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and officials in HMT, Revenue Departments and  
other Departments in Whitehall

TREASURY WEEKLY ECONOMIC BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 8 February, are  
sidelined.

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*RA*

R I G ALLEN

15 February 1982

EB Division  
HM Treasury  
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## A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

Main objectives are to achieve, over a period, a sustained improvement in the economy through reduction of inflation and promotion of enterprise and initiative. Reduction of inflation requires maintaining steady but not excessive downward pressure on monetary variables, and complementary fiscal policies. Improvement of supply side depends on restoration of flexible and competitive market economy and better incentives.

2. Relative importance given to inflation and unemployment?

Government is concerned about both. These are complementary not competitive objectives; unemployment will not be reduced by relaxing struggle against inflation.

3. What did 2 December 1981 announcements imply about overall policy stance?

Did not imply any change in broad direction of policy. Helpful to bring together various announcements due in the autumn. But only part of the picture. Need to be seen in context of forthcoming Budget.

4. Budget objectives

We intend to use the Budget to sustain and maintain the progress now evident. We shall continue with policies designed to reduce inflation and to create the conditions for sustainable growth.

5. Scope for tax cuts? Stimulation of economy?

Chancellor considers all representations. Cannot anticipate Budget judgement but no question of abandoning our strategy; cannot throw away gains already made. Will need to assess appropriate fiscal stance in light of circumstances at time, including monetary prospects and outlook for inflation.

6. PM and Chancellor at odds over TUC proposals?

[Chancellor says 'responsible' PM says 'irresponsible']

Certainly not. My rhF commenting on TUC's approach; my remarks referred to their conclusions. (See also A26). The document certainly comprehensive and well presented. But solutions it offers are totally wrongheaded.

7. Armstrong report - TCSC comment  
from TCSC

[Report/expected in the Spring]

Welcome interest shown by Treasury Select Committee in Armstrong report. Very important implications for conduct of Government bodies and for Parliamentary procedure. Shall look forward to Committee's report.

8. Endorse Armstrong recommendation?

Number of practical difficulties. Issues need further examination.

9. Government has failed to accommodate recession?

On the contrary. Have been flexible within the limits of prudence over the levels of public spending and borrowing. But experience shows that attempts to 'buy' jobs only temporarily beneficial. Repercussions weaken economy and worsen job prospects in longer run.

10. Failure to control monetary growth?

Judged by results rather than precise numbers, strategy successful. Growth in money GDP down from 17 per cent in 1980 to 10 per cent lending remains disturbingly high, particularly personal lending, despite the level of interest rates.

11. Why are high interest rates needed?

Current level of interest rates reflects both developments overseas and strength of bank lending. Although sterling has recently firmed, high level of bank lending continues. However it should be noted that bank base rates have come down by 2 per cent since September.

12. Pressure on interest rates likely following President Reagan's Budget message?

[Budget message involved doubling of earlier \$45 billion US deficit 1982: no new proposals to offset this by tax or spending changes]

everyone's interest that the US should defeat inflation. We know how difficult and painful the necessary decisions are. But concerned that the US deficit in 1982 will be higher than earlier planned. Welcome the intention that it will decline in later years although deficits will remain large. As in all other countries, it is desirable that the US pursue balanced monetary and fiscal policies. This is crucial to interest rates - a matter that affects us all.

13. Chancellor Schmidt has introduced reflationary package?

Not so. Germany planned to reduce Government borrowing in 1982 by nearly 30 per cent. Unlikely the investment/employment scheme will entail significant effect (see also S7).

14. Expectations for UK economy in 1982 disappointing?

Further falls in inflation in prospect. Good export prospects and current balance will remain in surplus. Industry Act forecast shows 1 per cent growth in 1982. Appreciable progress made on improving competitiveness and productivity. Important to build on this. Recent report from CBI West Midlands ('Winning Through') illustrates way forward - companies have improved performance and diversified and developed products to capture new markets.

15. Recovery faltering?

[Industrial production in December down 1 per cent on November, 3 per cent on October]

Last quarter of 1981 production broadly same as Q3 and up from Q2.

16. Productivity bound to be 'improving' when 1¼ million laid off in manufacturing in past 2½ years?

No escaping fact that much of industry has been inefficient, overmanned. But does not follow that there has been permanent loss of jobs. Improved productivity/competitiveness enhances, not diminishes long-term prospect for jobs.

17. Unemployment in 1982?

The rate of rise in unemployment has slowed. Increase in recent months one third that at end 1980. This trend should continue. But clearly any firm forecasts for unemployment very uncertain and depend on a number of factors. [IF PRESSED on unemployment prospects see C3].

18. Chancellor and some colleagues taking rosy view; Mr Pym's gloomier outlook nearer the truth?

Remarks have been quoted selectively from recent speeches by my various rt hon Friends. There is no logical discrepancy between what my rt hon Friends have been saying. They have drawn attention, as I have myself, to the accumulating indications of economic recovery. They have also warned that the soundly based reconstruction of our economy depends on keeping up the momentum of change in attitudes and practices.

19. Government has failed to check public spending?

No. Have made positive decision to increase spending in some areas but remain determined to stick to plans once set. This year, cash limits are generally holding; determined to set (and keep to) tight but realistic limits next year. [See also Section E]

20. Government has failed in objective of reducing burden of tax?

Burden has inevitably increased at time when national production not growing. But for vast majority real personal disposable income is still higher than for period of previous Government.

21. Inflation still higher than when Government took office?

True of the 12-month rate. But in May 1979 inflation was accelerating, on back of escalating wage settlements and increasing public sector prices. 12 month rate now broadly stable and set to resume downward movement later this year.

22. Labour Party reflationary programme?

[Mr Shore, 28 January Economic Debate, spoke of £6 billion reflation needed in 1982-83, over and above neutral Budget, to be 'no more and no less deflationary' than in 1981-82. Specific proposals include major attack on the unnecessarily high costs of British industry' through lower energy prices, lower exchange rates and a 'national understanding' on inflation; major investment in NIs and infrastructure; planning agreements and control over capital movements']

How can any such 'package' be credible when Mr Shore consistently backs away from costing it? He seems to have no fear of the extra borrowing that, he admits, would be necessary, nor of the cost in higher interest rates. And while he recognises the danger of inflation his proposals would involve, past experience of the social contract etc makes his idea of a 'national understanding' on pay and price scarcely credible. The package also threatens a return to planning agreements, control over capital movements and other bureaucratic nonsensities.

23. TUC Economic Review proposals?

[Annual Economic Review published 2 February calls for five-year strategy starting with £8.3 billion stimulus-extra public sector capital spending (£2.1 billion), social spending (£1.5 billion) and employment and training measures (£1.2 billion): suggests VAT cut equivalent to £2 billion: urges lower interest rates, orderly depreciation of sterling and quick-acting measure eg import controls, to protect trading position during first year of expansion. National Economic Assessment part of strategy.]

Macro-economic arithmetic unconvincing. Measures imply massive increase in inflation in medium term even if initial fall. National Economic Assessment idea reminiscent of former 'social contract' - and not likely to be of any more constructive use. Alleged employment effects not authenticated by TUC use of Treasury model because reflect TUC's own assumptions fed in.

24. TUC/Gilmour proposals tried out on Treasury economic model?

Computer models cannot be used in a mechanistic way. Results depend on assumptions. And, anyway, model relationships unlikely to hold eg for interest rates and exchange rates, for measures on scale proposed by TUC.

25. Sir Ian Gilmour points out HMT model says higher PSBR need not necessarily mean higher interest rates / PSBR self-financing ?

Treasury model can be operated in a number of ways : one option is to assume interest rates unchanged when PSBR rises. Effect on interest rates depends on market reaction - difficult to judge , impossible to model accurately. But not true model 'says' higher PSBR does not mean higher interest rates. (Depends on assumptions.) PSBR is not automatically financed by extra gilt sales , either in real world or Treasury model.

26. CBI Budget proposals

[Reflationary package increasing PSBR to £11-12 billion in 1982-83; 2 per cent cut in NIS, limits on increases in local authority rates for businesses, lower interest rates]

Representations will be taken into account. Cannot anticipate Budget decisions. But rhF Chancellor will, in arriving at his Budget judgement, take full account of the circumstances facing the company sector.

27. Mrs Williams' prescriptions?

[Mild reflation with extra public investment in labour intensive programmes - Debate 27 January - claims would get 1 million off register in 2 years - 'Newsnight' 27 January]

Real answer to long term problems of British economy lies in greater productivity and more realistic pay bargaining, not more public employment. Rh Lady's assumption of an effective incomes policy is just wishful thinking.

(i) Signs of recovery

- Total output (GDP) rose by  $\frac{2}{3}$  per cent in 3Q 1981.
- Short time working in manufacturing fallen to 1/4 of January peak; total hours worked have been stable since beginning of 1981.
- Latest 1981 figures show volume of engineering and construction orders up about 18 and 10 per cent respectively on 2H 1980.
- Private sector housing starts in 1981 up by 37 per cent on 2H 1980.
- Most recent major independent forecasts assess low point in activity reached in 1H 1981; prospect of some recovery in 1982.

(ii) Earnings and settlements. Increases halved in 1980-81 pay round. Public sector in line. There is a good deal of evidence that average settlements in private sector are running lower than in the 1980-81 round. [CBI pay data bank for manufacturing settlements suggests average is now around 7 per cent compared with 9 per cent in previous round.]

(iii) Productivity. Output per head in manufacturing in 1981 3Q 10 per cent higher than in 1980 4Q. Investment in plant and machinery holding up well.

(iv) Unit labour costs: Pay moderation and higher productivity has meant dramatically low increase in manufacturers unit wage costs in latest 12 months - up only 2 per cent in year to October.

(v) Competitiveness. Improved by over 10 per cent during 1981, reflecting pay moderation combined with exchange rate fall.

(vi) Profits: Non North Sea industrial and commercial companies gross trading profits (net of stock appreciation) rose some 13 per cent in 3Q.

(vii) Exports holding up well; non-oil export volumes in 4 months to December up  $3\frac{1}{2}$  per cent on 1980. Engineering export orders up 22 per cent in 1981 on 2H 1980.

(viii) Unemployment. Rate of increase in unemployment since mid 1981 about half that in 1H and  $\frac{1}{3}$  that in 4Q 1980. Vacancies improving over recent months. Short-time working in manufacturing reduced by  $\frac{1}{4}$  during 1981 and overtime working has increased. Total hours worked in manufacturing stable since Spring 1981.

(ix) Special employment measures. Total provision on Job Release Scheme, Temporary Short-Time Working Compensation and Community Enterprise Programme in 1982-83 now planned to reach over £520 million, with additional £61 million for young worker scheme (starting January 1982). Spending on Youth Opportunities Programme to rise to £700 million in 1982-83. 280,000 unemployed school-leavers last year found places on YOP by Christmas.



- (x) Training. Over next 3 years £4 billion to be provided to bring training schemes up to date. New Youth Training Scheme for school leavers to be introduced September 1983 represents major step towards comprehensive provision for young people.
- (xi) Industrial relations. Number of strikes in 1980 and 1981 less than in any year since 1941 and number of working days lost only a third of average of last ten years.
- (xii) Retail prices. Inflation almost halved since peak in spring 1980 (21.9 per cent). 12 monthly increase in January of 12.0 per cent. [NB Progress affected by lower exchange rate.]
- (xiii) Share Ownership Schemes: Number of schemes has increased from 30 in May 1979 to over 350. Number of employees covered roughly doubled between first and second years in office. Profit sharing schemes alone now cover about 250,000 employees.
- (xiv) Loan Guarantee Scheme. Over 2300 guarantees issued so far on loans totalling over £80 million. Over half of loans going to new businesses.
- (xv) Enterprise Zones. 10 out of 11 zones already in operation. Last one (Isle of Dogs) expected to start in April.
- (xvi) Examples of export successes reported in the Press include: £2½ million order to supply Leyland buses to Singapore; £3 million worth of equipment for the King Abdullah Aziz Military Academy in Saudi Arabia (SGB); £4 million worth of outside broadcasting vehicles and transmitters for Nigerian Television (PYE TV Ltd); £23 million worth of defence communications equipment for Austria (Racal jointly with Austrian counterparts); £20 million worth of power station pipework for Australia (Whessoe).
- (xvii) UK preferred location: US electronics industry survey reports UK most preferred location for establishing new plants.
- (xviii) Overseas debt repayments. Official external debt reduced from over \$22 billion, when Government took office, to \$13.3 billion at end-1981.

## B ECONOMIC ACTIVITY AND PROSPECTS

### 1. Current position and prospects?

[NB Q4 capital expenditure and stocks of manufacturers and distributors to be released Thursday 18 February. Q4 GDP (output) estimate to be released on Friday 19 February.]

Fall in output over. GDP (output), on latest figures, is rising. Q3 1981 up  $\frac{2}{3}$  per cent on Q2 with manufacturing and construction output up some 2 per cent in same period. Rate of destocking sharply cut. Industry Act Forecast - supported by most outside forecasts (see B5 and 6) - sees prospect of recovery during 1982.

### 2. Other evidence of improvement in economy?

Net new construction orders in 1981 up 9 per cent on H2 1980. Net new engineering orders 17 per cent; within this, export orders up 21 per cent in same period. Private housing starts for 1981 37 per cent up on H2 1980. Productivity (output per head) in manufacturing rising strongly - up 10 per cent in Q3 1981 from Q4 1980.

December cyclical indicators continue to confirm recovery under way. (Coincident indicator has been rising since May; longer leading indicator - weakening since May - improved slightly in November and December.) [IF PRESSED over weakening of longer leading indicators: decline halted in November; recall temporary weakness in last cycle.]

(Labour market indicators - see C1.)

### 3. Recent manufacturing production figures show resumed decline?

[Manufacturing output in November and December down some 2 per cent in each month with December figure reaching new low point.]

November and December figures affected by car disputes and exceptionally severe weather. Even so, index for Q4 as a whole much the same as in Q3, and about 1 per cent higher than in Q2.

### 4. Latest CBI Industrial Trends Survey shows prospects gloomy?

[January survey widely mis-quoted in Press as showing gloomy prospects - in the main based on Sir Terence Beckett's comments].

In judging the latest survey must look at survey itself. Survey shows an improvement in optimism and the expectation of some rise in the volume of orders and output, especially for exports, in the next four months. Much the same message is given by latest FT survey. The CBI's commentary draws attention to improving trends in profitability, investment intentions and productivity.

5. Government assessment of prospects

[Industry Act forecast (2 December) assessed recovery to have begun. End to destocking. Consumers' expenditure and Government expenditure flat.

	Increase in 1982 per cent
GDP	1
Manufacturing output	4
Exports	2½
Investment	2½

NB New assessment will be contained in FSBR to be published with Budget]

Industry Act forecast sees prospect of some recovery. (Last two Government assessments of economy were broadly correct.) Exports and investment up. Resumption of decline in inflation. Further progress depends on continued moderation in domestic costs and restoration of competitiveness.

6. Outside forecasts

[GDP profile in recently released major forecasts:

	<u>NIESR</u>	<u>LBS</u>	<u>CBI</u>	<u>Phillips &amp; Drew</u>	<u>OECD</u>	<u>IAF</u>
	(Nov)	(Nov)	(Nov)	(Feb)	(Dec)	(Dec)
Per cent change 1982 on 1981	+½	+1½	+1	+1	+½	+1 ]

Most recent major independent forecasts assess that low point in activity was reached in first half of 1981, with prospect of some recovery in 1982. Latest ITEM and OECD forecasts more pessimistic, seeing recovery delayed into 1983. ITEM more optimistic on inflation prospects, seeing inflation in 6-8 per cent range by early 1983.

7. High interest rates will abort recovery? Business confidence weakened?

Understand concern over interest rates, but it is absolutely essential to contain inflation. Inflation is inimical to sustainable recovery. Interest rates only one of factors affecting industry. Other costs, particularly labour costs, more important for improved profitability and competitiveness.

## C LABOUR

1. Unemployment continues to rise?

[January total count was 3,071,000 (12.7 per cent). Seasonally adjusted excluding school leavers figure was 2,829,000 (11.7 per cent).]

Magnitude of January rise reflects, in addition to normal seasonal increase, abnormally severe weather. Underlying rate continues to rise much less rapidly. Increase in recent months about 1/3 that at end of 1980 [some 40,000 per month compared with 115,000 per month in Q4 1980]. Also should note within manufacturing short time working sharply cut - (down  $\frac{3}{4}$  from January level), overtime showing signs of picking up and fall in employment much less. Result is that total hours worked have stabilised. Vacancies continue to improve: both in total available and rate of new ones being notified.

2. Employment continues to fall?

[Total employment declined 1.7 million or 7 $\frac{1}{2}$  per cent in 2 years to mid-1981. Preliminary Q3 figures indicate decline of 150,000 compared with 300,000 per quarter in H1 1981. Manufacturing employment fell back 32,000 a month in three months to November, compared with 50,000 a month earlier in 1981.)]

Third quarter decline in total employment half that in H1 1981. Manufacturing employment statistics show lower rate of decrease was maintained into fourth quarter.

3. Government forecasts for unemployment

[Government Actuary's Report published 2 December uses working assumption of an average level of 2.6 million unemployed in Great Britain (excluding school leavers) in 1981-82 and 2.9 million in 1982-83. (222,000 school leavers and adult students in 1981-82, 225,000 in 1982-83).]

Like previous administrations Government does not publish forecasts of unemployment, though some Government publications, eg Government Actuary's Report, contain working assumptions. Government is concerned about unemployment. Scale of special employment measures (SEMs) adequate evidence of this. Prospects depend on further progress on productivity and competitiveness. [See 4 below for independent forecasts.]

IF PRESSED GA figures consistent with the prospect of some fall in total unemployment before the end of 1982-83. They do not however necessarily imply this. If things go well - eg lower pay settlements, recovery in world trade - then reasonable to hope for fall in unemployment before end 1982-83.

4. Independent forecasts?

[Consensus is for medium term rise in "narrow definition" unemployment, reaching about 3 million in Q4 1982.]

History shows unemployment forecasts to be very uncertain (this is a major reason why Government does not publish one). Reflected in wider range especially for beyond 1982.

5. Unemployment higher than in other countries?

[OECD standardised data show UK H2 1981 at 11 per cent compared with OECD average of 7½ per cent.]

Yes, but it has reached record levels in a number of other industrial countries. Most OECD countries have seen steeper rises than Britain in the last few months; in France, despite President Mitterand's expansionist policies, it has gone over 2 million; in Germany it has reached 1.7 million, the highest figure since the early post-war period. In our case we are suffering the cumulative effects of lost competitiveness and low productivity and implications of inflationary pay settlements in 1978-79 and 1979-80 pay rounds. This is why the rise in UK unemployment has been higher than in most other countries, and points to the need to improve productivity and competitiveness.

6. What is the cost to public funds to the current level of unemployment?

[Subject of an oral PQ to a Treasury Minister 11 February and of CST speech at Guisborough 5 February]

Payments of unemployment benefit and supplementary benefit to people registered as unemployed are expected to total about £4 billion in 1981-82. Comparable figures cannot be given for revenues which were not collected - such figures could only be hypothetical.

7. Total cost of unemployment £13 billion?

Totals of this kind are by themselves meaningless. They imply a comparison with an economy with zero unemployment which is not feasible. A really major change in the level of unemployment would mean that taxes, benefits, wages, prices etc would be very different from the present. £13 billion is not a 'cost' which could be saved or spent elsewhere. We cannot wish unemployment away.

8. Why not employ unemployed people on public works etc?

['Layard' scheme; S Brittan in FT 11 February]

We continue to examine the options. But schemes to provide public jobs inevitably have a net public expenditure cost. Since schemes are not costless the need to finance them is likely to lead to some reduction in employment elsewhere. We are, of course, spending money where circumstances justify this (see 9-12 below). Balance of public finances complex and figures depend on particular measures. Other elements as well as benefit

savings and tax receipts. If jobs are in public sector there are wages and perhaps other expenses (supervision, costs of materials). If jobs in private sector, any subsidy would be an expenditure.

9. Should spend more on reducing unemployment - especially for young people?

Total provision on Job Release Scheme, Temporary Short Time Working Compensation Scheme, and Community Enterprise Programme in 1982-83 increased to over £520 million, with additional £61 million for young worker scheme starting on 6 January 1982. New Youth Training Scheme will be introduced in September 1983: cost in a full year £1 billion. Youth Opportunities Programme will cost £700 million in 1982-83 as courses are improved and lengthened. Spending on special employment and training measures will be some £1½ billion - almost £800 million more than in last Public Spending White Paper (revalued).

10. Need to bring system of industrial training up to date?

Agreed. White Paper 'New Training Initiative' sets out action required in industry and education as well as lead from Government. New Youth Training Scheme will guarantee full year's foundation training to those leaving school at minimum age. Government objective that employers and unions should accept that by 1985 all training should be to standards without regard to age. Government assistance for skill training will increasingly be conditional on reaching that objective and removing restrictions. 'Open Tech' programme being developed to make technical training available to those with ability to benefit.

11. Is likely level of allowances on new Youth Training Scheme - around £750 for 16 year olds (who will not get Supplementary Benefit) older trainees £1250 - too low?

Allowances under new Youth Training Scheme should realistically reflect trainee status of participants and benefits of comprehensive higher quality provision.

12. What has Government done to make labour market more flexible?

Have taken action on a number of points:

Training: extra spending on 16-17 year olds plans to reform apprenticeship system (see C9 above).

Young workers: subsidy to employers to take on youngsters at lower wage rates - object to price young back into labour market.

Mobility: Housing Act 1980 provisions for short-term tenancy in private rented sector.

Industrial relations: steps already taken and further proposals just published to redress imbalance of power between employers and unions.

Employment Act 1980 measures to reduce costs of employment and rigidity in wage-setting practices.

## D TAXATION

1. Burden of taxation

[Total taxation in 1978-79 was 34½ per cent of GDP (at market prices), 36 per cent in 1979-80, 37½ per cent 1980-81. It is forecast to be 40 per cent in 1981-82.]

This has inevitably increased during a time when national production has not been growing. But, for the vast majority, real personal disposable income is still higher than for most of the period when the Labour Party was in Government.

2. Not worse than in other countries?

Recent OECD report showed that the Government's total 'take' (by way of taxation and national insurance contribution) as percentage of GDP is less than in many other industrial countries - UK eleventh in OECD rankings, behind most other EC countries, including France and W Germany. [NB: HMG's position is that national insurance contributions are not a tax]. A similar picture is given in the article in Economic Trends for December (which also uses OECD statistics).

3. Prospects for 1982 Budget?

Cannot anticipate Budget decisions which will be taken in light of circumstances at the time. In spite of higher projected level of public expenditure, as rhF the Chancellor said in 2 December statement, we have no reason to depart from the projections for the PSBR published at the time of the last Budget. (See G5.) Other factors will also be important, including monetary targets and outlook for pay and inflation.

4. Government policy has harmed incentives?

Marginal rates of income tax for most taxpayers lower than when the Government came to power. Basic rate still 3p below rate inherited from Labour.

5. Distribution of incomes became more unequal between 1976 and 1980?

[CSO figures on income distribution in January Economic Trends reported in The Times 9 February]

True - but not as a result of unemployment. Many of the unemployed came from families with two or more earners, and were therefore high on the scale of household incomes before the loss of one income. Unemployment may therefore have caused a reduction in inequality. Important factor the increase in number of retired people.

6. NIC/NIS burden in fact increased?

True that as in previous years increase in earnings limits for NICs will also apply automatically to NIS. But increase in upper earnings limits is expected to add only £47 million (in 1982-83) to NIS burden (which is expected to total £3.8 billion this year). Major part (£225 million) of increase expected in NIS burden in 1982-83 will arise solely from increase in earnings. Total NIS/NIC burden on employers likely to fall in real terms in 1982-83 - for second year running.

7. Reduce National Insurance Surcharge?

Well aware of view of many in industry that a reduction in NIS would be of help. But cannot prejudge Budget judgment both on whether can afford tax relief on that scale and on whether a reduction in NIS should have priority. But position of employers was taken into account in decision to load April 1982 increase in National Insurance contribution on to employees.

8. Corporation Tax Green Paper: There are no constructive proposals?

This is a consultation document meant to contribute to public debate on corporation tax. It explores a wide range of possibilities put to Ministers. Government will consider what proposals to make in light of response (preliminary comments are requested by 30 September 1982).

9. The burden of corporation tax is too high/not high enough?

The Green Paper shows that the burden of corporation tax has more or less matched changes in company profitability. The question of appropriate burden of corporation tax is not covered in the Green Paper but will be considered by my rhF in reaching his Budget decisions.

10. Progress so far on tax reform/simplification?

Substantial progress has already been made in improving incentives and simplifying the tax system, eg switch from direct to indirect taxes in 1979, correction of worst features of Capital Transfer Tax, improvement in Capital Gains Tax and Development Land Tax regimes, introduction of Business Start Up scheme etc. But reform of the tax system must be pursued within a financially responsible framework.

11. North Sea fiscal regime?

See R2-3.



## E PUBLIC EXPENDITURE AND FINANCE

[The Chancellor announced 2 December 1981 main decisions for public spending 1982-83. Main increases are: local authority current expenditure (£1.3 billion), employment measures (£0.8 billion), defence (£0.5 billion) and finance for nationalised industries (£1.3 billion). Increases will be offset in part by general reduction in most cash-limited expenditure and by specific cuts - including increased prescription and other health service charges. Planning total for 1982-83 will be in region of £115 billion, against £110 billion for White Paper revalued.]

1. Further announcements?/Questions on later years?

Full details will be in White Paper to be published at time of Budget.

2. 1981-82: Overspending?

Spending is expected to be higher in 1981-82 than was planned in the last White Paper. Major reason for this is present level of spending by local authorities. But too early to be certain about likely outturn because civil service dispute has affected monitoring.

3. Plans for next year unrealistic, given likely overspending this year?

No. Realism, particularly in respect of local authorities and nationalised industries, is one reason why our plans for next year are higher than in last White Paper (revalued).

4. Failure to cut spending?

Decisions to increase spending next year reflect flexible but prudent response to changed circumstances. Increases were however offset in part by reductions elsewhere.

5. Further reductions possible in 1982-83?

[CBI's 'Winning Budget' suggests further savings possible - in 1982-83 £100 million in manpower costs, £700 million from reduced total for contingency reserve, shortfall, asset sales and interest payments]

Further savings in manpower not feasible. Plans take account of savings in administrative costs and reduction of manpower. 4 per cent provided for increases in public sector pay next year (see E12 and 13). Government considering question of index-linking of and contributions to public service pensions (see J15). Figures for contingency reserve, asset sales and interest payments must be realistic.

6. Increase spending during recession?

Not Government's intention to try to spend its way out the recession. That would only lead to more inflation and higher interest rates and taxes. But we are responding, within limits of prudence, to needs of current circumstances.

7. Fall in real terms?

We have increased cash provision for next year. In real terms this means that spending next year will be broadly at level planned for this year. Expect public expenditure will fall as proportion of GDP, which is what really matters.

8. Increase spending on worthwhile infrastructure projects?

First concern must be with realistic public expenditure levels. Within these, our aim is to encourage worthwhile capital projects wherever possible. The 2 per cent cut in cash-limited programmes reflects in part a reduction in administrative costs, in most cases of 2 per cent or more. But (as rhF Chief Secretary said during debate on 8 December), social security spending is only other area of major possible attack if we seek savings in current expenditure to make room for capital expenditure.

9. Cuts in public capital investment in 1982-83?

As far as nationalised industries are concerned, so long as they restrain their current costs, the extra cash provision we have made should allow them to maintain their investment next year at broadly same level in real terms as planned for this year - in real terms 15 per cent up on 1980-81. Other public capital expenditure will be a little lower in cash next year compared with the cash equivalent of the last White Paper, but recent fall in tender prices will mean the programmes should be carried out as planned.

10. Position on 1981-82 cash limits?

[Provisional outturn figures for first half year were published with Winter Supplementary Estimates in note by Financial Secretary to the Treasury 4 December.]

Central government cash limited expenditure overall is on course. For a number of individual cash limits expenditure was well in excess of profile for first half year. In many cases, the excess is due to a shift on timing of expenditure and/or receipts; in other cases, there have been cash limit increases. In remaining cases, position is being discussed with relevant departments to ensure that corrective action, if necessary, can be taken in good time.

11. Government overspending by £1,250 million?

[D Blake in The Times 27 January.]

My rhF's statement 2 December gave global adjustment of £3,300 million in arriving at total of £115 billion. Statement explained clearly that the £3,300 million included not only the contingency reserve [NOT FOR USE: not then decided] but also allowance for the effect on programmes [notably social security, housing and export credit guarantees] of revised economic assumptions.

12. Cash limits 1982-83 and public sector pay?

[Leader 'Who Guards the Guardians?' in The Times 4 February]

The Government last year concluded that provision for 1982-83 should be made on the basis of a 4 per cent pay factor overall. This remains its view. Recent evidence given to the Megaw Inquiry on Civil Service pay simply described, at the Inquiry's request, existing mechanisms for dealing with public expenditure including public service pay. Negotiations on the pay of those public services for which central Government is directly responsible have yet to take place. Offers have yet to be made and settlements have yet to be reached. Some public servants may get more than 4 per cent, some may get less. But there is no automatic entitlement. Every settlement will have to be justified on a rigorous assessment of its merits. That position is unchanged.

13. Preferential treatment for Civil Service?

Mechanisms for dealing with expenditure on public service pay apply to the Civil Service as they do to others. We did give an undertaking to the Civil Service unions last year that if agreement could not be reached in this year's negotiations we would be prepared to go arbitration. The award would be subject if necessary, to override-with the approval of this House. We stand by that assurance in the terms it was made.

14. Contingency reserve and pay

Existence of Contingency Reserve does not mean that excessive public service pay settlements will be financed. If a pay increase is justified and cannot be financed within cash limits or by savings elsewhere, access to Reserve is possible. This is a decision which Ministers would have to take at the appropriate time, bearing in mind other potential calls on the reserve. Government's view remains that 4 per cent is a reasonable overall provision within its expenditure planning.

15. Cut public sector pay bill/administrative costs of central government?

Only one third of current expenditure is on wages and salaries and much of that is for nurses, teachers, members of armed forces, police and so on. We have limited the provision for public service pay increases next year to 4 per cent. Administrative costs of central government are not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain the drive for more efficient management throughout the public sector. For example, two projects in Inland Revenue Department have identified improvements in PAYE procedures likely to save 1,050 posts and £6 million in administrative costs (in full year).

16. Cut staff numbers in public services?

Numbers in public service have already fallen since we took office. Civil Service has been reduced by nearly 8 per cent to 675,400. This is smallest for nearly 15 years. We are well on target to achieve our aim of having 102,000 fewer staff in post in April 1984 than when Government came into office; this will be smallest Civil Service since the war. Local authority manpower has been reduced by nearly 75,000 (over 4 per cent).

17. Ratio of public spending to GDP is getting back to the peak levels of the mid 1970's?

Ratios in 1980-81 (43½ per cent) and 1981-82 (45 per cent forecast) remain below the level of 1974-75 and 1975-76 (46 per cent in both years). The large rise from 41 per cent in 1979-80 is partly because of the "relative price effect" and partly because the volume of expenditure rose at a time when real GDP has fallen. Good chance that ratio will fall in 1982-83.

#### LOCAL GOVERNMENT

18. Spending plans for 1982-83? Too tough? Too weak?

In order to set local authorities reasonable and realistic targets, we have increased the plans by £1.35 billion. But substantial economies will still be required as plans only allow about 2 per cent more cash spending than latest budgets for this year.

19. Cut in RSG percentage will mean large rate increases?

Not at all. If local authorities budget to spend in line with Government's plans, rate increases should be very low. Where they are high, it is because local authorities have chosen to overspend.

20. Will the Government limit rates as suggested by the CBI?

We certainly share the CBI's concern about the harmful effect of high rates on business. The problem with limiting rates is that, unless local authorities cut their spending, it has to be paid for by domestic ratepayers or the taxpayer generally. However, we will be considering this further in the context of the longer term future of the domestic rating system. Meanwhile the Government's continuing pressure on local authorities to reduce expenditure will help all ratepayers.

21. Control of local authority spending?

We will maintain pressure to reduce spending through rate support grant system and otherwise. Provision in Local Government Finance (No.2) Bill to ban supplementary rates

will oblige local authorities to budget responsibly at start of year and prevent a repetition of the irresponsible increases in spending planned by some authorities this year. In Scotland, we are seeking power to oblige excessive spenders to reduce their rate demands.

22. Green Paper on Domestic Rating System: rules out change?

No, it reaffirms our long-standing commitment to reform which we want as quickly as circumstances allow. The issues are complex and highly important to domestic ratepayers. The Green Paper sets out the requirements of any alternative source of revenue and describes the advantages and disadvantages of the alternatives in order to present the best basis for consultation.

## F SOCIAL SECURITY

1. November 1982 uprating?

Most benefits to be increased in November 1982 by percentage movement in prices since November 1981. State retirement pension and other long-term benefits also to receive additional 2 per cent to make good shortfall in last uprating. No similar commitment for short-term benefits.

2. Restoration of shortfall on short term benefits (notably unemployment benefits?)

Final decision on rate of benefits will be announced at Budget time, when account can be taken of latest forecast of price inflation. In reaching our decision, we shall take into account views on matter expressed by hon Members.

3. Restoration of 5 per cent abatement of unemployment benefit?

[Unemployment and some short-term benefit rates were abated by 5 per cent in November 1980 in lieu of taxation. Unemployment benefit (but not other abated benefits) comes into tax from April/July 1982. Ministers have said they will announce their decision on whether to restore abatement before benefit comes into tax.]

We have not yet decided whether to restore 5 per cent abatement of unemployment benefit. A decision will be made before rates of benefit payable for November 1982 are announced at Budget time.

4. Death grant - increase to realistic level?

We recognise that the present death grant of £30 is of only marginal benefit, and have been looking at ways in which it could be improved. I hope there will be an announcement on this soon.

## G PUBLIC SECTOR BORROWING

1. PSBR in 1981-82

[Industry Act forecast showed PSBR in 1981-82 on target for Budget estimate of £10½ billion; PSBR in April - December published 4 February was £10¾ billion]

The Civil Service dispute has greatly affected the PSBR so far this year, but the underlying PSBR looks to be in line with the Budget forecast of £10½ billion. Despite the strike, the PSBR for April-December was only £10¾ billion. PSBR for 1980-81 as a whole was £13¼ billion.

2. Effect of civil service dispute on CGBR?/Revenue?

[CONFIDENTIAL: CGBR April-January to be published 9 February, was £8 billion.]

Effect of dispute (concluded July 1981) was to add around £2¼-2½ billion to the CGBR in April 1981-January 1982, of which £½ billion is the cost of extra interest payments.

3. Will the Government be able to collect all delayed revenue this financial year?

Some revenue is expected to be outstanding at the end of March.

4. Recession means that PSBR should be higher, not lower?

In my rhF's 1981 Budget statement he explained that this year's PSBR would be larger on account of the recession. But experience shows that attempts to buy jobs with reflation simply fuel inflation and quickly have to be reversed. Our policies are designed to cut inflation and secure a sustainable improvement in output and employment.

5. What are implications for next year's PSBR of 2 December statement?

No decisions have yet been made on 1982-83 PSBR. Must await Budget. But on conventional assumption, set out in Industry Act Forecast, figures point to a PSBR next year broadly in line with 1981 Budget projections. [IF PRESSED: This means PSBR is expected to decline as proportion of GDP (even before taking account of revenue delayed by civil service dispute).]

## H MONETARY AND FINANCIAL POLICY

1. Lower interest rates?

[Bank base rates rose to 16 per cent in September, fell to 14½ per cent in December, and were reduced by the clearing banks to 14 per cent with effect from 25 January. Market rates were firm in early part of January, in particular reflecting increases in US market rates. In second half of January and early February, interest rates generally fell back and have remained at or around these lower levels.]

Of course we want to see lower rates. But we must proceed cautiously if we are not to let up in the fight against inflation. Despite difficult conditions abroad, interest rates have fallen.

2. Will high US rates push up our rates?

High US rates are certainly an adverse development and in September were one of the key factors in driving our rates up. Recently, however, with the pound remaining stable in world markets, our rates have been able to ease somewhat, without creating inflationary dangers. The position of the pound has no doubt been helped by better prospects for the wage round and the good trade figures. Nevertheless, it remains true that domestic policy cannot ignore the difficult international background.

3. What is the Government doing about it?

As my right hon. the Chancellor stated in his speech to the House of 28 January, we support the anti-inflationary stand of the US authorities. But we have made clear on many occasions our concern about the balance of fiscal and monetary policy and its implications for interest rates.

4. If US rates are determining ours, why all the concern about the PSBR?

We do not claim that US rates are sole influence on our own and that there is nothing we can do to offset our own rates. Just as we are urging a balance between fiscal and monetary policy in the US, so we must achieve that ourselves.

5. Should not European governments jointly exert pressure on US?

Other European governments have made their views known in the same way we have.

6. Interest rates levels choking the recovery?

Agree that high interest rates pose problems for industry. But companies' financial position generally much stronger than a year ago. No purpose served by allowing higher inflation, whether due to falling exchange rate or credit-financed consumer spending.



7. Two tier system of interest rates?

Not practicable in highly sophisticated financial market like UK's. Very difficult to prevent money borrowed at lower rate being on-lent at higher. A lower rate for specified borrowers would require extra Government subsidy which would push up borrowing or require cross-subsidisation by the banks. In either case the level of interest rates to other borrowers would be increased.

8. Will there be an overshoot of money supply?

[£M3 increased by  $1\frac{1}{2}$  to  $1\frac{3}{4}$  per cent in banking January. Position remains seriously distorted by effect of civil service dispute and aftermath. Advice below is based on Industry Act forecast.]

Recorded figure for target period as a whole may be somewhat above top of target range. But too early to say by how much. Interpretation of recent figures very difficult because of civil service strike distortions. Some good features in monetary picture: 1981-82 PSBR should be close to forecast; funding programme is on track. But bank lending is disturbingly high, despite the level of interest rates.

9. When will the strike distortions be eliminated?

Distortion will continue for some months yet. The distortion to the CGBR was reduced by about £ $\frac{1}{2}$  billion in (calendar) January. In ten months ending January the effect of the strike was to add around £ $2\frac{1}{2}$ -£ $2\frac{3}{4}$  billion to the CGBR.

10. Status of MTFS if money supply overshoots for second year running?

MTFS remains basic framework of Government's economic policy. But as Chancellor said in Budget speech, take account of other monetary indicators as well as sterling M3. Will continue to maintain steady but not excessive downward pressure on monetary aggregates.

11. Plans for modifying MTFS?

Government's economic policy has evolved and developed since we have been in office -and no doubt will continue to do so - but the aims of our medium term strategy are still precisely those set out in the 1980 Budget Report - to reduce inflation and thereby create the conditions for sustained growth in output and employment. My rhF the Chancellor intends to present an updated MTFS in the forthcoming Budget.

12. What was purpose of new guidance issued to banks on mortgage lending?

Are concerned that competition with building societies in mortgage market may be leading to the monetisation of housing equity through additional lending unrelated to housing

finance. Guidance designed to hold off such a development and its adverse monetary consequences. Not seeking to obstruct competition. Should reduce any scope for abuse of tax relief for lending on housing.

13. Ceilings on non-priority bank lending?

In UK's complex financial system, ways would be found of by-passing credit controls. Any improvement to money figures would prove to be cosmetic. Would create distortions and inhibit competition between banks.

## J PRICES AND EARNINGS

1. Inflation has increased under this Government?

Considerable progress has been made in bringing down inflation from a peak of 21.9 per cent in May 1980 to 12.0 per cent in January.

2. Inflation back on a rising trend?

[Year-on year rate of inflation unchanged in January at 12 per cent, compared with lowest recent level of 10.9 per cent in July 1981.]

Progress in reducing inflation has been hindered by fall in exchange rate, and by higher mortgage interest rates. Industry Act forecast is for year-on-year rate of inflation of 10 per cent by Q4 1982. We expect downward trend to continue thereafter. [IF PRESSED: Precise timing of further progress is of course uncertain. Could be before the end of the year, could be early next year.]

3. Effect of 2 December measures on RPI/TPI?

[Measures include 1 per cent increase in employees' NIC, higher prescription charges, and council house rents.]

Effect of measures on RPI will be roughly 0.6 per cent from April 1982 [reflecting mainly increase in council house rents; higher prescription charges will have negligible effect]. Effect on TPI will be 1½-2 per cent from April 1982 [reflecting also higher NICs.]

4. Nationalised industry prices

Nationalised industry price rises have been due in part to the ending of the previous Government's policy of artificial and distortionary price restraint. The rate of nationalised industry price rises is now coming more closely into line with the RPI. [See P11-12.]

5. TPI

The fact that the TPI has been increasing faster than the RPI (roughly 3½ per cent faster over the year to December) reflects the measures which have been taken to restrain Government borrowing, which is essential if inflation is to be controlled.

6. A 4 per cent pay policy?

The 4 per cent factor announced on 15 September [for calculations in Public Expenditure Survey] is not a pay norm. It is a broad measure of what the Government thinks reasonable

and can be afforded as a general allowance for increases in pay, at this stage of fixing the programme from which the public service wage bill has to be met.

7. Does the 4 per cent apply to the Civil Service?

The 4 per cent factor does not imply that all public service pay increases will or should be 4 per cent. Some may be less; some more. [IF PRESSED: In response to enquiries from the civil service unions, they have been told that the assurances they were given last year about this year's pay negotiations are unaffected by the announcement of the 4 per cent factor.]

8. Local authority settlements ignoring 4 per cent pay policy?

[Firemen have settled at 10.1 per cent; LA manuals have accepted offer worth 6 - 7.8 per cent on basic rates, 6.9 per cent on current pay bill].

Pay negotiations in local government are a matter for the parties concerned. There is no pay norm. LA manuals' settlement higher than the Government thought right to provide for in RSG settlement, and the financial consequences will therefore fall squarely on the local authorities.

9. Nationalised industry pay

[Miners have accepted offer worth 9.3 per cent on basic rates [NOT TO BE QUOTED: 7.4 per cent on earnings]; water manuals have accepted offer worth 9.1 per cent on rates, 8.8 per cent on earnings].

Nationalised industry pay negotiations are a matter for the parties concerned, as are the financial consequences of any settlements reached.

10. Private sector pay - CBI claim most settlements for 4-6 per cent?

[In a recent press release, the CBI asserted that the bulk of manufacturing settlements monitored since 1 August were in the 4-6 per cent range. But their own CONFIDENTIAL evidence shows a weighted average of 7.3 per cent with majority of employees over 7 per cent.]

There is no doubt that settlements have been lower in recent months, reflecting an increasing sense of realism about pay. The need is for continuing low settlements which are consistent with maintaining economic recovery and improving employment prospects.

11. Government aiming to cut living standards?

[Latest (revised) RPDI figures suggest no further fall between Q2 and Q3 1981.]

Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less

of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

12. Average earnings index

[Decrease in year on year growth from 11.9 per cent in October to 11.3 per cent in November. However, (unpublished) underlying increase unchanged at 11 per cent]

Recent buoyancy of earnings partly reflects increase in hours worked, which is an effect of the emerging revival of activity, particularly in manufacturing. Change over the 12 months to November straddles two pay rounds - not useful indicator of recent trends.

13. Comparison of TPI and index shows that real take-home pay has fallen over the past year

Yes. But follows growth of  $17\frac{1}{2}$  per cent in personal living standards in three years 1977-80.

14. Incomes Policy

[Attention may be drawn to Prof. Meade's proposal in his book "Stagflation Vol I" (published 21 January) for an incomes policy, based on consensus about growth of aggregate national income, and featuring arbitration on employment - effect criteria; or to Prof. Layard's ideas for wage inflation tax (picked up by SDP).]

Proposals for incomes policies, including recent refinements, do not avoid many of the familiar problems of norms, evasion, administrative cost, and interference with market forces. Experience gives no encouragement to the idea that incomes policies can be made to work on a permanent basis. They always succumb to the distortions they create.

15. Index-linked pensions and the Scott Report?

The Government is considering the whole question in the light of the Scott Report. Our aim is to ensure that pensions to public servants are fair to taxpayers, as well as to employees, pensioners and their dependents.

## K BALANCE OF PAYMENTS

1. Balance of payments December 1981

[December trade figures published 25 January]

December current account is estimated to have been £498 million in surplus, compared with £218 million in November. Most of the improvement was due to increased surplus on oil and erratic goods. Although both exports and imports fell back from the high November levels, these figures confirm the underlying recovery in UK trade.

2. Trends in exports

Non-oil exports were  $3\frac{1}{2}$  per cent higher in volume terms than in 1980. Exports of intermediate and capital finished manufactured goods are now higher in both value and volume terms than in 1979 and 1980 despite loss of competitiveness. DoI survey of engineering industry suggests export deliveries will continue to rise in 1982, as does CBI Industrial Trends Survey.

3. Oil exports and erratics

Surplus on oil exports rose by £188 million to £402 million. Trade in erratics (precious stones, aircraft, ships, North Sea installations) improved by £86 million. This reflects recent trend towards surplus in ships and aircraft, consistent with UK manufacturers' general success in exporting finished capital goods.

4. Trends in imports

December import figures are in line with the average for the previous 3 months. The recovery in imports is across the board, including basic materials and manufactures used by UK industry. This supports the view that destocking is coming to an end and the economy picking up.

5. Trends in invisibles

Surplus on all invisibles is projected to be around £500 million in Q4 1981.

6. TUC proposal for an import deposit scheme?

[TUC Economic Review published 2 February]

This would raise prices in the shops, increase costs for domestic manufacturers, run counter to our international obligations and probably lead to retaliation against successful British exporters.

## L FOREIGN EXCHANGE, RESERVES AND IMF

1. Sterling still too high?

[Since last September, sterling has remained broadly stable and is currently over 12 per cent below its effective note peak early last year. Recent "lows" have been \$1.77 on 14 September, DM4.07 on 20 October. "Highs" were \$1.97 on 30 November, DM4.40 on 9 February. Rates at noon on 12 February were \$1.8387; DM4.38 and an effective rate of 91.52. Reserves at end January stood at \$23.2 billion, compared with \$23.3 billion at end December]

Our policy is to allow the rate to be determined primarily by the balance of market forces. The effective exchange rate is only slightly higher than when the Government took office. Manipulating the rate is no answer to problems in the real economy.

2. Has the Bank intervened to support the rate?

The Bank intervene to smooth excessive fluctuations and preserve orderly markets. They do not seek to maintain any particular rate.

3. Concerted intervention to reduce the value of the dollar?

All the experience in recent years is that exchange rates for major currencies cannot be manipulated by intervention alone. Intervention can help steady markets, but not counter major exchange rate trends. That takes changes in real policies, affecting interest rates, monetary conditions and fiscal policies. Lower US inflation is in everyone's interest: the matter for real concern is the US fiscal/interest rate mix, a problem all countries are familiar with.

4. Does the Government have an exchange rate target?

No. As my rhF the Chancellor has made clear (most recently before the TCSC last November) it is very difficult to make judgments about the 'right' level for the exchange rate or to resist strong market trends. That continues to be the Government's view. However, the Government is not indifferent to exchange market developments: account is taken of the level and movement in the exchange rate when taking decisions on interest rates.

5. Sterling should join the EMS?

[See M8]

6. Exchange rate and competitiveness?

I welcome the improvement in UK cost competitiveness of over 10 per cent in 1981. This has been partly due to a decline in the exchange rate; more importantly because there are

signs that our domestic unit labour costs are now growing more slowly than those of our major competitors.

7. Debt repayments

We have made substantial progress with our plans to reduce the burden of external debt substantially during this Parliament. We aimed to reduce official external debt to \$14 billion by the end of 1981. In fact, this has been more than achieved - the end December total was only \$13.3 billion, compared with over \$22 billion when the Government took office.



## M EUROPEAN MATTERS

## MEMBERSHIP OF EUROPEAN COMMUNITY

1. 'Mandate negotiations'

On 25 January, Foreign Ministers had a lengthy discussion on the four key issues in the negotiations over the Mandate. It was not possible to reach agreement. The main issue preventing agreement was the view of a number of other Member States that refunds to the UK should be arbitrarily and automatically reduced over time, regardless of the scale of the problem. That was quite unacceptable to the UK. There was also disagreement about the duration of the new refunds arrangement. The Presidents of the Council and Commission are now to try to find solutions to these problems.

2. Net UK contribution to community too high?

A lot lower than it would have been without the refund agreement of 30 May 1980.

3. Lower Commission estimates of net contributions in respect of 1980 and 1981?

The most recent Commission estimates suggest that our net contributions in respect of 1980 and 1981 will be significantly lower than expected at the time of the 30 May Agreement. That is very satisfactory. For we remain one of the less prosperous Member States. The problem of 1982 and later years remains to be solved.

4. Budget refunds reduced if net contribution less than originally estimated?

The UK is clear that the minimum net refunds payable under the 30 May agreement are 1175 million ecus (European Currency Units) for 1980 and 1410 million ecus for 1981.

5. Do supplementary measures grants lead to additionality?

There is additionality in that refunds enable public expenditure in the regions and elsewhere to be higher than would otherwise have been possible.

6. Policy for CAP reform

Key measures are price restraint, curbs on surplus production and strict control of the growth of guarantee expenditure.

7. Costs of CAP to UK consumers

My rhF, the Minister of Agriculture, has dealt with a number of questions on this. Costs to consumers of the CAP as such depend on nature of alternative support system that is

envisaged. Arrangements leading to a reduction in the cost of food to the consumer could well involve increased costs to taxpayers.

#### EUROPEAN MONETARY SYSTEM

8. What is the current attitude of the UK Government?

[FT 1 February alleged Government hardening against participating in exchange rate system.]

We fully support the EMS, and acknowledge the contribution which it has made to stability in the exchange markets. However, we do not yet feel able to join the exchange rate mechanism. We must wait until conditions are right for the system and for ourselves.

9. When will the conditions be right?

Sterling is an international financial currency and is also particularly affected by oil market factors. These mark sterling out from other Community currencies. Clearly there is a balance of advantages, risks and disadvantages to be struck - which must affect our judgement on timing.

## N INDUSTRY

1. Prospects for industry - recovery?

Fall in output has now come to an end. Manufacturing output broadly same in Q3 as Q4 1981. Autumn Industry Forecast sees recovery in 1982.

2. Company sector finances improved?

[Gross Trading Profits of industrial and commercial companies (ICCs) other than North Sea activities net of stock appreciation were around £4.3 billion in Q3 1981. Borrowing requirement of ICCs has improved over year to Q3 1981, and financial deficit turned into surplus. DOI's latest survey of company liquidity (published 4 December) shows further marked improvement in third quarter (particularly in manufacturing) bringing liquidity ratio back to 1979 Q3 level. NB figures difficult to interpret, however, particularly because of uncertain impact of CS dispute].

Figures mildly encouraging. Company financial position is in any case confused by effects of civil service dispute. After adjustment for stock appreciation and excluding North Sea, ICC profits have stabilised since mid-1980. Improvement in financial position partly reflects destocking and action to reduce overmanning.

3. High interest rates damaging for industry and investment?

[Each 1 per cent in interest rates raises interest payments on industry's borrowing by around £250 million.]

Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking. Recent rise in interest rates must be seen in context of priority attached to reducing inflation and need to control growth in money supply underlying the MTFs. (See brief H).

## SMALL FIRMS

4. Government help for small firms

Over 70 measures taken which help important small firms sector: in particular the Business Start-Up Scheme, the pilot Loan Guarantee Scheme, the Venture Capital Scheme, and reduction in the burden of small firms' corporation tax.

5. Response to Loan Guarantee Scheme?

Scheme operating successfully. We have already issued more than 2300 guarantees - well over half to new businesses. Total lending under scheme is already over £80 million. Ten

new banks were admitted to the Scheme in November 1981: a total of twenty-seven financial institutions are now participating.

#### ENTERPRISE ZONES

6. Progress with setting up Enterprise Zones?

Excellent progress being made. Ten of the eleven zones are already in operation. We expect the final zone - Isle of Dogs - to come into operation early in April 1982.

7. Response from private sector?

Response has been very encouraging. Many new firms are setting up in the zones, existing firms are expanding their activities and vacant land has been brought into use. Too early to assess success of zones.

## P NATIONALISED INDUSTRIES

## EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83?

Despite constraints on public expenditure as a whole, Government has recognised the problems faced by the industries in a period of recession and has increased provision for 1982-83 by £1.3 billion cash. This is larger than the increase in any individual Departmental programme.

2. Pay assumptions?

Government does not set a uniform pay assumption for the industries. But industries' own assumptions have been discussed, and external financing limits have been set on assumption that reasonable settlements will be reached. Moderate pay settlements -and restraint of current costs generally - essential if investment programmes to be maintained and prices to consumers kept down.

3. Government simply forcing financing burden on to the consumer, ie through higher prices?

Some further prices rises have been assumed in reaching decision on EFLs as in previous years. Should be possible to avoid large real increases experienced in 1980-81, but this will require continuing effort to keep down current costs, particularly pay.

4. Government still cutting back the industries savagely?

Not so. The industries made very large original bids for additional external finance in 1982-83, totalling about £2.5 billion, in their medium-term financial plans presented to the Government in early summer. This would have brought their total external finance to around £4 billion. The agreed increase of £1.3 billion is roughly halfway between the industries' original bids and the White Paper figure.

## INVESTMENT

5. Current year?

Last Public Expenditure White Paper showed nationalised industry planned investment 15 per cent higher in real terms this year than a year ago. Although we now expect the final figure

to be lower than this the industries will still be investing well over £6 billion. Quantity of investment frustrated by tight EFLs is less than often implied. TSSC report published last August estimated in range of £250-500 million this financial year.

6. Future years?

Investment approvals will be published in the forthcoming Public Expenditure White Paper, as in previous years.

7. But announced EFLs for 1982-83 will make it hard for the industries to keep up their investment?

The industries in aggregate should be more than able to maintain the same level of investment in 1982-83 planned in the last White Paper, despite lower revenues, with higher investment in important industrial priorities, eg telecommunications. This would represent the highest real level of investment in the industries since 1975-76.

8. Take nationalised industry investment out of the PSBR?

Since nationalised industries are part of the public sector, their borrowing - for whatever purpose - must by definition form part of the public sector borrowing requirement. The real problem of pressure on resources cannot be solved by changing statistical definitions.

9. Private finance for NI investment?

[The NEDC Working Party's study of nationalised industry investment was discussed at the Council's 5 October meeting; agreed that there should be a review of progress to be completed by June 1982]

We have indicated our willingness to consider new financing proposals, most recently in the context of the review carried out by the NEDC Working Party. But direct market finance can only be justified if there is a genuine element of performance-related risk for the investor, in order to improve incentives to management efficiency, and if new forms of saving are tapped, so as to avoid adverse monetary consequences. Market financing does not of itself reduce the PSBR, nor does it lessen the burden on financial markets.

10. Finance more nationalised industry investment by cutting current spending?

Yes. In particular, moderate pay settlements are essential. The ability to finance new investment in the nationalised industries is bound to diminish if excessive pay settlements are agreed. Each 1 per cent off wage costs would save about £140 million per annum; and each 1 per cent off total costs saves £330 million this year.

## NATIONALISED INDUSTRY PAY AND PRICES

11. Nationalised industries' prices

[Caution: gap between NI and 'all items' RPI index could widen again in near future. Factors include LT fare increases in spring, winter electricity discount scheme ending, dropping out of index of last year's double revalorisation of excise duties.]

Nationalised industries' price rises have been due in part to ending of previous Government's policy of artificial and distortionary price restraint. But since the middle of 1980-81 the gap between industry price increases and the RPI has started to narrow sharply. Alternative policies would result in an unacceptable increased burden on taxpayer and distortion of market forces.

12. Will HMG take action over electricity price rises to large users?

The review by the Electricity Council of the CEGB's Bulk Supply Tariff has now been produced and is currently being considered by Ministers.

## PRIVATISATION

13. Government simply selling valuable national assets to achieve PSBR target?

Of course the cash is welcome, but benefits run wider than that. Not only will the main financial benefit be that future borrowing of these undertakings will be outside the PSBR and no longer burden the taxpayer, but the organisations concerned will be made responsive to market forces and thus have greater incentives to improve efficiency.

14. Does the Government have more privatisation plans to announce?

Legislation already passed to enable public to hold equity stake in British Airways, British Transport Dock Board, subsidiaries of British Rail; and to dispose of some of British Telecom's peripheral activities. Oil and Gas (Enterprise) Bill published 17 December will permit public to invest in BNO's upstream business and certain parts of BGC's activities, in particular oil production. The Government expect to have sold shares in the National Freight Corporation by end of this financial year. We shall be announcing further measures in due course.

## R NORTH SEA AND UK ECONOMY

1. Will HMG reduce price of North Sea oil further in face of weak market?

[BNOOC have agreed \$1.50 reduction\* with BP - negotiations continuing with other companies].

UK continental shelf prices are set by commercial negotiation. BNOOC is largely a third party trader, and must find prices which satisfy both suppliers and customers.

2. Impact of falling oil prices on Government revenues and Government strategy?

Other things being equal, lower oil prices will reduce Government revenues from the North Sea. (New forecasts of Government revenues will be published at Budget time). But note that falling oil prices are good for the world economy. We will benefit from that - not only from impact on activity, but also lower oil prices will help in reducing inflation. On balance, despite lower revenues, UK should benefit.

3. Will HMG change North Sea fiscal regime in line with proposals received?

I commend the oil industry's representatives and others who have made suggestions, such as the Institute for Fiscal Studies, for the hard work they have put in. Obviously full study of their proposals is required. We are looking at their suggestions with an open mind.

4. Does HMG accept C&AG's criticisms of the North Sea fiscal regime?

A full review of the fiscal regime is in progress. We shall take the C&AG's observations into account.

5. North Sea oil depletion policy?

Secretary of State for Energy announced in June that the Government would review in the Autumn the possibility of oil production cuts in 1982. We shall give the industry proper notice of our intentions.

6. Benefits of North Sea should be used to strengthen the economy?

[Direct contribution of North Sea oil and gas to GNP is estimated to rise from 3 per cent in 1980 to about 5 per cent in 1984; expected contribution to Government revenues estimated at £3½ billion in 1980-81 and £6 billion in 1981-82 (at current prices). Less susceptible of measurement is boost given by North Sea to local employment and to industry in offshore equipment].

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve a lower level Means in price of Forties oil

\*1/4 per cent reduction/- effect in sterling terms will vary from this with fluctuations in exchange rate.



of interest rates to the benefit of industry and the economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Only one-twentieth of total general government receipts in 1981-82.

7. Government revenues from the North Sea should be used to finance cheap energy for industry?

It would be inequitable and inefficient to use the benefits of North Sea oil to subsidise some users. The age of cheap energy is past. Energy prices should recognise the cost of marginal supply and reflect the competitive position of industrial fuels. Only then can consumers receive reliable signals on which to base their energy consumption and investment decisions.

8. North Sea revenues should be channelled into a special fund to finance new investment, particularly in energy?

North Sea revenues are already committed. Setting up a special Fund would make no difference. More money would not magically become available. So the money for this Fund would have to come from somewhere else. This would mean higher taxes or lower public expenditure, if public sector borrowing is not to rise. If borrowing did rise, then so would interest rates. Not obvious that net effect would be good for investment.

9. North Sea oil bond?

As my rhF (Economic Secretary) announced on 17 December, we have abandoned plans to issue a North Sea oil bond. The proposed sale of 51 per cent of BNOC's upstream business means that an oil bond is no longer necessary.

## S WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Governments' policies pushing world economy into recession?

[Activity in OECD area very weak. Output in US may have fallen over 1 per cent in Q4. Industrial production picture in Q3 mixed, with falls in Germany, Italy and Canada offsetting rises elsewhere. Average unemployment rate rising.]

No. Healthy growth only possible if anti-inflation policies persevered with. Some recovery of output expected 1982. And unemployment should level off during the year.

2. Anti-inflation policies not working?

[Year on year consumer price inflation in major countries fell to 9¼ per cent in December. Underlying rates falling in US. OECD and IMF expect some decline in 1982.]

Takes time to squeeze inflation out of system. Year-on-year consumer price inflation in major economies down from peak of 13 per cent in April 1980 to around 9¼ per cent in December 1981. Further decline expected 1982.

3. Governments' policies have failed or worsened situation?

No. Adjustment to second oil shock better than to first. Investment has performed better, impact on wages better contained and dependence on oil reduced. But these gains must be reinforced by continued firm policies.

Countries disagree over direction of policy?

No. Both Ottawa Summit and IMF Interim Committee agreed that a clear priority had to be given to firm policies to reduce inflation. They stressed importance of steady and careful restraint on growth of monetary aggregates and emphasised need, in many countries, for reductions in size of budget deficits. [For US , see 9 below]

5. Other countries giving priority to reducing unemployment rather than inflation?

No. All major countries agree that lasting reduction in unemployment can only be achieved when inflation brought down. France, an exception till October, is now acting to curb inflation. This best way to secure lower interest rates, encourage productive investment and achieve better rates of economic growth and employment.

6. Other governments not following such stern policies as UK?

[Most major countries (US, Japan, Germany, Italy, Netherlands, Australia, Sweden) have recently announced measures to cut planned public spending. France has announced the deferral of FF15 billion (£1½ billion) of capital investment.]

Most governments persevering with firm policies to lay foundations of renewed non-inflationary growth. In particular, continuing with their efforts to control monetary growth, offset effects of recession on budget balances, and keep public spending in check.

7. UK is alone in Europe. Even Germany announced investment/employment scheme last week?

No. Germany planned to reduce Government Borrowing in 1982 Budget even in nominal terms by almost 30 per cent. Unlikely investment/employment scheme will entail any significant increase in borrowing - increase in VAT (by 1 per cent to 14 per cent) part of the package from 1 July next year. Impact on employment remains to be seen.

8. Prospects for UK economy worse than for other countries?

No. Treasury and most independent forecasts expect UK growth this year of about 1 per cent. This is broadly in line with the OECD's forecast for our major industrial competitors. Unemployment is expected to rise in all major countries except Japan. UK inflation (GNP deflators) likely to be around the OECD average and below that in France, Italy and Canada.

9. Even US using fiscal deficit to stimulate economy?

True US deficit is larger than anticipated. It is planned to fall but present level carries risk of prolonging period of high interest rates which could delay a European recovery. We strongly support the determination of the US authorities to combat inflation. But we believe fiscal and monetary policies must work together to that goal.

10. Recent international interest rate developments?

True that US interest rates have risen again in recent weeks. Prime rates are well below their peak of 21½ per cent last summer.

11. Prospects for international interest rates?

Always difficult to forecast interest rates with certainty, but firm policies should over a period bring lasting reduction in both inflation and interest rates.

## PRESENT SITUATION

Most recent major outside forecasts (NIESR, P&D, CBI, LBS, St James) assess fall in output ended in H1 1981, with some recovery thereafter (in range  $\frac{1}{2}$ - $1\frac{1}{2}$  per cent for 1982). ITEM and OECD are more pessimistic; seeing further falls of output into 1982. Year-on-year inflation is forecast by most groups to fall further to a range of  $9\frac{1}{2}$ - $11\frac{1}{2}$  per cent in 1982 Q4. Whilst some groups (ITEM and NIESR) see the possibility of further reductions (to 7-8 per cent), others see inflation remaining around 10 per cent in 1983. The Industry Act forecast, of a 1 per cent rise in output in 1982, and 10 per cent inflation in Q4 1982 is broadly in line with this consensus. Unemployment (UK adult seasonally adjusted) forecast to reach around 3 million by end 1982.

GDP output estimate rose  $\frac{1}{2}$  per cent in Q3 1981 the first rise for 7 quarters. In Q4 1981 industrial output rose  $\frac{1}{2}$  per cent while manufacturing output was little different from the previous quarter.

Consumers' expenditure rose  $1\frac{1}{2}$  per cent in Q4 1981: the overall level in 1981 was only very slightly higher than 1980. Retail sales fell back in December 1981 but the average level in Q4 1981 rose  $\frac{1}{2}$  per cent. The volume of visible exports in Q4 1981 was  $5\frac{1}{2}$  per cent higher than in Q4 1980. The volume of visible imports rose 14 per cent on the same comparison. DI investment intentions survey conducted in October/November suggests volume of investment, by manufacturing, distributive and service industries (excluding shipping) will rise by about  $\frac{1}{2}$  per cent in 1982 following an estimated fall of 4 per cent in 1981. A large rise is tentatively expected in 1983. Investment by manufacturing (including leasing) is expected to rise during 1982, but for the year as a whole it is likely to be 1 per cent lower than 1981. An appreciable rise is expected in 1983. Manufacturers', wholesalers' and retail stocks dropped by £0.1 bn (at 1975 prices) in Q3 1981 compared with destocking of £1.0 bn in H1 1981 and £1.9 bn in 1980 as a whole.

Unemployment (UK, seasonally adjusted excl, school-leavers) was 2,829,000 (11.7 per cent) at January count, up 47,000 on December. Vacancies rose 6,700 to 114,200 in January.

Wholesale input prices (fuel and materials) rose  $\frac{3}{4}$  per cent in January; however the year-on-year increase fell to  $13\frac{3}{4}$  per cent. Wholesale output prices rose 1 per cent and are 11 per cent above a year ago. Year-on-year RPI increase remained at 12.0 per cent in January. Year-on-year increase in average earnings was 11.3 per cent in November. RPDI was flat in Q3 1981 following falls in the previous two quarters and a 17.5 per cent rise over the 3 years 1977 to 1980. The savings ratio rose 1 per cent to  $14\frac{1}{2}$  per cent in Q3 1981.

PSBR £9.7 bn in the first three quarters of 1981/82 and CGBR (unadjusted) £8.0 bn in ten months to January 1982; but both distorted upwards by the civil service dispute. Underlying PSBR believed in line with Budget forecast (£10½ bn).

Sterling M3 estimated to have increased by 1½ to 1¾ per cent in banking January.

Visible trade showed average monthly surplus of £190 million in the 4 months to December 1981 compared with an average monthly surplus of £525 million in the first two months of 1981. Invisibles surplus in 1981 estimated at £2.8 billion. Reserves at end-January \$23.2 bn. At the close 12 February the sterling exchange rate fell to \$1.84 but the effective rate remained at 91.6.