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PS/Secretary of State for Trade
PS/Secretary of State for Energy
PS/Secretary of State for Transport
PS/Chancellor of the Duchy of Lancaster
PS/Secretary of State for Employment
PS/Paymaster General
and officials in HMT, Revenue Departments and other Departments in Whitehall

TREASURY WEEKLY BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 21 June, are sidelined.

EB is much indebted to contributors and to staff of WPU and others for what they have done, despite transport troubles, to keep this document appearing.

M M Deyes

M M DEYES

R I G ALLEN

28 June 1982

EB Division
H M Treasury
01-233-3364

ECONOMIC BRIEF: CONTENTS

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. Economic recovery in doubt?

[GDP figures for Q1 1982, published 22 June, show little change on Q4 1981. Industrial production also broadly flat since last autumn, but still 2 per cent higher than a year ago.]

Profile of recovery likely to be uneven and jerky particularly when affected by such factors as very severe weather and industrial disputes. It remains the case that activity is above levels of last spring. Prospect is for resumed and continued recovery. This is supported by most independent forecasts, CSO's cyclical indicators and other forward indicators. Most encouraging pointer for sustainable recovery is progress being made against inflation. (See also Section B.)

3. Latest GDP figures?

[Provisional figures for Q1 1982 published 22 June by CSO].

Information adds little more to what already known about economic recovery. Activity remains higher than a year ago. [IF PRESSED: figures also confirm view of some hesitation in recovery; activity in Q1 little different from Q4 1981.] Some other encouraging signs eg fixed investment beginning to recover and industrial and commercial company profits sustaining higher level reached in H2 1981. And growth in money GDP continues to slow down - increase about 9 per cent in 1981-82.

3A Latest CBI Inquiry /LBS forecast ? See 7 on page B3.

4. Contribution made by 9 March Budget to economic strategy?

Budget continuation of Government's medium-term strategy for economy. Designed to make further progress on inflation and restore base for economic growth, improved output and increased employment. Government able to introduce tax cuts and other measures designed particularly to help business, but also individuals, consistent with continuation of medium-term strategy for the economy.

5. Lower than forecast 1981-82 PSBR means fiscal policy tighter than intended?

[Estimated PSBR outturn 1981-82 now below £9 billion (3½ per cent of GDP) cf £10½ billion forecast at time of Budget March 1981 and in 1982 FSBR.]

No reason to change Budget forecast of £9½ billion for 1982-83. Need to consider the wider context. Relatively modest level~~s~~ of public sector borrowing so far this year has been a factor underlying the downward~~s~~ movement in interest rates, now some 3 percentage points lower than at turn of year.

6. 1981-82 PSBR outturn inconsistent with MTFS?

Misleading to look at PSBR for individual years in isolation. Government's aim remains to reduce PSBR as ratio of GDP over medium-term. Latest estimates for outturn in 1981-82 suggest a ratio of about 3½ per cent, similar to ratio forecast for 1982-83. But looking over a longer run of years trend is clearly downward. (See also Section H.)

7. Over-funding/money market assistance / monetary package 25 June

See Section J.

8. Progress on inflation not being maintained?

[12-monthly increase in RPI rose from 9.4 per cent in April to 9.5 per cent in May.]

No, trend is firmly downwards. Indeed, we may do rather better than FSBR forecast of 9 per cent by end-1982. By contrast, when Government took office, inflation rate was 10½ per cent, and rising. (See also Section K.)

9. Unemployment accelerating again?

[June figures published 22 June show rise in UK, seasonally unadjusted, level to 3.06 million; seasonally adjusted figure shows 39,000 increase on previous month, compared with average 22,000 monthly rise between January and May.]

Of course figures provide no grounds for satisfaction or complacency. But not too much should be made of June figure by itself; unemployment tends to follow a very erratic and uneven monthly pattern. Rise in unemployment this year less than half that in first six months of 1981.

[IF PRESSED Apparent general weakening of labour market indicators can be interpreted as consistent with hesitation in recovery since last autumn. Cannot draw implications from June figures about future levels of unemployment.]

(See also Section C.)

10. Trade figures disappointing?

[April figures published 25 June.]

No. Current account remains in healthy surplus (£0.9 billion in January-April). Exports in last six months have held up better than many feared, given earlier loss in competitiveness. (See also Section L.)

11. Do FSBR forecasts still hold?
[Observer and Sunday Times claim shift in latest internal Treasury forecasts]
No reason to question broad shape of forecast - this is in line with the consensus of major outside forecasts (see B) but in certain areas, eg inflation, progress is faster than foreseen at Budget time. [NB: Not the practice to issue revisions between twice-yearly publication of forecasts under Industry Act ie Budget-time and autumn.)]

12. Report on Budgetary Reform by the TCSC ("Armstrong" Report)

[Report published 17 June.]

Government cannot be expected to agree with all it says, but it seems carefully thought out and constructive, and the Government will want to consider its recommendations thoroughly. Reply will be made when the Government's study of the report's recommendations is complete. Will not attempt to predict a date at this stage.

13. Do you accept the TCSC's criticisms of the way decisions are taken and announced?

No, not wholly. Government drew attention in its evidence to the various practical and other contraints and also to the progress which had been made in the Armstrong direction under this Government (eg MTFS). Committee did not perhaps give full weight to what had been achieved. But cannot anticipate reply to the report. Will be thinking carefully about recommendations to publish Green Book/PEWP in January etc. Cannot anticipate reply.

14. Falklands conflict and after?

See Section U.

15. Labour party economic policies

[Plan for economic revival published 25 June]
Proposals for return to policies tried and failed under previous Labour Governments. More Government intervention, more controls and regulation, irresponsible levels of public spending (and implied higher taxes), abandonment of financial disciplines. Do not believe this is the way to lasting recovery, nor a programme commanding much support from the British people as a whole.

BULL POINTS As at 25.6.82

(i) Activity. Recovery has begun: industrial and manufacturing output up 2 per cent from spring 1981. [But NB, underlying level of output broadly flat for last 6 months.] Business opinion surveys, most recent major independent forecasts, and CSO's cyclical indicators see prospect of resumed and continued recovery.

(ii) Investment. Total fixed investment rose 4 per cent between 4Q 1981 and 1Q 1982. DOI investment intentions survey suggests 2 per cent rise in and services' investment in 1982. Suggests fall in investment all but over. Private sector investment, particularly in plant and machinery holding up well. Investment in plant and machinery in 1981 only slightly (1½ per cent) lower than 1980, 8 per cent higher than in 1H 1979.

(iii) Total housing starts up 2/5 in four months to April 1982 on 1981 average.

(iv) Interest rates. Short-term rates have fallen 3-4 points since turn of year (now 12½-13 per cent). Process temporarily interrupted by Falklands dispute, now resumed. Recent falls reflect several factors:- single figure inflation, M1, £M3 and PSL2 developing favourably in relation to target, Government borrowing under control, exchange rate firm.

(v) Inflation. 12-monthly increase in RPI now in single figures - 9.5 per cent in May - more than halved since spring 1980 peak (21.9 per cent). Inflation in April and May lowest since January 1979, but trend now firmly downwards, not upwards as then. Manufacturers' output prices up just 8¾ per cent in year to May.

(vi) Costs.

- Increase in average earnings halved in 1980-81 pay round. Public sector pay in line. Further moderation in average level of settlements in current round. CBI pay databank for manufacturing settlements suggests average now around 7 per cent compared with 9 per cent in previous round.
- Little increase in manufacturers' unit wage and salary costs over last year - only 3 per cent up in year to 1Q 1982, below average of our major competitors and comparable to that of Germany and Japan.
- Manufacturers' input prices little changed since last August; up just 4¾ per cent in year to May (lowest increase since November 1978).
- CBI April survey shows lowest degree of unit cost pressures for 15 years.

(vii) Manufacturing productivity. Output per head rose 12 per cent since end 1980. Output per head and output per hour 5 and 8 per cent higher than previous peak in 1H 1979.

(viii) Competitiveness. Cost competitiveness improved by 10-15 per cent during 1981 reflecting pay moderation, higher productivity and exchange rate fall, but remains $^1/_3$ worse than in 1975.

(ix) Profits: Industrial and commercial companies gross trading profits (net of stock appreciation) up about 25 per cent between 1H and 2H 1981, higher level of profits in 4Q 1981 sustained in 1Q 1982. Recovery in profits from very low base: ICC's pre tax real rate of return just 2½ per cent in 1981.

(x) Exports have held up better than many feared following 50 per cent loss of competitiveness between 1975 and 1Q 1981. Recent months figures suggest non-oil exports (exluding erratics) slightly (about ½ per cent) higher than in 1980. Engineering export orders up 17 per cent in 1981 on 2H 1980 to reach their highest level.

(xi) Special employment measures. Total provision for special employment schemes planned to reach £1½ billion in 1982-83, and to be £4 billion over current and next two financial years. 280,000 unemployed school-leavers last year found places on YOP by Christmas.

(xii) Overseas investment in UK: US direct investment in Britain amounted to stock of over $14 billion in 1980. Nearly 60 per cent of all US outward non-oil direct investment now takes place in EC - over half of that in UK. Half of all Japanese investment in the EC also comes to Britain.

(xiii) Overseas debt repayments. Official external debt reduced from over $22 billion in May 1979 to around $13.7 billion at end-May 1982.

Economic Briefing Division, HM Treasury, 01-233 3819/5809

ECONOMIC ACTIVITY AND PROSPECTS

1. Recovery faltering?

- Taken together, all three measures of GDP suggest some hesitation in recovery in Q1 1982, but GDP remains above levels of last spring. In part reflects impact of very severe weather and industrial disputes at turn of year.
- Some recovery in industrial production in February and March, but little change in April. Underlying level of industrial/manufacturing output broadly flat over last 6 months.
- Manufacturing productivity risen 12 per cent since end 1980. Company profits up by over one quarter between H1 and H2 1981, but little changed in Q1 1981. Inflation 9.5 per cent in May. Interest rates fallen 3-4 points since turn of year. Competitiveness improved by 10-15 per cent since Q1 1981.
- Prospect of resumed and continuing recovery broadly shared by business opinion surveys, bulk of outside forecasts and CSO's cyclical indicators. Leading indicators suggest continuation of recovery after some hesitation through early 1982.]

Inevitable that recovery be uneven and jerky, especially so when affected by such factors as very severe weather and industrial disputes. Activity remains above levels of last spring. Prospect is of resumed and continued recovery. This supported by almost all independent assessments. Recovery in productivity and profitability encouraging. Best help for sustained recovery is lower inflation and interest rates.

2. Recent hesitation in recovery reflects rise in interest rates last summer/autumn?

[PM's Question Time 22 June Hansard col 151.]

Possible that slow and fragile recovery makes economy particularly sensitive to shocks adversely affecting confidence and activity. Whole host of factors - temporary rise in interest rates last summer/autumn, pause in progress on inflation, difficult world environment - could have weakened business confidence in this way. But prospects for continued recovery (see B1).

3. Investment and stockbuilding?

[Fixed investment broadly flat in 1981 rose 4 per cent between Q4 1981 and Q1 1982. DOI's investment intentions survey suggests 2 per cent rise in manufacturers', distributors' and service industries' investment in 1982. Despite slight fall between 1980 and 1981 plant and machinery investment in 1981 8 per cent higher than in H1 1979. Rate of destocking slowed sharply in H2 1981: destocking in Q1 1981 at same (much reduced) level at Q4 1981.]

Recent figures (MDS investment figures for Q1 1982; DOI's investment intentions survey) suggest fall in investment all but over. Investment has held up well in relation to output. Welcome end to period of rapid destocking which accounted for major part of earlier fall in output.

3. June CBI Trends Enquiry?

~~[To follow.]~~ See 7 on page B3.

4. Other evidence of improvement in economy?

See Bull Points (following Section A).

5. Government assessment of prospects

[FSBR forecast (9 March) assesses recovery to have begun. Main points are:

	per cent increase on year earlier	
	1982	1983 H1
GDP	1 ½	2
Manufacturing output	3	2
Consumers expenditure	½	½
Investment (private sector and public corporation)	4½	5
Exports	3 ½	3

Forecast expects some stockbuilding in 1982, Government expenditure flat.]

FSBR forecast sees prospect of some recovery continuing into 1983. (Last two Government assessments of economy were broadly correct). Healthy rise in private sector investment and exports. Inflation well into single figures (7 ½ per cent) by mid 1983. Further progress depends on continued moderation in domestic costs and restoration of competitiveness.

6. Outside forecasts

[GDP profile in major post-Budget assessments:

	NIESR (May)	LBS (~~Apr~~ June)	St James (Apr)	Phillips & Drew (June)	CEPG (April)	CBI (May)	FSBR (March)
Per cent change 1982 on 1981	+1	+1[illegible]	+1 ¼	+1 ½	- ½	+1	+1 ½]

Nearly all see prospect of continued recovery in 1982 in line with FSBR, (as always, a range, with Cambridge forecast (CEPG) being the more pessimistic) and see single figure inflation through rest of 1982 - also in line with FSBR. [See also C2 (unemployment), K3 (inflation) and L6 (balance of payments).]

7. Latest CBI Industrial Trends Enquiry, and LBS Forecast, both gloomy?

[CBI Enquiry for June reports little change in order books or stocks since last April, and expectations of broadly flat output over next four months. LBS has revised downwards previous forecast for growth in 1982, but predicts fairly rapid recovery for 1982 H2 onwards, and falling inflation.]

CBI Enquiry disappointing: confirms recent indications of temporary flattening out in activity since last autumn. But encouraging signs of further moderation in inflationary expectations – necessary condition for improved growth. June LBS forecast, like latest CBI forecast, believes recovery will resume in second half of this year, and predicts inflation rate below 8 per cent this autumn.

C LABOUR MARKET

1. Recent unemployment figures and other labour market indicators?

[In June, unemployment (UK adult seasonally adjusted) rose by 39,000 to 2,911,000 (12.2 per cent). Total unemployment rose by 92,000 to 3,061,000 (12.8 per cent). Vacancies (UK seasonally adjusted) fell for fourth consecutive month to 105,000 compared with 113,000 in February. Vacancy flow data for May (latest month available) show inflow and outflow much same as April, slightly down on March, but much improved this year - about 164,000 per month this year compared with about 145,000 per month in 2Q 1981. Recent unemployment vacancy figures are shown below:

	1980 Q4	1981 Q1	Q2	Q3	Q4	1982 Q1	Q2
Unemployment (UK adult sa)	105	77	62	51	33	21	30
Vacancies level	99	98	89	96	104	112	107

[Other labour market indicators (overtime, short-time, hours worked in manufacturing) improved during 1981, but have shown tendency to weaken since turn of year.]

Just as Government did not put undue weight on relatively low increases (5-6,000) in unemployment in February and March of this year, not too much should be made of relatively high June figure. Underlying rate of increase in unemployment in H1 1982 less than half that of same period last year. Vacancies in June one third higher than Q2 1981, and turnover so far this year higher than last.

[IF PRESSED on general weakening of labour market indicators: reason for weakening uncertain, but can be intepreted as being consistent with hesitation of recovery since turn of year. Prospects are for resumed and continued recovery. (See B1.)]

[IF PRESSED VERY HARD on implications for future levels of unemployment: cannot draw any conclusions from one month's figures. Very difficult to forecast (see C2-3 below). Prospect remains of continued and resumed recovery. (See B1.)]

2. Unemployment expected to continue rising rapidly?

[Most outside forecasters see continued rise in registered unemployment during 1982 reaching about 3 million (UK adults) in Q4. Opinion divided for 1983; some (CEPG, Cambridge Econometrics, ITEM, NIESR) see rise continuing but at a slower rate, some broadly flat (LBS, St James) others (P&D, S & Coates) expect slight (roughly 50-100,000) fall in 1983. Liverpool foresee fall of 400,000. Cambridge Econometrics new forecast claims '3 million jobless to end century'.]

Unemployment forecasts uncertain; independent forecasters encompass differing views for 1983 - several projecting stabilisation, some [a slight] decline. Rise in unemployment drastically reduced since end 1980. Employment situation will benefit from some further recovery in activity this year (see B1).

3. Government forecasts for unemployment

[1982 PEWP uses working assumption of an average level of 2.9 million unemployed in Great Britain (excluding school leavers) in 1982-83 and rest of survey period. School leavers, adult students, temporarily stopped and Northern Ireland imply UK total unemployed of 3.2 million in 1982-83.]

Very difficult to forecast; depends on so many factors. Following well-established precedent of previous administrations in not publishing. Public Expenditure White Paper figures are planning assumptions not forecasts.

IF PRESSED that PEWP figures show Government planning sustained higher level of unemployment: No. Maintaining constant figure for the Survey period is conventional assumption adopted by previous Administration. Greater the progress that can be made in reducing inflation and maintaining moderation in pay settlements, the better the prospects for unemployment.

4. Report of House of Lords Select Committee on Unemployment contradicts Government policy?

[Report (1) states "it is crucial to achieve and maintain realistic pay levels if we are to regain competitiveness"; committee agree this must be primary objective to alleviate unemployment. (2) makes it clear that inflation needs to be brought under control before unemployment can be tackled effectively and rejects general reflation which is seen as "primrose way leading to destruction. (3) Calls for more money - £5 billion (net PSBR cost £1.95 billion) over 2-3 years - to be spent in short term to relieve unemployment.]

No. Main proposals (need for realistic pay settlements, low inflation, restoration of competitiveness, and rejection of general reflation) strongly endorse Government policy.

5. House of Lords Committee suggested more spending on special employment measures?

Government already plan to spend £1½ billion on special employment and training this year. (See also C11.) Continue to do all we can to help those hardest hit by economic adjustment and promote training, but inconsistent to support need for action against inflation at same time as calling for very large extra sums of money for such measures

6. House of Lords Committee's figures for cost of unemployment correct?

[Committee calculate Exchequer cost of unemployment about £5,000 per unemployed person, with social costs (eg burdens on NHS, social services, judicial system) adding several hundred pounds more per annum.]

Report's figures no doubt based on careful study, but all such estimates depend on assumptions made and concepts followed. No single figure of this kind can really purport to show how changes in unemployment affect public finances.

7. Employment continuing to fall?

[Total employment declined 2.1 million (9 per cent) between mid 1979 and end 1981.]

Decline in H2 1981 about two-thirds that in H1. Best help for permanent jobs is sustainable recovery.

8. Unemployment higher than in other countries?

[On standardised definitions in Q4 1981 UK employment was 12½ per cent compared with 7½ per cent OECD rate; a UK doubling compared with an OECD rise of almost one half since 1979.]

Whole world affected by rising unemployment. In our case we have additional self inflicted wounds of high pay awards and low productivity. Unemployment now rising very fast in some countries eg Germany.

9. What is Government doing to provide more jobs?

Government pursuing sensible fiscal and monetary policies to curb inflation and creating conditions for enterprise - only measures that will ensure sustainable increase in employment. Nevertheless Government expanding schemes to meet special difficulties and improve training - eg plan to spend £1½ billion in cash on 1982-83 (40 per cent more than in 1981-82) on special employment and training measures; new Youth Training Scheme costing £1 billion a year from 1983-84; and MSC working on proposed new community work scheme announced in Budget Speech.

10. MSC Task Group proposals on youth training?

Government has accepted Task Group's scheme as immense step towards setting standards and systems of training for young people as good as those anywhere overseas.

D TAXATION

1. Burden of taxation

[Total taxation (i.e including for example income tax, indirect taxes, corporation tax, rates and NIC) 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 and 39¼ per cent in 1982-83.]

This has inevitably increased during a time when the recession has been adding to public spending. Changes proposed in Budget will reduce total burden in 1982-83 compared with 1981-82. [NB: Not true of burden on persons.]

2. Burden of tax has risen for most households since 1978-79?

[Comparisons given in Parliamentary Answers to Mr Straw 3 December, 17 February and 18 March col W199.]

Slow growth of output and difficulty of restraining public expenditure have inevitably meant higher tax burden. But real personal income after direct taxes still higher than under last Government. And more honest to raise taxes to finance necessary higher expenditure than to increase borrowing, with the increased interest rates and inflation that would bring.

3. Burden has fallen for the rich?

Abolition of absurdly high marginal rates and raising of thresholds in 1979 essential to remove disincentives. Reimposition of an 83 per cent top rate of income tax would finance a reduction of less than one quarter of 1p in the basic rate.

4. Burden has risen most for the poor?

Proportion of income paid in income tax and NICs will fall in 1982-83 for lowest paid taxpayers. And low paid with children entitled to benefits such as FIS.

5. Personal tax burden increased by last Budget - when NICs taken into account?

[Full explanation given in Parliamentary Answer 11 March OA col 955].

The real increase in personal allowances and tax thresholds will reduce income tax as a percentage of income at all levels of incomes. Those over pension age who are taxpayers will benefit from income tax changes and will be unaffected by NIC rise, and, of course, State pensions are being uprated from November. [IF PRESSED: In immediate cash terms, increases in personal allowances etc will compensate for NIC increase for majority of taxpayers. Taking into account increased earnings in 1982-83 (for example using the Government Actuary's 7½ per cent assumption) percentage of income paid in income tax plus NIC will rise for most people, but will fall for the lowest paid, ie below about ½ average earnings (married) and below about 1/3 average earnings (single).]

6. No improvement in incentives?

There will be 1.2 million fewer taxpayers than if allowances had remained at 1981-82 levels, and ½ million fewer higher rate taxpayers. For the substantial number taken out of tax or with reduced marginal rates, incentives will improve.

7. Poverty trap/unemployment trap getting worse?

[Treasury and Inland Revenue officials have given evidence to TCSC sub-committee.]

The poverty and unemployment traps are a matter for concern. Must be remembered that result from attempts to relieve poverty over a period of years when the economy has shown little growth. The answer is to get sustained growth going again - this is the objective of our economic policies.

8. Family Forum call for Green Paper on effects of taxation and benefits on the family

[Published 21 June.]

Issued raised are among those covered by TCSC subcommittee's inquiry. Chief Secretary will be giving evidence on 21 July. Await report with interest.

9. Budget reduction in NIS not enough for industry?

Cut welcomed by CBI and industry generally. Provides substantial help on business costs. 1 per cent reduction maximum possible without risks for PSBR: outright abolition too costly. And other measures to help business directly - energy, construction, innovation and enterprise packages plus helpful - and welcomed - improvements in capital tax regime (see also Section P).

10. Excise duties increases inflationary/harmful to industries

Increases in excise duties as a whole slightly less than broadly compensate for past year's inflation. Variations between duties take account of industrial considerations e.g supplementary increase last July on tobacco/Scotch whisky industry/help for industry by smaller increases on e.g derv - mainly used by industry.

11. Merger of tax and social security planned?

See G4.

E PUBLIC EXPENDITURE AND FINANCE

[Public Expenditure White Paper (Cmnd 8494) published 9 March. Gives planning totals of £115.2 billion in 1982-83, £121.1 in 1983-84 and £128.4 in 1984-85. About £5 billion higher than last White Paper in 1982-83 and £7 billion in 1983-84. Net effect of changes announced in Budget is to reduce totals to £114.9 billion, £120.4 billion and £127.6 billion].

1. Public expenditure too high?

Spending in 1982-83 planned to be about £5 billion (4½ per cent) lower than intended by last Government even if higher than planned when this Government first took office. Decisions to increase spending represent flexible but prudent response to changed circumstances e.g additional spending to help young unemployed. Drive to improve management in public sector and reduce administration expenses continues.

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

Ratios in 1980-81 (43½ per cent) and 1981-82 (45 per cent forecast) remain below level of 1974-75 and 1975-76 (46 per cent in both years). [NB 1981-82 ratio could be nearer 44½ per cent. See H5.] Rise in ratio in 1981-82 mainly reflects higher expenditure on social security at a time when real GDP falling. Ratio expected to fall in next few years: assumptions in MTFS would mean figures of 44½ per cent in 1982-83, 42½ per cent in 1983-84 and 41 per cent in 1984-85. Reflects assumed GDP growth and curbing of public expenditure.

3. Increase spending in recession?

No good trying to spend way out of recession. Any benefits would be short-term. If increased spending not financed responsibly, would soon lead to more inflation. If financed prudently, would lead to higher interest rates and/or higher taxes. We are responding, within limits of prudence, to needs of current circumstances.

4. Government has complacent attitude to public expenditure?

No. The Chief Secretary told a Conservative Party Conference on Saturday 12 June that "the momentum of public spending programmes is frighteningly great. Unless all of you are able and willing to join us in pressing for new initiatives to control the escalation of public spending the prospect for greater tax incentives is bleak indeed".

5. Real terms comparisons

No volume equivalents of cash plans. But cash increase in plans between years is 9 per cent in 1982-83, 5 per cent in 1983-84 and 6 per cent in 1984-85 (and projection of GDP deflator in MTFS is rather lower than this in 1982-83, rather higher in 1983-84 and about same in 1984-85). So in cost terms [i.e cash inflated/deflated by general movement in prices] there is an increase in 1982-83, a decrease in 1983-84 and a small decrease in 1984-85.

6. Not enough capital expenditure?

Government prepared to give priority to worthwhile capital projects wherever this can be done within overall spending totals. Plans do allow for changes between 1981-82 and 1982-83 as follows:

- public sector spending on new construction increased by 14 per cent;
- nationalised industries investment to rise by 26 per cent;
- increase in housing investment output [NOTE: if LAs take full advantage of receipts from sales, gross new investment can be as high as £3 billion next year];
- slight increase in work done on water and sewerage projects even though provision reduced).

7. Cuts in capital

Some reductions in cash provision necessary, but recent falls in tender prices (following sharp increases between 1978 and 1980) will mean that programmes mainly affected (roads, water, local environmental services) should be carried out as planned. Planned capital expenditure also reflects decline in needs since early mid-1970s (e.g roads, schools). Planned spending should not jeopardise future standards and availability of public amenities and services.

8. Cash planning means concentration on first year, not enough on services in later years?

Government recognise case for medium-term planning. But planning must be related to availability of finance as well as prospective real resources. Cannot accept unconditional commitment to forward plans for services. Volume plans formerly had to be cut when conflicted with financial constraints - e.g after IMF intervention in 1976.

9. Cash figures should be accompanied by constant price figures to give some idea of levels of service?

Constant price figures of limited value in new situation. Cash programmes intended to have primacy. Necessary to get away from old system of volume planning and destroy idea that programme managers automatically entitled to be compensated for effects of inflation by revaluing their programmes. In any case old 'volume' figures not a measure of level of service. Simply measured resources put into programmes - inputs. The level of service provided - output - takes account not only of resource inputs, but efficiency and effectiveness of their use. We are continuing to review and develop use of output measures in planning and management of public expenditure.

10. End-year flexibility?

Possibility of end year flexibility is being looked at again. There could be some managerial advantages in such a scheme. But we also have to consider question of cost.

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

(See Sections F and K.)

12. 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. Provision for public service pay increases 1982-83 limited to 4 per cent. Administrative costs ae not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain drive for more efficient management throughout public sector.

LOCAL GOVERNMENT

13. Overspending in 1982-83? Government response?

Local authorities are budgeting to spend some £1½ billion above Government's plans (£1¼ billion in England, £200 million in Scotland, £60 million in Wales). Government cannot ignore this large planned overspend.

Action in ENGLAND: Secretary of State for the Environment intends to implement scheme for grant abatement announced last year and is considering further across-the-board grant cut.

Action in SCOTLAND: Secretary of State for Scotland is seeking to reduce grants of Lothian Regional Council (by £45 million) and Stirling District Council (by £1½ million).

Action in WALES: Secretary of State for Wales has announced his intention to withhold grant. He also asked Welsh local authorities to submit revised budgets. Amount of grant to be withheld will be determined in light of these.

Local authorities have only themselves to blame for these grant penalties.

14. Large rate increases this year are Government's fault?

Not at all. If local authorities had sought 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.

15. Effect of NIS reduction on local authorities?

As Chancellor announced in Budget, we intend that local authorities overall will [illegible] neither involved in offsetting the reduction by a decrease in grant, and are looking constructively at possibility of postponing the reductions for local authorities until April 1983.

16. Green Paper on Domestic Rating System: Government response?

Government is considering carefully all representations received. We wish to produce proposals for a scheme that will remedy shortcomings of present system while commanding wide support.

F CIVIL SERVICE STAFFING AND PAY

1. Civil Service too big/does too much/is over staffed?

Since Government came to office, Civil Service has been reduced by 9 per cent to 666,400. This is smallest since 1966. Results from reduction in functions, privatisation and improvements in efficiency. On course to achieve aim of having Civil Service of 630,000 by April 1984. This is 102,000 fewer staff in post than in April 1979, and will mean the smallest Civil Service since the end of the Second World war.

2. Civil service pay: non-industrial civil servants

[Settlement date 1 April 1982.]

Civil Service Arbitration Tribunal awarded pay increases ranging from 4.75 per cent to 6.25 per cent - worth 5.9 per cent overall - and increases in annual leave. Government have accepted the award which is now being implemented. Increases (announced 12 May) for the higher civil service (under-secretary and above) are larger; they have been decided in the light of the recommendations of the Top Salaries Review Body. Cash limits and manpower targets are not being adjusted. (See also Section K) The report of the Megaw Inquiry into arrangements for deciding civil service pay in future may be made at the end of this month.

3. Civil Service pay: industrials

[Settlement date 1 July 1982]

Claim for increase in pay in line with inflation, shorter working week and longer holidays, is under discussion with the unions.

4. Scott Report/Public sector pensions?

?

See K 21

G SOCIAL SECURITY

1. Now that unemployment benefit is to be brought into tax why not restore November 1980 5 per cent abatement ?

Decision to abate UB not simply taken as proxy for tax but to reduce public expenditure and improve incentives to find and keep work. (Chancellor's Budget statement in March 1980 made that perfectly clear.) Those reasons remain valid. Any improvement on rates announced would seriously worsen incentives. Cost too would be high - £60 million in full year [net of reduced claims for supplementary benefit, but gross of tax].

2. Why cut child dependency additions to unemployment benefit?

[In line with practice in recent years, uprated level of child dependency additions to unemployment benefit (not Supplementary Benefit) abated by amount of increase in Child Benefit. In consequence, CDAs will drop from current level (80p) to 30p next November.]

Child dependency additions to unemployment benefit are being phased out, and will eventually be replaced entirely by Child Benefit. In this we are following practice adopted by last Labour Government.

3. Death grant - increase to realistic level?

[Consultative document about death grant published 3 March, comments asked for by 30 July.]

Social Services Secretary would welcome comments on recently published consultative document on death grant. As have made clear, aim is to redistribute in more sensible fashion resources now devoted to death grant - cannot afford to add to those resources.

4. Merger of income tax and national insurance planned?

Government's written evidence to TCSC did not suggest such a merger. Committee asked about feasibility of merging the two systems, and the evidence gave an illustration of what a joint system would look like.

H PUBLIC SECTOR BORROWING

1. Government's expectations for PSBR in 1982-83?

Budget forecast for 1982-83 was £9.5 billion. No reason to change this forecast.

2. If PSBR higher in 1982-83 than in 1981-82 won't interest rates have to rise?

As percentage of GDP, outturn for 1981-82 is more or less equal to the forecast for 1982-83 ie around 3½ per cent. The 1982-83 forecast is still a low figure both by comparison with deficits abroad and in relation to size of deficits over past decade.

3. Implications for public expenditure in 1981-82 and 1982-83?

Detailed public expenditure outturn information for 1981-82 will not be available until early July. Until then, implications for 1982-83 uncertain. [IF PRESSED: It is estimated, on very incomplete information, that the planning total will fall from £105.2 billion in the FSBR to around £104.5 billion (around £104 billion was provisional estimate given in other briefing) and that ratio of public expenditure to GDP will fall from 45 per cent to 44½ per cent].

4. Implications of CGBR outturn in April and May for PSBR in 1982-82?

[CGBR for April was £0.8 billion, for May (published 9 June) £1.1 billion. April 1981 was £2.4 billion, May 1981 was £2.7 billion].

Last year's figures severely distorted by Civil Service dispute so comparisons can be seriously misleading. Too soon to make any amendment to forecast for the year.

5. How much was PSBR undershoot in 1981-82 and why?

[PSBR 1981-82 undershoot now appeas to be less than originally thought: published (3 June) estimate £8.9 billion, provisional (issued 22 April) estimate £8.6 billion, 1982-82 FSBR (published 9 March) estimated outturn of £10.6 billion.]

Study of the reasons for shortfall has revealed possible improvements which can be made to improve our forecasting technique. However, the Civil Service dispute added considerably to uncertainties at time of Budget and was main influence on most of the errors.

6. Why treat PSBR as a crucial statistic when forecasting errors of this size can occur?

Importance of balance between government's spending and income recognised by all governments, whatever the difficulties of forecasting.

7. Implications for fiscal policy and MTFS?

See A5- 6.

8. Effect of Civil Service dispute on PSBR?

PSBR in both 1981-82 and 1982-83 affected by Civil Service dispute. In 1981-82 some £¾ billion of receipts delayed from March 1981 were collected, but some £1½ billion of receipts due in 1981-82 will now be collected in 1982-83. Debt interest cost of the strike some £½ billion in 1981-82. Dispute also damaged our ability to interpret and forecast the PSBR reasonably accurately (see question ~~7~~ 5).

9. Fiscal policy should be based on cyclically adjusted/real PSBR?

Some merit in inflation-adjusted measure as indicator of fiscal stance in some circumstances. But there are dangers here: it would be quite wrong to expand PSBR in cash terms in response to an upsurge in inflation merely to keep inflation-adjusted measure constant. Policies intended to eradicate inflation, not to adjust to it.

J MONETARY AND FINANCIAL POLICY

1. Monetary growth in 1981-82

[In banking May (third month of target period) £M3 rose by 1.1 per cent, bringing growth in the target period to 9.7 per cent at an annualised rate; M1 rose by 0.6 per cent (0.2 per cent at an annual rate this target period); PSL2 rose by 0.7 per cent (10.1 per cent at an annual rate over the target period) - all figures seasonally adjusted].

Too early to judge outturn over target period as a whole, but recent figures encouraging. Figures point to continuing steady downward pressure on inflation.

2. Monetary conditions too tight?

Exchange rate, money GDP and monetary aggregates suggest financial conditions have been moderately restrictive whilst allowing recent further falls in interest rates. Bank lending is still growing rapidly, however; we do not believe that monetary conditions have been too restrictive.

3. Bank lending

Too early to say whether growth is slowing, though banking May figure lower than in preceding months. Part of recent rapid growth at least is in substitution for building society lending and other forms of consumer credit, but to the extent that it is additional it may add to inflationary pressures, so must continue to proceed cautiously on interest rates.

4. Over funding / monetary package of 25 June

See Questions and Answers on pages J3-4.

5. Recent falls in interest rates

Base rates cut from 13-12½ per cent wef 8/9 June. Continues decline seen since last October when base rates were 16 per cent. Market unease over Falklands disguised underlying trend. Recently rates eased creating the conditions for 8 June base rate cuts as victory comes in sight. The latest falls are consistent with continued progress against inflation.

6. Prospects for further falls

Of course want to see rates lower still, but we have only just seen a further welcome cut in base rates and we have to be cautious about the future. We shall not jeopardise counter-inflation policy, but in due course further progress with MTFS should lead to rates being lower still.

7. Will high and unstable US rates affect UK rates?

[US rates became firmer last week. Prime rates 16½ per cent.]

US rates not sole determinant of UK rates, but high US rates certainly an adverse development and in September were a key factor in driving our rates up. Recently, however, sterling has remained reasonably firm, probably helped by improved prospects for wage round, and good trade figures. UK interest rates have eased this year against US trend; but we cannot insulate ourselves from difficult international background. (See also T11.)

8. MTFS being quietly shelved?

[3rd MTFS states Government's objectives 'to reduce inflation and to create conditions for sustainable growth in output and employment', by 'steady but not excessive downward pressure on monetary conditions'. Key financial indicators are the monetary aggregates and exchange rate. Target range for growth of M1, £M3, PSL2 in period February 1982 - April 1983 of 8-12 per cent. Illustrative path of 7-11, 6-10 per cent in 1983-84, 1984-85. Targets for later years to be set nearer the time.]

No. Updated MTFS is realistic and flexible, describes how monetary policy operated in practice. MTFS serves useful purpose. Right to retain and adjust in light of experience.

9. Monetary targets discredited?

Monetary targets have important role in defining medium term direction of policy. But short term movements in monetary aggregates not always reliable guide to monetary conditions. Policy decisions based on assessment of all available evidence.

25 JUNE MONETARY PACKAGE

Will the tax change on zeros and deep discounts reopen the corporate/bond market? Surely the tax treatment remains unfavourable?

It is too soon to say how companies will respond. The tax treatment is clearly is not as favourable as some would want - but to allow companies to offset discount against tax and investors to be taxed as on capital gains would introduce unacceptable asymmetry. Announcement represents an important step forward - and we have said we are looking at an accruals based system on US model. The best hope for the revival of the corporate bond market of course remains lower inflation and lower interest rates. We are on course for both.

Doesn't the amendment to the National Loans Act remove the only constraint on the Bank's purchases of bills? Will it mean even huger purchases in the future?

National Loans Act amendment is designed to remove an essentially fortuitous constraint on the Government's ability to borrow. Existing law could have prevented Government funding its borrowing requirement. Does not necessarily mean large increase in bill purchases. The scale of money market assistance will depend on the future course of bank lending etc. Other measures designed to ensure it does not grow so rapidly - encouragement of corporate bond market and variable rate lending to local authorities.

Doesn't high Government funding and money market assistance merely mean higher long rates and lower short rates? Isn't it this that prevents companies borrowing long?

The level of interest rates depends essentially on the scale of Government borrowing rather than its form. We have succeeded in reducing the PSBR and the Government's call on financial markets and it is this which has paved the way for lower interest rates. Lower funding and higher short term finance would mean higher money supply which would cause expectations of higher inflation and raise interest rates.

J4

<u>Isn't Government simply acquiescing in rapid growth of bank lending and accommodating it?</u>

The rapid growth in bank lending is a response to high inflation and structural changes following ending of direct controls- which would prove to have little effect. Tax and borrowing measures announced on Friday will have some impact on rate of growth but if impact of bank lending on money supply minimised no cause for alarm about inflationary prospects.

K PRICES AND EARNINGS

PRICES

1. Recent trends in inflation

Over the past year, the year-on-year rate of inflation has fallen from 11.7 per cent in May 1981 to 9.5 per cent in May 1982. Over the last year of the Labour Government, the year-on-year rate of inflation increased from 7.7 per cent in May 1978 to 10.3 per cent in May 1979.

2. Inflation lower than under previous Government?

[Average year-on-year rate of inflation between February 1974 and May 1979 was 15.4 per cent; average level of inflation since May 1979 has been 14.2 per cent.]

Year-on-year rate of inflation had risen to 10.3 per cent when previous Government left office. And on present forecasts average level of inflation will be lower under this Government than under its predecessor - first time this has happened in over 30 years.

3. But inflation rising again?

[12 monthly rate of inflation 9.5 per cent in May compared with 9.4 per cent in April, 10.4 per cent in March and 21.9 per cent in May 1980.]

No particular significance is to be attached to the 0.1 per cent rise in the monthly inflation rate in May.

4. How low inflation by end 1982?

No new forecast to offer at this stage, but the year-on-year rate of inflation was already 9.5 per cent in May, and should decline further over the year.

5. Could it be 7½ per cent?

[Industry Secretary Speech to CBI 24 May. Latest Reward Regional Survey also forecasts 7½ per cent.]

Fall to 7½ per cent by end of year not impossible - it is within the margins of error attached to the Budget forecast of 9 per cent. Recent figures have been encouraging and an outturn somewhat better than 9 per cent is quite possible.

6. What reason is there to expect a further decline in inflation?

Over next year or so, moderation in unit labour costs should continue to exert downward pressure on rate of inflation, as should weak commodity prices. Competitive pressures on firms to limit price rises are also likely to remain strong.

7. Inflation still not as low as competitors

[UK inflation 9.4 per cent in April, compared with 6.6 per cent in US, 5 per cent in West Germany, and 2.8 per cent in Japan.]

UK inflation now lower than Western European (OECD Europe) average, and well below many countries - such as France and Italy. Still some way to go to match US, West Germany and Japan, but good progress being made in right direction.

8. Movement in tax and prices index?

[Increase over 12 months to May 9.8 per cent, compared with increase of 9.5 per cent in RPI].

Fact that TPI has been increasing faster than RPI reflects measures taken to restrain Government borrowing, which is essential if inflation is to be controlled. But following recent Budget, difference is now small.

9. Nationalised industry prices

[Increase over 12 months to May 14.0 per cent, compared with an increase of 9.5 per cent in the RPI (see also R7)].

Gap between nationalised industry price increases and RPI due in large measure to cumulative effect of years of artifical price restraint. World oil price rises of 1979 and 1980 have also played important part. Increases regrettable, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so, but sustained improvement only possible if industries succeed in holding down current costs, particularly pay.

10. Effect on retail prices of EC farm price settlement?

[EC Agriculture Ministers agreed on 18 May, by majority decision, to raise level of farm support prices under CAP by average of just over 10 per cent].

Estimates of effect of the CAP price settlement on retail prices can only be made in general terms, and will depend on such factors as the type of support operated and the prevailing market conditions in the sectors concerned. Agriculture Minister (in statement to House 19 May) estimated that direct impact of total package would add about ¼ per cent to retail prices index and 1¼ per cent to retail food price index in full year. [NB Treasury believes this may be under-estimate because assumes constant absolute profit margins.]

PAY

11. Current level of pay settlements

Recent decisions on public service pay announced by Government confirm downward trend of settlements since the last pay round, when they generally averaged 8-9 per cent. Settlements are also well below rate of inflation for second year running.

12. 4 per cent pay factor abandoned?

The 4 per cent factor is not pay norm, but a broad measure of what Government thinks reasonable and can be afforded in fixing provision from which public service wage bill has to be met. Government decided to accommodate cost of Civil Service arbitration award within the relevant provision. (Only if exceptional difficulties arose later in the year would limited calls on the contingency reserve be considered.)

13. Government norm now 6 per cent?

There is no norm, nor has there been. The 4 per cent factor remains the basis on which provision for public service pay has been set. Where extra provision has been needed to help finance proposed higher increases, as with nurses, doctors and dentists, it has been found partly from other savings on programmes concerned and partly from contingency reserve.

14. NHS pay

Social Services Secretary announced 23 June that a further £90 million should be made available for increased pay offer in Health Service. This would allow increase in average pay for nurses of 7½ per cent, ambulance men and hospital pharmacists 6½ per cent, and other staff 6 per cent. Government believes this provides sound basis for settlement.

15. Top Salaries Review Board increases too large?

[Government announced on 12 May increases of 14.3 per cent for senior civil servants and senior members of the Armed Forces, and 18.6 per cent for the judiciary.]

Government believes these increases are fully justified. Essential to ensure adequate supply of candidates of sufficient calibre for the Bench, and to provide adequate career structure and differentials in higher levels of Civil Service and Armed Forces. TSRB are only group whose present salaries are below those recommended for April 1980.

16. Average earnings index

[Year on year growth 10.2 per cent in April compared with 11.0 per cent in March. Underlying unpublished increase also around 10¼ per cent.]

Encouraging that underlying rate of growth continues to fall. But must remember change over the 12 months to March straddles two pay rounds - not entirely indicative of recent trends. Also, earnings index inflated recently by some increase in hours worked.

17. Latest pay figures mean living standards rising?

[Financial Times has pointed out that 10.2 per cent increase in average earnings in April exceeds 9.7 per cent TPI increase for that month.]

Must remember that 12 month earnings increase is still influenced by last pay round. But figures dispose of wilder claims about living standards.

18. Government exhortations on pay imply aiming to cut living standards?

[Although RPDI was 1 per cent higher in 1981 Q4 than in 1979 Q1, it is likely to fall below the 1979 Q1 level during 1982]

No. 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.

19. Index-linked pensions and Scott Report?

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

20. Incomes Policy

[SDP Green Paper "Towards Full Employment" (published 8 June) includes proposal for permanent incomes policy]

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

L BALANCE OF PAYMENTS

1. April trade figures?

[Figures published 25 June show current account in estimated £346 million surplus during April, following £331 million surplus during March. Exports increased £147 million (+3 per cent) due to higher oil exports. Imports rose £173 million (+4 per cent) due to higher imports of finished manufactured goods. Invisibles surplus projected at £150 million a month.]

Current account continues in substantial surplus, with exports holding up well, particularly in oil and chemicals.

2. Non-oil export trends gloomy?

[Oil exports rose by £200 million to £419 million; non-oil trade back in deficit after March surplus.]

Non-oil export volumes continue at level of 1981 Q4, which was 9 per cent higher than in 1981. Exports of chemicals continue to do particularly well, with volumes 5 per cent higher in three months to April. Overall, the underlying trend in export volume-which rose significantly in 1981-may now have started to rise again.

3. Imports?

[Imports 4 per cent increase in April mainly due to a rise in car imports and intermediate and capital goods.]

Imports of finished manufactured goods rose about £100 million; about half of this was an increase in capital goods imports. Total imports in the last three months (February-April) are £350 million lower than in the previous three.

4. Disappointing trend in invisibles contrary to expectations

[Figures published 8 June show Q1 current account surplus of £0.6 billion, a visible trade surplus of £0.2 billion but a reduced surplus on invisibles of £0.3 billion against the £1.4 billion projection published with February Trade figures].

It would be wrong to read too much into these figures, which need careful interpretation. About half the fall from the earlier projection results from a new seasonal adjustment to the figure for EC refunds. This will add the same amount to the figures over the rest of the year. Most of the rest reflects a substantial [around £500 million] change to the CSO's estimate of net interest profit and dividend payments from and to countries abroad. This is a very erratic item, subject to revision. Trade in services remains in large and growing surplus (£1043 million in Q1, up from £1006 million in Q4 1981).

[NB. If the comparison is with the revised figures for Q4 1981 our net payments to the EC increased in Q1, and there was a fall in net interest and dividend receipts. But in that comparison the seasonal adjustment point does not apply since the revised 1981 figures are also seasonally adjusted.]

5. Overseas investment reflects abolition of exchange controls?

[Mr Shore's speech 'The Scandal of Capital Outflows' Airdrie 13 June. UK private investment overseas put at £8 billion in 1980 and £11 billion in 1981 - figures including direct, portfolio and oil companies' investment.]

Higher overseas investment reflects variety of factors - high exchange rate in 1980 and early 1981 making overseas assets cheap; oil companies beginning to receive returns on massive North Sea investment and diversifying abroad; portfolio stock adjustment; and, generally, higher rates of return available abroad. Impact of abolition of exchange controls of direct investment uncertain - possible that it may have made both inward and outward investment more attractive, but figures do not suggest huge change in behaviour.

6. Overseas investment takes jobs away from UK?

30 per cent of UK exports are bought by overseas firms connected to UK companies. By increasing the links between UK and overseas companies, overseas investment helps UK exports and production producing more jobs. If the UK does not take profitable opportunities to invest overseas, others will.

M EXCHANGE RATE AND THE RESERVES

1. Policy towards the exchange rate/falling £?

[Since last autumn sterling has remained broadly stable. The average £ effective rate in Q1 1982 was over 10 per cent lower than in Q1 1981. Previous lows were $1.7470 on 6 April, DM 4.098 on 21 May. Highs were $1.97 on 30 November, DM 4.407 on 9 February. Rates at close on 25 June were $1.7215, DM 4.2891 and an effective of 91.13. Reserves at end May stood at $17.8 billion, compared with $18.2 billion at end April.]

The Government has no target for the exchange rate. The rate is taken into account in interpreting domestic monetary conditions and taking decisions on policy. Despite recent sharp fluctuations in the value of some currencies caused by strength of dollar, sterling's effective exchange rate has remained stable.

2. Bank of England intervening to support the rate?

Policy is unchanged. The Bank do intervene to smooth excessive fluctuations and preserve orderly markets particularly when conditions are unsettled. But as the Chancellor has already stated we have no target - undisclosed, secret or otherwise - for the exchange rate. Most recent reserves figures confirm that policy is unchanged.

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 to 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. Improve UK competitiveness by devaluing the exchange rate

Experience shows that exchange rate cannot be manipulated by Government against underlying market trends. Any attempt to lower it by intervention or by relaxing monetary control leads to higher inflation. For example although effective exchange rate depreciated by over a quarter between 1972 and 1976 competitiveness was unchanged, this remedy has been tried and it has failed.

5. Debt repayments

We have made excellent 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 end of 1981. This has been more than achieved - external debt is now around $13 billion, compared with over $22 billion when the Government took office.

6. French devalue to improve competitiveness

[At EMS realignment on 12 June the Deutschemark and Dutch guilder were revalued by 4.25 per cent; the French franc devalued by 5.75 per cent and the Italian lira devalued by 2.75 per cent]

EMS realignment conference on 12 June - at which the Chancellor assisted - adjusted exchange rates to allow for underlying market trends. The realignment - and accompanying measures taken - show that other European countries have the same priority as ourselves: to defeat inflation and so create the conditions for sustained economic growth.

N EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. 1982 Budget - Parliament/Commission dispute

An agreement between the Parliament and the Council which would form the basis for settling the 1982 budget (Parliament had adopted more than the Council agreed) was discussed at Foreign Affairs Council on 21/22 June-but no conclusion. It is hoped that a settlement might be reached by end of month. This would pave the way for withdrawal of the Council's court action against the Parliament.

2. UK budget settlement

Foreign Ministers agreed on 25 May to a settlement for the UK budget contribution for 1982. The settlement provides for a basic refund of £490 million ecus in respect of 1982, with provision for changes to this figure if our unadjusted net contribution varies from the Commission estimate of £880 million. It was also agreed that the problem for the longer term would be settled by the end of November.

3. UK objectives for longer-term negotiations?

Government has made it clear that, in spite of our relative economic position, UK is prepared to remain a net contributor - but only on a very modest scale.

4. Implementation of budget settlement -

This is still under discussion in Brussels. 25 May agreement envisaged partial rebates to Germany, Italy, Greece and Ireland for their share in financing UK refunds, making France bear a larger burden - but France will remain a substantial net recipient from the budget.

5. Remainder of Commission 'Mandate' report

The other member states broke the link between the different parts of the mandate report when they voted through the agricultural prices. But we are prepared to continue to work on the basis of previous agreements where applicable.

6. CAP prices 1982-83 and the Luxembourg Compromise

As Agriculture Minister made clear in his statement on 19 May, we consider the adoption of the 1982-83 CAP prices to have been wholly contrary to the Luxembourg Accords, which were in existence before we joined the Community and which have been observed for 16 years. This action raises serious constitutional issues. Only progress made in Foreign Affairs Council was an agreement about right to disagree. Council will return to the question later, but not to be raised explicitly at European Council. Practical effects may be felt in discussion of OECD export credit consensus, which will be raised at European Council. (see 15 on page N3)

7. UK refunds in respect of 1981

Commission paid us before 31 March £813 million for supplementary measures as first instalment of our refunds in respect of 1981. This represents 81 per cent of our entitlement for that year. Our net contribution for 1981-82 is now put at some £200 million - very substantially less than it would have been without the 30 May 1980 budget agreement.

8. UK a net recipient in 1981?

In fact we remained a small net contributor to the allocated Community budget. We also, of course, contribute to aid etc. which is part of the unallocated budget. Very satisfactory that the outturn was better than expected: for we remain one of the less prosperous member states.

9. Will UK have to repay or forego refunds if net contribution less than originally estimated?

No. The UK is clear that minimum net refunds payable under 30 May agreement are 1175 million ecus (European Currency Units) for 1980 and 1410 million ecus for 1981.

10. 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.

11. Policy for CAP reform

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

12. Costs of CAP to UK consumers

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

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

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.

14. Join the EMS for exchange rate stability?

There is no reason to suppose that by the simple act of joining the EMS exchange rate mechanism we would guarantee exchange rate stability. This has not been the experience of the current participants. Genuine stability requires a return to low inflation rates throughout the Community.

15 Progress on Export Credit Consensus negotiations

[Failure could result in export credit subsidy war : The Times 24 June]

In October 1981 the participants at the OECD-sponsored Consensus reached an interim agreement on the new terms to be applicable for export credits. These terms were to be effective until 15 May 1982. A new agreement has not yet been concluded. Second set of compromise proposals are to be discussed again at EC Council of Ministers on 30 June.

P INDUSTRY

1. Prospects for industry-recovery?

See A[ ] and B[ ].

2. SDP policy for industry?

/Emphasis on partnership and co-ordination ,with thrust applied by bringing industrial policy into PM's Office. Main role for unions in NEDO context. Additional £1,100 million would be committed : £750million cheap credit ,£300 million British Technology Group, £150 million small businesses./

Few signs of completely fresh thinking;reasonable to suspect that changes in machinery would be largely cosmetic. Costs would presumably be taken in an increased PSBR.

3. Companies financial position?

[~~Non-oil~~ Industrial and commercial companies (ICC's) gross trading profits (net of stock appreciation), ICC's real rate of return just 2½ per cent in 1981. ICC's finances showed some weakening in 4Q reflecting slowdown in destocking and unwinding of civil service dispute, but finances better in 1981 as a whole -

£bn

	1979	1980	1981 Year	H1	H2
Net borrowing requirement (+)/repayments (-)	+6.1	+5.7	+4.4	-1.2	+5.6
Financial surplus (+)/deficit (-)	-2.7	- 1½	+1.2	+1.5	-0.3

Some apparent deterioration in financial position reflects slowdown in rate of destocking, and effects of unwinding of civil service dispute (which delayed companies' tax payments), but companies' finances much healthier in 1981 than in two previous years. Company liquidity improved considerably in first three months of 1982 [new DOI Survey figures published 4 June].

/ rose by about a quarter between H1 and H2 1981; little changed between Q4 1981 and Q1 1982. But rise from a very low base -

4. Rate of return still too low?

[Real pre-tax rate of return of ICCs was 2½ per cent in 1981 - half the previous lowest figure in 1975.]

Yes, but Government can only help in limited ways. Fundamental improvement in ICC's profits and real rates of return depend on improved performance by companies, both management and employees. Much encouraged by recent productivity gains and trend towards moderate pay settlements.

5. 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.]

Budget measures have eased pressure on interest rates, and the recent ½ per cent fall in the banks' base rates is encouraging. But 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. Continuing relatively high level of 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 J).

6. Government help for small firms

Budget provided further help for small businesses, increasing the number of measures taken so far to over ninety. Enterprise package included further reduction in weight of corporation tax; further increases in VAT registration limits; increase in global amount available for loans under Loan Guarantee Scheme (see below); and doubling of investment limit under Business Start-Up Scheme to £20,000 a year. New measures will encourage start-ups and existing firms.

7. Response to Loan Guarantee Scheme?

Scheme operating successfully. We have already issued more than 4,440 guarantees - about half to new businesses. Total lending under scheme is just over £149 million. Budget provided for the lending ceiling - in year to May 1982 - to be raised from £100 million to £150 million. Further £150 million available in year to May 1983. Three more banks admitted to scheme in April making total of thirty financial institutions now participating.

8. High failure rate under Loan Guarantee Scheme expensive for Government?

Too early to assess overall cost of scheme. After first year of the 4000 guarantees issued, 45 have been 'called'. Cost has been more than covered by the premium income received over the period.

9 Government thinking again about Loan Guarantee Scheme?

[Article in FT 24 May]

Scheme under continuous review.

10. Enterprise zones: response from private sector?

All eleven zones now in operation. 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.

R NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83 and future years?

Nationalised industries' total external finance increased by £1.3 billion in 1982-83 (£1.2 billion after allowing for NIS cut and other changes). Increase in 1982-83 was roughly half what the industries bid for. Government has given full recognition to problems faced by the industries in a period of recession.

INVESTMENT

2. Investment plans unlikely to be attained?

No Government can unconditionally guarantee a level of investment by the nationalised industries. Approved levels set out in last White Paper (Cmnd 8494) are consistent with the industries' agreed external financing requirements, on the basis of their internal resource forecasts. But perfectly possible that plans might need to be revised, for example if the industries fail to restrain their current costs, including pay.

3. But shortfall in capital spending 1981-82?

[Figures in FSBR imply shortfall of £¾ billion, latest estimates suggest that this may be nearer £1 billion.]

Not easy to establish firm reasons after the event. Such evidence as we have suggests a mixture of reasons. Most important has been cut in investment in response to changed circumstances such as lower market demand. These cuts have been extraneous and have not borne any direct relationship to EFL pressures. Other cuts have been for wholly beneficial reasons, such as lower than expected inflation and cost savings.

4. Take nationalised industry investment out of PSBR?

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

5. Private finance for NI investment?

We have indicated our willingness to consider new financing proposals, provided they can be structured so as to induce improvements in efficiency at least sufficient to offset the extra cost, and provided the finance is raised in fair competition with the private sector.

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

Yes. As in private sector, moderate pay settlements and control of other costs are essential. Ability to finance new investment in nationalised industries bound to diminish if excessive pay settlements agreed. Each 1 per cent off wages saves about £140 million this year; and each 1 per cent off total costs saves £330 million this year.

NATIONALISED INDUSTRY PAY AND PRICES

7. Nationalised industries' prices

[Having risen approximately in line with retail prices for several months, the May figures again showed nationalised industry domestic prices increasing more rapidly than the RPI, by 14.0 per cent for NI against 9.5 per cent for all items RPI over the 12 months to mid-May. The restoration of this differential was expected, and reflects March increase in London Transport fares and ending of electricity industry's rebates to consumers. The removal of these temporary distortions confirms that nationalised industry prices are still increasing somewhat faster than the RPI, largely because of increases in the energy sector. In May average gas and electricity charges were higher but average charges for telephone calls fell slightly following some price adjustments.]

Gap between nationalised industry price increases and RPI has been due in large measure to cumulative effect of years of artifical price restraint. World oil price rises of 1979 and 1980 have also played an important part. We greatly regret the need for these increases, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so, but sustained improvement will only be possible if the industries succeed in holding down their current costs, particularly pay.

PRIVATISATION

8. What further sales expected?

Special sales of assets in 1982-83 forecast at around £700 million and around £600 million in each of the later years. These figures well above those in last White Paper. This reflects primarily very large sales of energy assets - Britoil and the British Gas Corporation's major offshore oil assets - to be made possible by Oil and Gas (Enterprise) Bill currently before the House.

9. Special asset sales in 1981-82

Gross sales in 1981-82 totalled £481 million, so target published in 1981 Public Expenditure White Paper of £500 million nearly met. Pleasing result - included two large sales - Cable and Wireless (£182 million) and Amersham International (£64 million).

10. But what about net figure?

Delivery of BNOC oil in 1981-82 paid for in 1980-81 and taken into account in special disposals figure for that year reduced 1981-82 receipts by £573 million to total of -£92 million. But it is the gross figure which is the true measure of success of Government's privatisation programme.

11. Government has sold assets too cheap?

[Heavy oversubscription for British Aerospace, Cable and Wireless, Amersham International, followed by large increases in prices when shares first traded.]

Not in Government's interest to see shares underpriced, given the loss to the PSBR, but also risks in pitching price too high. Getting balance right not easy - especially when company's shares have not previously been traded. Government will continue to consider alternative forms of sale eg tender, but critics should note that sale by tender could make it harder for small investor to buy shares.

S NORTH SEA AND UK ECONOMY

1. Impact of $2.50/barrel rise in North Sea oil price on Government revenues?

[$2.50/barrel rise from 1 June agreed with oil companies.]

Treasury estimate that a sustained $1/barrel rise in the North Sea oil price, all other things being equal, would directly raise Government North Sea revenues by about £350 million in a full financial year.

2. Onerous tax system damaging future field developments?

[Shell/ESSO announcement plans for Tern shelved partly because of tax system; reports that Phillips are postponing T-block complex and BP their Andrew field].

Other adverse factors - falling oil prices; high development costs - much more important. Detailed study showed that under new tax structure, levels of profitability should still be sufficient to make exploratio and development attractive. Hope that new structure will provide more secure and stable tax regime.

3. Chancellor's oil taxation package announced 9 June

[Summary: No field to pay APRT for more than 5 years; APRT repaid after 5 years if not set off against PRT; APRT allowed as a deduction in computing payback; further proposals to smooth PRT payments in second half of 1983; cost £55 million 1982-84]

Following Budget proposals, industry expressed concern on a number of specific matters; we have decided that some mitigation of the burden for less profitable, more marginal fields is appropriate to meet particular problems. The tax system introduced in the Budget, plus these changes, should enable the nation to get its fair share from the profits of this national asset, while leaving plenty of incentive to continue developing it.

4. Government should do more to stimulate UK Continental Shelf oil production in 1990's?

[Select Committee on Energy's Report on depletion policy published 18 May: recommends reserve powers to impose production cuts but main emphasis on promoting development of fields to come into production in 1990s - increase pace of licensing rounds and overhaul fiscal regime].

Government's considered reply will be given in due course. Accept need to prolong high levels of UKCS production until end of century at least. Energy Secretary announced 17 May Government's plans for Eighth Round of licensing. Do not accept that fiscal regime makes North Sea development unattractive. On Committee's general proposal for overhaul of regime, would point out that industry does not want a structural upheaval: it would create serious uncertainty and major transitional problems.

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

[FSBR projections (in money of the day) of Government revenues from North Sea: £6.4 billion in 1981-82, £6.2 billion in 1982-83, £6.1 billion in 1983-84, and £8.0 billion in 1984-85. Lower than last year's projections, principally because of downward revision to oil price expectations. Projections incorporate March fall to $31 a barrel for Forties oil. Contribution of North Sea to GNP estimated at 4 per cent of GNP in 1981. Not projected to rise before 1985.]

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 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. Less than 6 per cent of total General Government receipts in 1981-82.

6. Is the Government underestimating North Sea revenues?

[Stockbrokers Scott Goff Hancock reported to be estimating Government revenues of £7.4 - £8.1bn in 1982-83, compared with FSBR estimate of £6.2bn]

No. Other estimates of Government revenues based on assumptions that seem over-optimistic eg on future production.

7. 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.

8. Are we really any better off for our North Sea oil?

We are better off with oil - at current oil prices - than we would have been without it. We have been spared the fall in real national income that other industrial countries have suffered following oil price rises. But North Sea oil is costly to produce, so we are not necessarily any better off than we would have been had oil prices not risen. No need therefore for the possession of oil to require a contraction in our industrial base.

/ continued

9. Taxation of Petrochemical feedstocks

[Government has announced that new rules on valuation of ethane for petrochemical use in interaffiliate transfers (Finance Bill Clause 119) should be extended to mixed streams of gas with a large ethane component. ICI complain that the extension and the new rules themselve give unfair advantage to their integrated oil company competitors.]

Government convinced that new formula will give fair valuation. New valuation will not have effect of providing subsidy to ICI's competitors. Will do best to reassure ICI. Inland Revenue officials to have further consultations with ICI about the changes.

T WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Why don't major industrial countries together lead revival of Western economy?

Road to revival lies through combating inflation. Remarkable unity at Versailles Summit, at OECD Finance Ministers meeting and at Interim Committee of International Monetary Fund - on which smaller industrialised and developing countries sit - that reduction in inflation must precede sustained revival. IMF's Interim Committee agreed "combating inflation is a necessary step for resumption of sustainable growth at a satisfactory pace". Most Summit partners have made good progress reducing inflation.

2. Versailles summit: international monetary undertaking

Major countries explicitly accepted "joint responsibility to work for greater stability in world monetary system". Could be significant step towards greater stability if five countries whose currencies make up SDR basket preserve value of their own individual currencies by reducing inflation at home. UK and France still some way to go in that respect.

3. French and Italian devaluations?

[French franc devalued by 10 per cent and Italian lira devalued 7 per cent against Deutschemark on 12 June. Sixth and biggest revaluation in EMS's 3½ year history. Simultaneously French government announced package of austerity measures including 4 month prices and wages freeze (to reduce inflation to single figures), increases in social security and unemployment contributions and limit to budget deficit of 3 per cent of GNP in 1982]

Second EMS realignment this year was necessary because French and Italian inflation rates considerably above those of European partners. Strength and stability of Western economies as a whole will benefit if France and Italy can control inflation. So we welcome French government's recognition that inflation is as serious a threat as unemployment and that reining in public sector borrowing is essential part of counter-inflation strategy. (See also M6.)

4. French government 'seen the light' over reflationary policies? / OR French prices and incomes policy more humane than massive deflation?

Have seen that prices and incomes policies don't work in this country; nor is international experience encouraging. Our experience shows long term inflationary expectations not dented by policies lasting few months or even year or two; inflation always bounces back afterwards. French government not relying on prices and incomes policy alone but intend to curb Budget deficit and restrain growth of money supply.

5. Anti-inflation policies are working

2½/ [Inflation down from a year ago in 6 of major 7 economies - significantly down in US (from 10 to 6½ per cent), Japan (5 to ~~3~~), Italy (20 to 15) and UK (11½ to 9½). Small reductions in Germany (to 5 per cent) and Canada (to 11½), but increase in France (from 12½ to 14).]

Yes. Firm fiscal and monetary responses to 1979-80 vindicated by events. UK still some way to go to match US, Germany or Japan in bringing down inflation, but moving in right direction and ahead of some other European countries. Realism in wage settlements is growing, US, Germany, Japan and UK all have wage settlements in single figures. Other policies also working: oil savings have helped cut OECD oil demand. All point towards basis for sustainable recovery.

6. 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.

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

No. Treasury and most independent forecasters expect UK growth this year of about 1½ per cent rising to an annual rate of 2 per cent by early next year. This is very closely in line with the OECD's forecast for OECD Europe. 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.

8. Prospects for US economy?

[Preliminary Department of Commerce estimate of GNP in US showed slight rise in Q2, indicating recession has probably bottomed, although industrial production fell in April and May. Seasonally adjusted unemployment 9½ per cent. M1 significantly above target range half way through year. Year on year rate of consumer price inflation down from 11 per cent in September 1981 to 6.7 per cent in May.]

Welcome signs that US recession may have ended. US has made good progress in reducing inflation. Some signs now of activity recovering, with housing starts and retail sales rising in May.

9. US budget?

[One day after Congress agreed on budget deficit of $ 104 billion, Congressional Budget Office revised its economic and technical a assumptions and re-estimated Congress's proposed FY deficit at $ 116½ billion. Congress's decision is not legally binding; outline agreement has now to be translated into detailed budget by Congressional committees.]

Welcome outline agreement on budget by both Houses of Congress. Hope Congress will soon reach agreement on details of budget for FY 83, as uncertainty about budget is probably an important factor adding to pressure on US interest rates.

10. US interest rate developments

[Prime rates still 16½ per cent, 3-month CD's stayed at 15½ per cent]

True US interest rates rose recently. But prime rates well below peak of 21½ per cent last summer. Agreement on details of budget would improve prospects for lower interest rates.

11. Prospects for international interest rates?

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

12. OECD see bleak prospects for UK economy?

[Report in The Times 24 May]

Latest OECD forecast ('Economic Outlook') published in December; next not due to be published until 7 July.

13. Economic forecasts by EC leaked to Press ?

[Details from Commission's forecast prepared for European Council leaked to Reuters and FT 25 June]

Commission provided background paper to aid discussion by European Council this week. Forecast showed Community's average inflation rate declining to single figures next year, and average GDP growth recovering to 2½ per cent.

U FALKLANDS CRISIS EFFECTS/COSTS

1. UK economy affected by Falklands crisis?

Possible economic consequences cannot of course be ignored. But UK is basically in a strong financial position: inflation is coming down; interest rates on downward trend; balance of payments remains healthy; output is higher than a year ago. Disturbance due to Falklands dispute small in relation to overall macro-economic picture. No question of requiring any change in basic economic strategy.

2. Effect of Falklands dispute on markets?

[Exchange rate strong; domestic interest rates now ¾ per cent lower than before crisis began]

Despite a few uncertain days, the markets have come through the crisis well, reflecting confidence in government handling of crisis, and in economic policies. Too early to say what long term effects will be, but Government determined not to be deflected from its path.

3. Will dispute with Argentina affect UK trade figures?

Volume of UK-Argentine trade negligible (£20 million a month on either side).

4. Will freeze on Argentine assets affect standing of City?

We have not confiscated Argentine's assets, merely frozen them. This action was taken under extraordinary provocation; we believe international financial community will understand this.

5. Effect of restrictions on Argentina?

The crisis and our action will greatly reduce Argentina's capacity to raise loans on the international markets. A number of Argentine public foreign borrowing operations amounting to many hundreds of $million have been suspended since crisis began.

6. Future of restrictions?

European Community have ended their measures; UK's remain in place. Waiting for cessation of hostilities to be confirmed. Must also take into account Argentina's restrictions against UK.

Lifting of EC import ban (effective from 22 June) does not affect UK's own economic measures (separately imposed under article 224 of Rome Treaty). Specifically agreed by the 10 Foreign Ministers that EC sanctions would immediately be re-instated if there were further acts of force in the South Atlantic.

7. Argentina's debts

[NOT FOR USE: Argentine foreign debt at end 1981 estimated at $34 billion - about half size of Mexico's or Brazil's.]

Sign of times that Argentine military aggression should create instability in global capital markets. All more important to negotiate settlement quickly and to discourage similar acts in future. [IF PRESSED on debt default possibility: banks have taken fairly relaxed atttude because ultimately overseas debt must be repaid by exports; Argentina's export sector is agriculture, which, according to most experts, is fundamentally healthy.]

8. How much has operation cost so far?

[No official statement has been made so far - despite Press reports and media guesses.]

It is not possible to give an accurate assessment of the costs so far. They have been and are being incurred thousands of miles away; and of course the task force is still operating in the South Atlantic. It is however clear that the costs represent a small proportion of total public expenditure.

9. How will the costs be met?

Costs of the Falklands campaign, including cost of replacing lost equipment, and any future garrison costs, will be met by the Government out of monies additional to the 3 per cent annual rate of real growth already reflected in sums currently provided for defence. The extra costs, when known, will nevertheless be financed in ways consistent with the Government's economic strategy. They will be met in a non-inflationary way. It should be borne in mind there is a substantial Contingency Reserve of £2,400 million in 1982-83.

10. What about costs of reconstruct~~ur~~ing the islands' econom~~ic~~y and repairing damage?

Too soon to say what these costs will be. Work has begun on restoration of essential services. Civil Commissioner is examining what further assistance is necessary.

AIDE MEMOIRE ON THE UK ECONOMY 25 June 1982

RECENT DEVELOPMENTS AND INDICATORS

(i) Activity. GDP fell by 6 per cent between 1979 H2 (last cyclical peak) and 1981 Q2 (trough of current recession), rose about 1 per cent between 1981 Q2 and 1981 4Q then declined by ¼ per cent in 1982 Q1. Weakening at turn of year in part reflects impact of severe weather and strikes, but underlying level of output broadly flat in 6 months to March 1982; above levels of last spring. Most independent forecasts, business opinion surveys, and CSO's cyclical indicators expect resumed and continued recovery.

Volume of new engineering and construction orders in 1981 up 15 and 11 per cent on 2H 1980. Private housing starts up over one third in same period. Total housing starts in 4 months to April 1982 up two-fifths on 1981 average.

Recovery in 1981 largely reflected sharp fall in rate of destocking. Consumers' expenditure and Government consumption broadly flat. Fixed investment broadly flat in 1981, up 4 per cent between 1981 Q4 and 1982 Q1 ~~in 1982 Q1~~; DOI investment intentions survey suggests rise of 2 per cent in MDS fixed investment in 1982.

(ii) Lack of complete trade figures for 1981 and changed documentation procedures make recent figures difficult to interpret. Exports have held up better than many had feared. In 8 months to April non-oil exports slightly (about ½ per cent) higher than in 1980. Non oil imports have risen - up 12 per cent in same period - in part reflecting reduced rate of destocking and higher output. Current account estimated to be in surplus of £1 billion in first four months of 1982 following £7 billion surplus in 1981.

(iii) Employment and unemployment. UK employment fell 2.1 million (9 per cent) between 2Q 1979 and 4Q 1981 (about two-thirds concentrated in manufacturing), though rate of decline has slowed down. UK adult unemployment risen by 1.7 million (less than fall in employment) and stood at 2.91 million (12.2 per cent) in May. Total unemployment (including school leavers) was 3.06 million (12.8 per cent). Underlying rate of increase in unemployment slowed sharply during 1981 (105,000 per month in 4Q 1980 cf 25,000 per month in H1 1982). Other labour market indicators improved during 1981; eg short-time working down by ¾ during 1981, overtime up by over 10 per cent during 1981, and vacancies - despite slight weakening since February - up by 1/5 in 2Q 1982 on 2Q 1981, and with more rapid turnover. Little or no further improvement in unemployment or other labour market indicators since turn of year.

(iv) Wages and prices. Increase in earnings in 1980-81 pay round 11 per cent (settlements averaged about 9 per cent), half that of previous pay round. Settlements well inside single figures are now widespread (CBI average for manufacturing 7 per cent) suggesting further moderation in current pay round. 12-monthly increase in RPI 9.5 per cent in May; well inside single figures. Recent progress suggests outturn to November this year could well be within Budget time forecast of 9 per cent. Manufacturers' input prices now no higher than last August; in 12 months to May they rose just 4¾ per cent. Corresponding rise in manufacturers' output prices 8¾ per cent.

(v) Productivity and Competitiveness (manufacturing). Output per man risen 12 per cent since end-1980. Output per man and output per man hour 5 and 8 per cent respectively higher than previous cyclical peak (1H 1979). Together with pay moderation, resulted in little increase in unit wage and salary costs during 1981 - rise of less than 3 per cent in year to 1Q 1982 - a rate below average of our competitors and comparable to Germany and Japan. Competitiveness (relative normalised unit labour costs) improved by 10-15 per cent during 1981, but remains about 1/3 worse than in 1975.

(vi) Company finances. Gross trading profits of ICCs (net of stock appreciation) rose by about one quarter between 1H and 2H 1981, little changed between 4Q 1981 and 1Q 1982. But real pre tax rate of return just 2½ per cent in 1981. Despite rise in company borrowing and deterioration in liquidity in 4Q 1982 (largely reflecting reduced sale of destocking and unwinding of civil service dispute which delayed companies' tax payments), company finances healthier in 1981 as a whole than in 1979 and 1980. Company liquidity improved in 1Q 1982.

(vii) Monetary aggregates. £M3 grew at an annual rate of 13 per cent in 1981-82 target period (from mid-February 1981 to mid-April 1982) compared with target range of 6-10 per cent. At least part of excess reflected increased market share of banks in mortgage lending. Over the same period, M1 and PSL2 grew at rates of 7 and 12 per cent per annum respectively. In recent months monetary aggregates have grown more slowly; in first 3 months of 1982-83 target period developing favourably in relation to 8-12 per cent target range.

(viii) Interest rate/exchange rates. Interest rates have fallen since turn of year; process temporarily interrupted by Falklands crisis, but now resumed. 3 month inter-bank rate fell from 16 per cent in December to 13 per cent early June. After falling over 10 per cent during spring and summer 1981, effective exchange rate broadly constant at around 90 since last August.

(ix) Government borrowing. Latest published (3 June) provisional estimate suggests PSBR £8.9 billion in 1981-82 (3½ per cent of GDP, compared with 5 3/4 per cent in 1980-81) about £1.7 billion lower than estimated at Budget time. CGBR £1.9 billion in April-May 1982 at time when central government borrowing usually largest.