes in cost terms (i.e. including relative price effect)

| | 1978-9 to 1979-80 | 1979-80 to 1980-81 | 1980-81 to 1981-82 | 1981-82 to 1982-3 |
|---|---|---|---|---|
| Preceding White Paper | +3.3 | +1.1 | -1.0 | -2.3* |
| Outturn | 0.0 | +3.0 | +1.7 | |

* Change implied by Chancellor's December 2nd statement.

16. In cost terms public expenditure has clearly been higher than expected; in order to achieve their 1982-3 plans, therefore, the Government will need to secure a substantial relative fall in public sector costs, as well as holding to their plan not to increase further the volume of public spending. Obviously it will prove difficult to keep public sector cost increases below other cost increases.

Gaps in the Figures Presented

17. The public expenditure totals presented with the Chancellor's December 2nd statement refer only to the "planning total" for public expenditure. This does not include debt interest payments. Without estimates of debt interest for 1981-82 and 1982-83 we are unable to form an overall view of public expenditure in these two years. In oral evidence Treasury officials were only able to tell us that interest payments would be higher this year than planned at the time of the last Public Expenditure White Paper but they were unable to give us fresh estimates.[11] Debt interest payments contribute significantly to public expenditure - last year's figure net of transactions within the public sector was £4.3 billion (1980 Survey Prices) equal to the housing programme for example.[12] We therefore recommend that estimates of debt interest be included in any future statements about the overall levels of public spending.

10. Treasury RPI forecast 4th quarter 1981 to 4th quarter 1982.
11. The reply to Q 198 states that the estimate given at the time of the Budget "is probably an under-estimate".
12. Cmnd 8175

18. Included in the planning total for 1982-83 are receipts broadly estimated for sales of assets. The precise size of these has, according to the Treasury paper 'Summary of Public Expenditure Decisions for 1982-83', yet to be determined with therefore presumably consequential effects on other items of public expenditure within the fixed total. (We leave aside here the question of the correctness or otherwise of deducting receipts from assets sales from the total of public expenditure.) Prospective large asset sales (in particular of BNOC) could occur during 1982-83 and significantly affect total public expenditure. It would have been helpful if firmer estimates for asset disposals had been provided.

Nationalised Industry Borrowing

19. Of the £5 billion increase in 1982-83 public spending in cash terms over 1981-82, £1.3 billion is attributable to higher external financing of the nationalised industries;[13] this total does not of course include figures for other public corporations.[14] In previous reports we have argued that planned levels of nationalised industry external financing have been too low and that their planned levels of internal financing were too high.[15] The £1.3 billion adddition is half of what the nationalised industries themselves wanted.[16] It is possible that their external financing requirements are again being under-estimated and that either the limits will have to be raised or the industries may resort to generating cash by raising prices or cutting investment programmes. We note that none of the £1.3 billion extra is to go towards raising nationalised industry investment beyond the level previously planned at the time of the Public Expenditure White Paper.[17]

13. The Treasury were unable to supply information on all public corporations - letter dated 14 December to Clerk (not reported).
14. A full list of the different classifications of public trading bodies is given in our 8th Report HC(1980-81)348-III, p.71.
15. Second Report, 1979-80, HC 584, p.x. Fifth Report, 1980-81, HC 232, p.xii.
16. Official Report, 2 December 1981, Col 240
17. "Summary of public expenditure decisions in 1982-83", para 30.

1982-83 Public Expenditure Changes and the RPI

20. In seeking to keep down the increase in public expenditure in 1982-83 the Government have turned to measures some of which will have the effect of raising prices. As the Chancellor has acknowledged, the proposed higher council house rents would directly raise the RPI by half a percentage point.[18] The reduction in the Rate Support Grant percentage will tend to raise rates. There is the possibility just mentioned that nationalised industries may raise their prices. This will be in addition to the rises in the prices of electricity and gas above the rate of inflation announced at the time of the Budget.[19] All these price rises are occurring at a time when pay settlements are low and when private sector prices are showing only modest increases. Pressure to raise wages may also be increased as a result of the higher national insurance contributions.

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18. Official Report 7 December, Col WA 317
19. See our Fifth Report HC(1980-81) 232-I, para 19.

## C. THE GOVERNMENT'S MONETARY POLICY

### The original aims of the Medium Term Financial Strategy

21. In our report on Monetary Policy[20] we examined the original aims of the Government's Medium Term Financial Strategy. It was clearly stated by the Government that part of the way in which the strategy was intended to work would be by influencing expectations. This depended on the credibility of the targets and the Government asserted that "there would be no question of departing from the money supply policy".[21] Sterling M3 was chosen as the appropriate measure of the money supply and the 1980-81 Financial Statement and Budget Report stated that there should be a "progressive deceleration" in its growth over a four year period, to about 6 per cent in 1983-84. It was said such a strategy would "both result in a marked reduction in the rate of inflation and will prove the only way of achieving a permanent reduction".[22]

### The Strategy in practice

22. Last year the Treasury's November paper, "Economic Prospects", suggested that by the end of that financial year "underlying monetary growth ... will come back towards the top of the target range". In the event Sterling M3 grew over the period February 1980 to February 1981 by about 20%, compared with a target range of 7-11%; only about 3½% of this growth was attributed to the end of the "corset" arrangements.[23]

23. In March 1981 the Sterling M3 targets were "rebased" to allow for the 1980-81 overshoot but it was stated that it was "the Government's intention to consider clawing back some of the past year's rapid growth of £M3 by permitting an undershoot as and when the opportunity arises."[24]

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20. HC (1980-81) 163-I, pp xvii-xix
21. FSBR 1980-81, p.19
22. HC(1979-80)450 Evidence, p.5
23. Note on 'Monetary Developments in Banking April' by the Treasury and Bank of England submitted to the Committee earlier this year. (Not reported)
24. FSBR 1981-82, p.16

24. This year the "Economic Prospects" paper suggests that the growth of Sterling M3 "may be somewhat above the top of the target range", i.e. the one which resulted from the upward rebasing, in part due to the Civil Service dispute and the move by the banks into the housing market. Treasury officials estimated that the tax revenue outstanding at the end of October as a result of the Civil Service dispute amounted to £5½ billion and that between £0.75 billion and £1 billion of this would still be outstanding at the end of the financial year. By the end of November the amount outstanding on this account had been reduced to about £4 billion. If all of the revenue delayed by the Civil Service dispute was paid to the Exchequer out of bank deposits rather than by increasing bank lending, the scale of the movement would be great enough to bring Sterling M3 growth within its current target range[25]. However this seems unlikely to happen, since the Bank of England's note on the provisional estimate of the money supply in November[26] suggested that collection of delayed taxes "appears to have added substantially to bank lending" and Sterling M3 had already grown by nearly 13% over the nine months since the start of the target period. Even the rebased target range (6-10% at an annual rate) may be exceeded for a second successive year.

25. Despite the £M3 overshoot last year and £M3's increase so far in this financial year, the Treasury expect the annual rate of inflation to continue to fall slowly to about 10% in the fourth quarter of 1982 compared with 12% in the fourth quarter of 1981 and 15% a year earlier. In their current assessment of the prospects for inflation, the Treasury stress movements in the exchange rate and productivity rather than past changes in the money stock[27]; we were told that these represented the "channels" through which monetary policy operates.[28]

26. Sterling M3 was not mentioned in the Chancellor's statement of 2 December. This surprised us, given the importance originally attached to it, but we have been given no satisfactory explanation of the omission. In oral evidence, the Chancellor agreed that £M3 is an "accident prone" measure

25. Q.96 et seq. and Q.310
26. Press Notice, 8 December 1981
27. "Economic Prospects for 1982", paragraphs 3,7,20 and 21.
28 Q 223

of monetary growth[29]. As it is not considered to be a wholly reliable indicator, its movements are assessed "in the context of what happens to other figures".[30] These include the narrower measures of money supply growth such as M1, the wider aggregates such as PSL1 and PSL2 and the exchange rate. The Treasury have not made clear however what would constitute satisfactory performance by those measures and no target ranges have been set in advance as is the case with £M3. If the yardsticks are unspecified, it is impossible to judge the policy.

Interest rates and the exchange rate

27. When we started our inquiry on 16 November it was clear that the level of UK interest rates had been increasingly influenced by overseas interest rates. But UK interest rates have not fallen as quickly as world interest rates in the last few months.[31] We were told that if both monetary growth and the exchange rate were thought by the Government to be satisfactory, UK interest rates would be allowed to fall. The Chancellor was not able to specify the policy to be followed if one were satisfactory and the other not,[32] saying that "both of them could produce evidence which pointed in the opposite direction. There is no uniquely satisfactory state of affairs but both of them have to be taken into account."[33]

28. The increased emphasis on the exchange rate as a factor in assessing monetary conditions leads on to the question of whether it would be wise to have an explicit policy on the exchange rate. The Treasury have, at our request, set out the arguments for and against one such policy, membership of the exchange rate mechanism (ERM) of the European Monetary System.[34] This is a subject of increasing debate, but one which we have not yet examined, although it was the subject of a report by the Expenditure Committee of the last Parliament.[35]

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29. Q 30
30. Q 33
31. HC(1981-82)28-i, pp 1-5
32. Q 78, Q 79 and Q 124
33. Q 124
34. Appendix 3
35. HC(1978-79)60

The current state of monetary policy

29. The Government's current objectives were repeatedly expressed to us as the pursuit of "steady though not excessive downward pressure on [the] monetary aggregates making due allowance for events in the world beyond our shores".[36] What this means has not been explained to us. The growth of £M3 exceeded its target range last year and may do so again this year.

Percentage Growth in £M3

| | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|---|
| MTFS Ranges | 7-11 | 6-10 | 5-9 | 4-8 |
| Outturn | 16½(a) | 13(b) | | |

(a) adjusted for removal of the corset

(b) growth over 9 months since beginning of target period; seasonally adjusted but unadjusted for effects of Civil Service dispute.

Given the original description of the MTFS, the apparent complacency of Treasury Ministers to these overshoots is important.

30. We welcome increased flexibility in the application of monetary policy. It is evident that the Government have had to modify the Medium Term Financial Strategy, which was originally intended to influence expectations and reduce uncertainty by making a clear commitment to the achievement of targets for a declining rate of growth of £M3 over a period of four years.

31. The effect of a high level of interest rates is of particular concern to the Committee, not least because a higher level in this country than abroad will tend to put upward pressure on the exchange rate; given the deterioration in UK competitiveness over the last few years this will damage prospects for recovery. Lower interest rates will partly depend on a reduction in the level of Government borrowing.

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36. Q4 and passim

35. It is difficult to obtain precise information on the costs of unemployment. We are surprised to learn from a Treasury Note that it is not yet possible to estimate the proportion of those unemployed claiming benefit divided between Unemployment Benefit and Supplementary Benefit.[43]

36. The turnround in stockbuilding from de-stocking of £2.3 billion in 1981 (1975 prices) to an increase of £0.3 billion in 1982 is equivalent to an increase in GDP of 2.6%. However the effect on GDP is smaller than this since stocks have a high import content. Imports are forecast to rise by 8½% between 1981 and 1982.

37. There seems little reason to expect any of the other components of demand to boost 1982 GDP much beyond the Treasury's current forecasts. Consumers' expenditure is expected to remain steady despite falling post-tax real wages; so a fall in the savings ratio is anticipated although inflation is only expected to fall by 2%. If inflation actually fell further this could further reduce the savings ratio and increase consumers' expenditure. Government expenditure on goods and services in current prices is planned to rise by less than inflation between 1981-82 and 1982-83. The Treasury already forecast investment to rise by 2½% between 1981 and 1982, partly reflecting thehope that private housebuilding will recover from its present low level.[44] Finally, it surprised us that the Treasury forecasts assume 4-5% world trade growth (manufactures, weighted by UK share of markets) next year, more than double the rate they estimate for this year. Given the world recession and the deterioration in UK competitiveness in the last two years which the fall in the exchange rate has only partially offset, there seems little hope of a significant extra boost from export demand. Indeed we may not have seen the full effects of the rise of Sterling in 1980; from past experience the Treasury suggest that "effects on trade volumes, particularly exports, take some time to come through".[45]

43. Appendix 4
44. Q 272
45. Evidence, p.1, para 4

38. The 4% increase in manufacturing output (stock adjusted) between 1981 and 1982 which the Treasury forecast will, if achieved, be welcome; this would, however, still leave it by the second half of 1982 6% below its level of the first half 1980and 11% below its 1979 level.

39. On productivity, the Treasury suggest that, bearing in mind the need for a cautious interpretation of recent short run movements, it "has held up better than might be expected" but "It is still too early to say however whether this ... presages a sustained improvement in the future trend."[46] As far as productivity in the public sector is concerned, we were told that Government cannot set manning targets for the local authorities but did assume that there would be a substantial improvement in the efficiency of the National Health Service as a result of reductions in staff for the same output.[47]

Comparison with other forecasts

40. The forecasts provided for the Committee by the Economist Intelligence Unit, the London Business School, the National Institute of Economic and Social Research and that of Phillips and Drew set out in the Annex to the Report show that there is no major disagreement with the Treasury. All forecasts predict a small GDP increase between 1981 and 1982 (the LBS predicts a rather larger increase than the others); the main source of increased GDP is the end of de-stocking although much of this is reflected in increased imports; inflation remains in double figures at the end of 1982; and UK unemployment (seasonally adjusted and excluding school leavers) is forecast to be between 2.8 and 3.0 million in the fourth quarter of 1982.

46. HC(1981-82)28-i, p.7
47. Q 202

Risks and uncertainties

41. Although the various forecasting institutions are in closer agreement than they have been in the recent past it should be stressed that there is still a margin of error surrounding their results, particularly as a result of external factors. The Treasury's forecast at this time of year for GDP growth between the current year and the next has been subject in the past to an average error of 1½ per cent of GDP.[48] Within this margin of error GDP could rise at twice the rate the Treasury are forecasting or, alternatively, it could actually fall.

42. The uncertainties of forecasting are made larger this year by the lack of information about the UK's recent trade performance and by the world situation. Export prospects may be seriously damaged by recessions in Europe and the United States on the one hand, while changes in US interest rates would have significant effects on UK interest rates and the exchange rate. We have gained no idea of what variations of strategy, if any, the Chancellor might adopt if external forces behave very differently from their assumed course.

The medium term

43. The upswing which is forecast for 1982 is weak, with GDP growing much more slowly than in similar stages of previous economic cycles.[49] Moreover, of the 1% forecast increase in GDP between 1981 and 1982 between a quarter and a half is a result of higher North Sea oil and gas output.[50] The end of de-stocking, which more than accounts for the GDP increase between 1981 and 1982, is a short term influence. We have not seen any firm evidence of factors leading to a sustained level of growth in the medium term which would significantly reduce unemployment.

48. 'Economic Prospects for 1982', Table 1.
49. Q 257
50. Q 281

E - RESTATEMENT OF THE STRATEGY

45. In our Second Report of Session 1979-80, on the Budget and the Government's Expenditure Plans 1980-81 to 1983-84, we commented on the launching of the Medium Term Financial Strategy welcoming in particular the bringing together of expenditure and revenue plans for a four-year period.[51] We saw the introduction of the Strategy as a method of establishing disciplines, and the announcement of targets for various important constituents of the national economy (e.g. the financing of the nationalised industries) as a significant method of verifying progress towards achieving those declared targets. At the same time, we expressed reservations and anxieties about certain of the targets and the feasibility of realising them at that time. In our Third Report of Session 1980-81 (on Monetary Policy) we made further comment on the concept underlying the Strategy, describing it as "a bold experiment".[52]

46. In view of the emphasis which the Government originally accorded to the Strategy and to certain particular targets, notably those for the money supply and the Public Sector Borrowing Requirement, it is a surprise to the Committee to find a lesser emphasis being currently given to these items. The evidence we have taken in the course of the present enquiry indicates a marked lack of certainty in relation to these targets, which is in strong contrast to the position of eighteen months ago. This makes it difficult for the Committee to measure and assess the position which the economy has now reached, and must throw doubt on the underlying Strategy as it was promulgated at the time of the Budget in 1980. We therefore believe that the time has come for a major re-statement of the Strategy, so that Parliament and public may be fully informed of the economic objectives which the Government now have set.

51. HC(1979-80)584, p.vii, para 3
52. HC(1980-81)163-I, p.xcvi, para 11.26

ANNEX

1.The Table overleaf compares the latest Treasury forecast with forecasts prepared for the Committee by the Economist Intelligence Unit (using the Treasury model), the London Business School and the National Institute of Economic and Social Research and Phillips and Drew's latest forecast.

2. Three of the forecasting teams submitting forecasts to the Committee supplied two forecasts. One - the basic forecast - was based on their own assumptions about the likely development of the world economy and UK economic policy. The other was based on a set of assumptions common to all three teams. These common assumptions were agreed among the forecasters (Mr Paul Ormerod from the Economist Intelligence Unit, Dr Bill Robinson from the London Business School and Mr Brian Henry from the National Institute of Economic and Social Research) and were essentially compromises between their individual assumptions. The forecasters argue that the estimates based on their own individual assumptions are their best guesses of how the economy is likely to develop. The LBS base forecast used in this exercise does not fully reflect latest developments and is felt by them to be probably over optimistic.

3. The Treasury and Phillips and Drew forecasts include the impact of the latest measures announced by the Chancellor. The other forecasts do not. (The common assumptions forecasts, though, assume a path for public expenditure similar to that now being planned as well as a similar view of future tax policy to that lying behind the Treasury forecast.)

4. Some of the salient points that arise are:-

(i) with the partial exception of the LBS, all forecasts predict slow economic growth.

(ii) all forecasters see stockbuilding as being the main source of increased demand, although much of this is dissipated in higher imports.

(iii) inflation is unlikely to fall into single figures by the last quarter of 1932.

(iv) unemployment (UK, seasonally adjusted and excluding school leavers) is likely to be only marginally below 3 million by the 4th quarter of 1982.

5. A note to this Annex discusses the common assumptions forecasts in some more detail.

## COMPARISONS OF FORECASTS

| | NIESR A | NIESR B | LBS A | LBS B | EIU A | EIU B | Treasury | Phillips & Drew |
|---|---|---|---|---|---|---|---|---|
| A. Output and expenditure at 1975 prices. Per cent changes between 1981 and 1982 | | | | | | | | |
| (i) GDP (Factor cost) | 0.6 | 0.6 | 2.3 | 2.0 | 0.5 | 0.5 | 1.0 | 1.0 |
| (ii) Consumers' expenditure | -0.3 | -0.2 | 1.0 | 0.6 | -0.5 | -1.0 | 0.0 | 0.2 |
| (iii) General Government current expenditure on goods & services | 0.5 | -0.9 | 0.4* | -0.6* | 0.5 | 0.5 | 0.5 | 1.0 |
| (iv) Fixed investment | -1.9 | -1.3 | 1.2 | 0.6 | -2.0 | -1.5 | 1.8 | -1.2 |
| (v) Exports of goods and services | 3.3 | 4.5 | 1.9 | 1.8 | 1.0 | 1.5 | 2.5 | 3.9 |
| (vi) Imports of goods and services | 6.7 | 7.6 | 9.8 | 8.6 | 7.0 | 7.5 | 8.5 | 5.4 |
| (vii) Change in stock building (as per cent of level of GDP) | 2.0 | 2.0 | 2.7 | 2.7 | 2.0 | 2.0 | 2.5 | 2.1 |
| B. Balance of payments on current account £billion | | | | | | | | |
| 1982: First half | 1.4 | 2.0 | 0.5 | 0.75 | 0.0 | 0.0 | } 3.0 | } 1.8 |
| Second half | 0.6 | 2.4 | -0.5 | - | 0.0 | 0.0 | | |
| C. Public Sector Borrowing Requirement £billion | | | | | | | | |
| Financial year 1981/2 | 11.3 | 11.0 | 10.3 | 10.5 | 12.5 | 12.5 | 10.5 | |
| 1982/3 | 12.0 | 11.0 | 9.0 | 8.5 | 10.5 | 10.5 | n.a | 11.0 |
| D. Retail price index Per cent change 4th Quarter 1981 to 4th Quarter 1982 | 11.2 | 10.0 | 10.4** | 11.0** | 11.5 | 11.5 | 10.0 | 9.9 |
| E. Money Supply (£M3) per cent change March 1982 to March 1983 | 15.5 | 9.5 | 14.9 | 12.3 | 3.0*** | 8.0*** | n.a | 9.0 |
| F. Unemployment, UK., excluding school leavers, 4th Quarter 1982, millions | 2.9 | 3.0 | 2.8 | 2.8 | 2.8 | 2.8 | 2.9**** | 2.9 |

n.a. not available

Common Assumption Forecast

Basic Forecast. /That of the NIESR is taken from their November Review, the LBS base was done for the Committee, and the EIU's is their October forecast./

Includes Nationalised Industry Investment

Consumer Price Index

* April 1982 to March 1983 at annual rate

** Government Actuary's assumption; GB excluding school leavers, average.

Note to the Annex

## Common Assumption Forecasts

1. Three major forecasting teams (the Economist Intelligence Unit, the London Business School, and the National Institute of Economic and Social Research) have in the past provided the Committee with forecasts of the economy. Such forecasts have been used to outline possible developments in the economy. They embody the forecasters' best guesses of where the economy is going.

2. Each of the forecasting teams usually produces a different forecast. Differences arise from

(i) differing views of how the economy works, embodied in the structure and coefficients of the model

(ii) differing assumptions about future UK economic policy

(iii) differing assumptions about economic developments outside the UK

(iv) differing assumptions about recent past events the statistical record of which is incomplete or provisional

(v) differing choice of residuals or judgemental adjustments to model forecasts.

A common assumptions forecast should eliminate (ii), (iii) and (iv), concentrating attention on how the economy works and judgemental adjustments, which may be made to support views on how the economy works. A necessary condition for differences in views as to how the economy works to be small is that common assumption forecasts should be similar. Their dissimilarities help to indicate where, in the assumed scenario, there are important differences in view on how the economy works.

3. The Table in the Annex details the salient results from the forecasting teams using both common assumptions and individuals', preferred assumptions. The forecasters point out that their common assumptions forecasts were not constructed with as much concern for detail as their normal forecasting exercises are and must be seen as being somewhat rough and ready. The Tables overleaf present the differences

between basic forecasts and common assumption forecasts. The general picture is that using common assumptions increases the differences between forecasts. This can be interpreted as showing that basic model differences are greater than the basic forecasts suggests.

4. Another interpretation is possible. In constructing a forecast forecasters often adjust the results their models produce. Such adjustments essentially over-ride the economic views embodied in the model and the empirical evidence on which the model is based. For example, the model may predict that a 10% fall in the exchange rate will raise import prices by 5% after one year. The forecasting team may feel that this effect is say too big in the circumstances envisaged by the forecast overall, and reduce it. To an extent this kind of adjustment is absent from the common assumption forecasts. The greater divergence of the forecasts may therefore indicate that forecasters in adjusting these results from their models tend to produce forecasts that converge.

5. This exercise in producing common assumptions forecasts is very much a first step down this particular path of inter-model comparisons. Moreover, only the most rudimentary analysis of the results has been presented here. It is hoped that a more detailed examination of the results will be included in and contribute to, a similar exercise now being undertaken by Professor Artis for the Bank of England. The more thorough comparison of models requires examination of systematic sets of 'ready reckoners' prepared on comparable assumptions on different economic models, with any differences that arise traced back to the underlying theory, structure and estimation of the models themselves, their component sectors and individual equations. The Committee wish to encourage the Social Science Research Council and the forecasting teams, including the Treasury, to make provision for such work, and consider it of direct relevance to the work of the Committee.

## Comparison of Base and Common Assumption Forecasts

(i) % increase in GDP at 1975 prices between 1982 & 1981

| | Base Forecast | Difference from average of base forecasts | Common Assumptions Forecast | Difference from average of common assumptions forecasts |
|---|---|---|---|---|
| NIESR | 0.6 | -0.4 | 0.6 | -0.5 |
| LBS | 2.0 | +1.0 | 2.3 | +1.2 |
| EIU | 0.5 | -0.5 | 0.5 | -0.6 |
| Average | 1.0 | | 1.1 | |
| difference between highest and lowest forecast | 1.5 | | 1.8 | |

(ii) % increase in Consumption at 1975 prices between 1982 & 1981

| | Base Forecast | Difference from average of base forecasts | Common Assumptions Forecast | Difference from average of common assumptions forecasts |
|---|---|---|---|---|
| NIESR | -0.2 | 0.0 | -0.3 | -0.4 |
| LBS | 0.6 | +0.8 | 1.0 | +0.9 |
| EIU | -1.0 | -0.8 | -0.5 | -0.6 |
| Average | -0.2 | | 0.1 | |
| Difference between highest and lowest forecast | 1.6 | | 1.5 | |

(iii) % increase in Fixed Investment at 1975 prices between 1982 & 1981

| | Base Forecast | Difference from average of base forecasts | Common Assumptions Forecast | Difference from average of common assumptions forecasts |
|---|---|---|---|---|
| NIESR | -1.3 | -0.6 | -1.9 | -1.0 |
| LBS | 0.6 | +1.3 | 1.2 | +2.1 |
| EIU | -1.5 | -0.8 | -2.0 | -1.1 |
| Average | -0.7 | | -0.9 | |
| Difference between highest and lowest forecast | 2.1 | | 3.2 | |

(iv) % increase in Exports ofcGoods and Services at 1975 prices between 1982 & 1981

| | Base Forecast | Difference from average of base forecasts | Common Assumptions Forecast | Difference from average of common assumptions forecasts |
|---|---|---|---|---|
| NIESR | 4.5 | +1.9 | 3.3 | +1.2 |
| LBS | 1.8 | -0.8 | 1.9 | -0.2 |
| EIU | 1.5 | -1.1 | 1.0 | -1.1 |
| Average | 2.6 | | 2.1 | |
| Difference between highest and lowest forecast | 3.0 | | 2.3 | |

(v) % increase in Imports of Goods and Services at 1975 prices between 1982 & 1981

| | Base Forecast | Difference from Average of Base Forecasts | Common Assumptions Forecast | Difference from average of common assumptions forecasts |
|---|---|---|---|---|
| NIESR | 7.6 | -0.3 | 6.7 | -1.1 |
| LBS | 8.6 | +0.7 | 9.8 | +2.0 |
| EIU | 7.5 | -0.4 | 7.0 | -0.8 |
| Average | 7.9 | | 7.8 | |
| Difference between highest and lowest forecast | 1.1 | | 3.1 | |

(vi) Change in stockbuilding 1982 on 1981 as % of GDP

| | | | | |
|---|---|---|---|---|
| NIESR | 2.0 | -0.2 | 2.0 | -0.2 |
| LBS | 2.7 | +0.5 | 2.7 | +0.5 |
| EIU | 2.0 | -0.2 | 2.0 | -0.2 |
| Average | 2.2 | | 2.2 | |
| Difference between highest and lowest forecast | 0.7 | | 0.7 | |

(vii) Balance of Payments, Current account 1982, £ billion

| | | | | |
|---|---|---|---|---|
| NIESR | 4.4 | +2.7 | 2.0 | +1.3 |
| LBS | 0.8 | -0.9 | 0.0 | -0.7 |
| EIU | 0.0 | -1.7 | 0.0 | -0.7 |
| Average | 1.7 | | 0.7 | |
| Difference between highest and lowest forecast | 4.4 | | 2.0 | |

(viii) PSBR, 1982/83, £ billion

| | | | | |
|---|---|---|---|---|
| NIESR | 11.0 | +1.0 | 12.0 | +1.5 |
| LBS | 8.5 | -1.5 | 9.0 | -1.5 |
| EIU | 10.5 | +0.5 | 10.5 | 0.0 |
| Average | 10.0 | | 10.5 | |
| Difference between highest and lowest forecast | 2.5 | | 3.0 | |

(ix) RPI % change 4th quarter 1981 to 4th quarter 1982

| | Base Forecast | Difference from average of Base Forecasts | Common Assumptions Forecast | Difference from average of common assumptions forecasts |
|---|---|---|---|---|
| NIESR | 10.0 | -0.8 | 11.2 | +0.2 |
| LBS | 11.0 | +0.2 | 10.4 | -0.6 |
| EIU | 11.5 | +0.7 | 11.5 | +0.5 |
| Average | 10.8 | | 11.0 | |
| Difference between highest and lowest forecast | 1.5 | | 1.1 | |

(x) £M3, % change March 1982 to March 1983

| | Base Forecast | Difference from average of Base Forecasts | Common Assumptions Forecast | Difference from average of common assumptions forecasts |
|---|---|---|---|---|
| NIESR | 9.5 | -0.4 | 15.5 | +4.4 |
| LBS | 12.3 | +2.4 | 14.9 | +3.8 |
| EIU | 8.0 | -1.9 | 3.0 | -8.1 |
| Average | 9.9 | | 11.1 | |
| Difference between highest and lowest forecast | 4.3 | | 12.5 | |

(xi) UK Unemployment, excluding school leavers, 4th quarter 1982, millions

| | Base Forecast | Difference from average of Base Forecasts | Common Assumptions Forecast | Difference from average of common assumptions forecasts |
|---|---|---|---|---|
| NIESR | 3.0 | +0.1 | 2.9 | +0.1 |
| LBS | 2.8 | -0.1 | 2.8 | 0.0 |
| EIU | 2.8 | -0.1 | 2.8 | 0.0 |
| Average | 2.9 | | 2.8 | |
| Difference between highest and lowest forecast | 0.2 | | 0.1 | |

## Assumptions used in Base and 'Common Assumptions' Forecasts

Per cent changes

| | Base forecasts | | | Common assumpt forecasts |
|---|---|---|---|---|
| | NIESR | EIU | LBS | |
| North Sea Output 1981 Q3/1982 Q4 | 22.5 | 11.0 | 9.1 | 10.4 |
| World Oil price 1981 Q2/1982 Q4 | 7.0 | 4.8 | 5.7 | 5.3 |
| $/£ rate 1981 Q2/1982 Q4 | -9.0 | -8.7 | -18.8 | -13.5 |
| Effective Exchange Rate 1981 Q2/1982 Q4 | -9.3 | -5.1 | -17.3 | -11.2 |
| World Interest Rates (percentage points) 1981 Q4/1982 Q4 | -2.0 | -3.5 | -4.7 | -4.0 |
| World Export Prices (dollars) 1981 Q2/1982 Q4 | 10.0 | 13.5 | 5.5 | 9.3 |
| World Trade in manufactureds 1981 Q2/1982 Q4 | 6.5 | 5.1 | 5.1 | 5.1 |
| UK short-term interest rates (levels) 1982 Average | 15.5 | 12.6 | 15.7 | 14.1 |
| General Government current expenditure on goods & services 1982/1981 | -0.9 | 0.5 | -0.6* | 0.5 |

*includes nationalised industry industry investment

### Tax assumptions

(a) Base forecasts:
NIESR: Tax rates and allowances indexed at 1981/2 levels
EIU: " " " " " " " "
LBS: income tax held at constant proportion of personal incomes, indir taxation held at constant proportion of consumption, national insurance surcharge reduced from 1982/3

(b) Common Assumptions Forecasts:
Tax rates and allowances indexed at 1981/2 levels