SECRET

PART 14

PA MT

CONFIDENTIAL FILING

ECONOMIC STRATEGY

PAY AND PRICES MONTHLY ECONOMIC REPORT

THE ECONOMIC PROJECT

ECONOMIC

POLICY

Part 1: May 1949

Part 14: ~~Jan~~ Feb 1982

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HMT Weekly Brief 29/3

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Cabinet / Cabinet Committee Documents

Reference	Date
E(82) 20	26.2.82
E(82) 35	26.3.82

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed C Wayland   Date 16 August 2012

PREM Records Team

Econ Pol

CBT

Prime Minister

MCS 26/3

Econ Pol

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

26 March 1982

Michael Scholar, Esq.,
No.10 Downing Street

MS

Dear Richard,

You should be aware of the attached exchange of letters between the Chancellor and Mr. Jack Straw, MP. Central Office will release today the text of the Chancellor's letter. Our press people are forewarned, and you may wish to show the exchange to Bernard Ingham.

A copy of this letter, and the two texts, goes to David Heyhoe in the Lord President's Office.

Yours ever,

John Kerr.

J.O. KERR

Treasury Chambers. Parliament Street. SW1P 3AG
01-233 3000

26 March 1982

Jack Straw Esq MP
House of Commons
LONDON   SW1A 0AA

Dear Jack

Thank you for your letter of 22 March.

I was delighted to see that you have been studying my Budget speech and all the speeches which the Prime Minister and I made in the course of the 1979 General Election.

But I am surprised that you should have failed to note how often and emphatically we stressed before the Election that Britain's deeply rooted and long standing economic problems would not be instantly or easily solved. Many of the quotations which you list in your letter make precisely that point.

And I am puzzled at your apparent failure to find any mention of the need to sustain, over the life-time of more than one Parliament, the effort to reverse the national economic decline. You imply that, contrary to what I said on Budget Day, this was a startling new thought, only revealed after our 1979 election victory.

This is just not so. The 'Right Approach' - widely regarded at the time and since as the most important statement of our policies in Opposition - was published as long ago as October 1976. It said:

> "... it is sustained recovery that is needed. For the troubles of our economy are by now long-standing and deep seated. To make the structural changes that are necessary to restore the dynamic of a mixed economy will need a settled approach over a long, hard haul. It is idle to talk, as so often before, of an economic miracle that is round the corner. The foundations of economic health will not be relaid in less than a decade. Our best hope is to start this difficult task sooner rather than later."

That "decade" began in May 1979.

/I myself believe

I myself believe that our willingness to tell the electorate the truth about this country's long-term difficulties, and our declared determination to tackle these difficulties vigorously and over a sustained period, were a key factor in the last Election, and will be no less important in the next one. I cannot recall from the Labour Party, in Government or more recently in Opposition, an equally thorough diagnosis or as straightforward a prescription.

Since you released your letter to the press, I shall similarly release this reply.

Yours —

Geoffrey

GEOFFREY HOWE

Seen

Prime Minister.

Econ.Pol

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D.F.T. [illegible]
23/3/82.

Qa 05869

23 March 1982

To: PRIME MINISTER

From: J R IBBS

1. Before I see you on Wednesday it may be helpful if I provide a few observations that occur to me in the light of my two years as Head of the CPRS. I look at all these items against the Government objectives which I have summarised before, namely -

(i) to create a vigorous and healthy free market economy;

(ii) to create a society in which individuals are free and encouraged to make economic and other decisions for themselves while those most in need are protected;

(iii) to improve defence and law and order;

(iv) to obtain re-election for a further period of office in order to attain these objectives within ten years.

Economic Policy

2. It is certain that economic policy, together with the worldwide recession, has succeeded in bringing home the need to be competitive; there has been improvement not only in behaviour but also in attitudes, especially in the private sector. Managers are more determined in pursuit of efficiency; many workers have better understanding of economic realities. But belief in the existence of an easier way out persists, especially among trade unionists. Wishful thinking is difficult to change and it is hard to appear both realistic and simultaneously properly concerned about social aspects. Sensitive and effective handling of the economic message is therefore very important.

Public Sector Disputes on Pay and Productivity

3. Many parts of the public sector lag behind in improving productivity and in appreciation of economic realities, as the current trouble with ASLEF demonstrates. I am convinced it is right for Government to avoid direct involvement in such disputes. But when a major battle occurs on pay or productivity it is very important to the Government that the management should prevail. Success will only come if the issue and timing are carefully selected and if the dispute is skilfully handled. At present the competence of some Nationalised Industries' Boards on this is questionable; and in this context the relationship with Sponsor Departments is also shaky. The handling of disputes must remain with the Boards, although at some point Government influence may be needed. I believe that, as these industrial relations issues which are central to the success of policy develop, it is important that in addition to the advice available from the normal Government machine you should have access to further well-informed and experienced views of the kind I have tried to provide from the CPRS.

The Miners

4. I continue to be apprehensive about future pay and other demands by the miners. High coal stocks will mean that a strike could be withstood for longer and to that extent the management can be rather more confident when bargaining. But miners with a strong sense of grievance would have the will to remain on strike for a greater period than is offered by any practical level of stock envisaged at present. In the forseeable future it will never be safe simply to assume a confrontation can be "won". On any particular issue the first key judgement is whether it is one on which they would be willing to come out and stay out. Its nature and the extent to which they feel threatened will greatly influence their behaviour, and it is hard to judge how much their increasing affluence may have weakened the resolve they showed in 1926 or in the 1970s. I should like to emphasise the importance of planning ahead to next November (and to later negotiations), of not alienating moderate opinion among the miners, and of avoiding confrontation on weak ground of Scargill's choosing.

The Desirability of Soundly Based Expansion

5. For the economy the point has now been reached where it is important to avoid conflict between the need for continuing improvement in competitiveness (which is essential) and the need to get some soundly based expansion which will benefit employment, social and political objectives. The CPRS Study on Unemployment aims to establish how the labour market can be made in practice to work better, including the lessons from Professor Minford's work, and what other steps could reduce unemployment without undermining the basic improvements in efficiency. I am convinced that entrepreneurship and innovation (which depend heavily on medium term confidence) are still less vigorous in this country than they need to be. This warrants special attention and goes beyond encouraging small businesses, on which a great deal has been done. The morale of manufacturing and service industry seems to me immensely important in achieving the objective of a vigorous and healthy free market economy.

Education and Training

6. The CPRS has repeatedly become involved in the question of education and training. The overall system in this country is not providing the attitudes and skills required to achieve a high productivity, high wage economy. More fundamental changes are needed than have so far been proposed, and this may well entail some infringement of what teachers have tended to regard as their prerogative. Quite apart from the needs of industry, the schools are a key area in which the attitudes needed for a healthy society are formed. Education and training is a subject on which I hope the CPRS will be able to provide some helpful long term thinking.

The Conurbations

7. Some of the main problems currently facing the Government are unemployment, industrial weakness, urban transport, inadequate education, and crime. These all tend to be concentrated in their most acute form in the older conurbations. These areas, where local government too has the greatest challenge but often appears least able to cope, are the testing point for some key policies. Perhaps a valuable insight will emerge from Merseyside. If not, further systematic study will be needed

both on how to sharpen the effectiveness of policies and how to co-ordinate them and govern the areas. This is potentially a subject to which the CPRS should return, and on which its current work on central/local government is relevant.

Public Sector Management

8. There is a need for some fundamental rethinking on how to manage the big bureaucracies, namely the Nationalised Industries, the Health Service, the Civil Service, and local authority education and other services. Most suffer from an inadequate awareness of the needs of their consumers, and an absence of market forces; furthermore they have a sense of impregnability. With all of them Government is in effect into 'business' in a big way. But most Ministers and civil servants lack the management experience and skills to keep these enormous concerns moving in the direction of steady improvement. I am sure there is a need to press very strongly for greater management experience and skill in Departments generally.

The Nationalised Industries

9. Within the public sector I have been considerably involved with the nationalised industries. For them the greatest need is to secure top management of the highest quality. (There is no more important example than the next Chairman for the National Coal Board.) If a good Chairman of an industry is given reasonably clear objectives I remain convinced that in most instances much can be achieved. But the jobs have got to be made sufficiently attractive to command the best people, and obviously the catchment area should not always be limited to this country. Quality of management is the prime need and excessive intervention must be avoided. However, there are other helpful things that can be done and I believe that persistence in carrying through the recommendations in the CPRS Report on Nationalised Industries will pay off. I attach particular importance to increasing the amount of broadly based business experience in Departments.

Japan

10. So long as the main trading nations were broadly evenly balanced,

each having a share of various types of resources and trading by roughly the same rules, fairly untrammelled free trade suited this country well. But Japan (and newly industrialised countries) pose a new threat if they pursue deliberate policies of taking established markets before we have the resilience or guile to counter them effectively, or the innovative strength to have secured our own position through new specialisms. There is a need to work out both how to resist them and whether we can learn from their skill in successfully focussing their resources. (They appear to be able to do this without making serious errors of choice or undermining the basic strength of their market economy.)

The Need for Long Term Strategies

11. Many of the problems in this short review appear rather intractable and this is partly because quick solutions are usually hoped for. Gradual progress through persistence may be the only way forward on some and this demands clear long term strategies. For this reason I believe there are opportunities for some useful long term thinking by the CPRS. The items you have included in our 1982 Work Programme, such as unemployment and the power of the state monopolies, are good examples. More long term thinking on some of the other problems would fit well with the review of public expenditure up to 1990 which the Chancellor has recently initiated.

The CPRS

12. A current problem for the CPRS is the high demand for its services. This is obviously good and indicates that its work is valued. But it means careful selection, particularly if space is to be found for longer term studies. I believe the credibility of the CPRS depends on its awareness of major current policy issues and its ability to make a constructive contribution on some of these. It is unique in its blending of outside experience in the Government machine. I therefore see a need for it to continue to bring earthy experience to even its longer term studies. But above all your support and interest in its work is crucial.

13. I am sending a copy of this minute to Sir Robert Armstrong.

Ryton regional job pack
must be destroyed

Lord Selsdon

Coals

George Turnbull.

Industrial People

L5 Nb

PPS/CHANCELLOR

file no TEB/CA/01

copied to:

Mr Salveson (for transmission to No.10)
PS/CST
PS/FST
PS/MST(C)
PS/MST(L)
PS/Home Secretary
PS/Lord Chancellor
PS/Foreign Secretary
PS/Secretary of State for Education and Science
PS/Lord President of the Council
PS/Secretary of State for Northern Ireland
PS/Secretary of State for Defence
PS/Minister of Agriculture, Fisheries and Food
PS/Secretary of State for Environment
PS/Secretary of State for Scotland
PS/Secretary of State for Wales
PS/Lord Privy Seal
PS/Secretary of State for Industry
PS/Secretary of State for Social Services
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 ECONOMIC BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 15 March, are sidelined.

M M Deyes

M M DEYES

RIA

R I G ALLEN
22 March 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. Relative importance given to inflation and unemployment?

Government is concerned about both. These are complementary not competing objectives; unemployment important economic and social problem. But will not be reduced by relaxing struggle against inflation.

3. Effect of falling oil prices?

Very welcome: in some ways like a cut in indirect taxes or NIS supporting recovery and lower inflation. Does reduce room for manoeuvre through fall in Government revenues, but also need for tax reductions. [IF PRESSED on fiscal implications of continued oil price falls: would be of substantial future benefit to inflation and output. As Chancellor said in Budget Speech, wholly irresponsible to rule out possibility of action to adjust fiscal balance.] (See also Section R).

4. Contribution made by 9 March Budget?

Budget continues 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. Tax cuts and other measures designed to help both business and individuals, within responsible fiscal framework.

5. Reflationary/deflationary/effect on demand?

Oversimple questions. Wrong to talk about what government is 'putting into' or 'taking out' of economy. Ignores links between fiscal and monetary policy and their effects through financial behaviour (interest rates and exchange rate), on economy. Budget's overall effect is to support sustainable recovery.

6. Effects of Budget and December announcements together?

[December announcement provided for £5 billion increase in public expenditure plans for 1982-83 and increased NIC rates yielding £1 billion extra revenue. But total Government revenue in 1982-83 now expected to be some £3½ billion higher than at time of 1981 Budget. Taking account of all these changes, pre-Budget PSBR for 1982-83 about £8¼ billion; post-Budget forecast about £9½ billion.]

No simple answer to this question. So much depends on base one starts from, and what counts as a policy change. Overall effect is reflected in PSBR for 1982-83 a little higher than planned in March 1981. But important thing is continuing decline in PSBR, with benefits for interest rates already apparent, plus substantial cuts in taxation.

7. Not enough help for industry?

Main help for industry is in pursuing policies that allow for lower inflation and ease pressure on interest rates. In addition, specific Budget measures aimed at industry and business will cost about £1 billion in 1982-83. Signs of recovery in profits and financial position of industrial and commercial companies. (See also Section N).

8. Does more for industry than for people?

Help to industry is help to people. Higher allowances and thresholds more than compensate for inflation in last year and make up some of ground lost last year. Many other smaller changes (eg on charities) will help particular groups of people.

9. Another Budget pushing up prices?

No. Changes in excise duties slightly less than required for full revalorisation. 12-monthly inflation rate now 11 per cent (February figure published 19 March) - down from 12 per cent in January. Further fall forecast to 9 per cent by November 1982.

10. Effect of Budget on personal incomes, incentives etc?

See Section D.

11. 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.

12. Monetarism dead?

'Monetarism' a much over-used, misused and misunderstood word. Have always maintained that success of strategy - lower inflation and establisment of conditions for sustained recovery - would require responsible attitude towards monetary growth, and Government borrowing and expenditure. That is how we have acted and will continue to do. [IF PRESSED on dogmatic pursuit of MTFS: Medium-term framework provides essential reference point for policy. Nonsense to suggest MTFS is being slavishly and dogmatically adhered to. Only right to take account of changing circumstances: that is what we have done. But such adjustments do not reflect any weakening in resolve to tackle inflation. Judged by results, policy is succeeding. Inflation has been reduced and is now coming down again.

13. If this is, as claimed, a Budget for output, and employment , how many jobs will it create?

Budget forecast shows continuation of recovery; but it is not the practice to publish estimates of the overall effects of the Budget, or its individual measures, on employment or output.

14. Not keeping to commitments to reduce expenditure?

Increases announced in Budget offset by reductions leaving totals still around £115 billion. FSBR shows declining ratio to GDP in future years. (See also Section E).

15. Armstrong/unified Budget?

[TSCS will be questioning Chancellor on this 5 April].

Proposals have wide implications. Need careful consideration. Government does take account of tax and expenditure when taking decisions on each. Await TCSC report with interest.

16. Labour Party's Plan for Jobs

[Ten-point plan launched 15 March: aims at reducing unemployment below 1 million within a Parliament; using increased Government expenditure, shorter working week, planned industrial strategy, annual national assessment, no formal incomes policy, new Price Commission, import controls and lower exchange rate, exchange controls on movement of capital plus withdrawal from EEC, more progressive taxation action to relieve poverty, end to arms race, increased aid to Third World.

Previous Government's policies did not prevent unemployment from rising to levels exceeding 1 million for three quarters of their term of office. Under social contract with last Labour Government RPI-measured inflation reached nearly 27 per cent and wage inflation over 30 per cent. Subsequent reduction followed by 'winter of discontent'. Withdrawal from EEC and control of imports would cause severe dislocation and inefficiencies.

17. Programmes 'run through Treasury model'

Use of Treasury model to try to quantify effects of Plan for Jobs (or any other suggested measures) does not of itself guarantee accuracy or confer credibility. Results depend on judgments and assumptions fed in more than 'pressing buttons'.

BULL POINTS As at 22.3.82 (Tape 455)

(i) Signs of recovery

- Total output (GDP) rose in both 3Q and 4Q 1981. Level in 4Q some 1 per cent above 2Q.
- Short time working in manufacturing fell in 1981 to below ¼ its January peak;
- 1981 figures show volume of engineering and construction orders up about 17 and 9 per cent respectively on 2H 1980.
- Private sector housing starts in 1981 up by 37 per cent on 2H 1980.
- Most recent major independent forecasts assess low point in activity reached in 1H 1981; prospect of some recovery in 1982.

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

(iii) Productivity. Output per head in manufacturing rose 10 per cent during 1981. Investment in plant and machinery holding up well.

(iv) Unit labour costs: Pay moderation and higher productivity has meant dramatically low increase in manufacturers unit wage costs over last year - just 2½ per cent in year to 4Q 1981.

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

(vi) Profits: Industrial and commercial companies gross trading profits (net of stock appreciation) rose strongly in 1981, up 28 per cent between 1Q and 4Q 1981.

(vii) Exports holding up well; non-oil export volumes in 4 months to December up 3½ per cent on 1980. 1981 figures (incomplete) show engineering export orders up 20 per cent on 2H 1980.

(vii) Unemployment. Rate of increase in unemployment since mid 1981 about half that in 1H and 1/3 that in 4Q 1980. Vacancies improving since mid 1981. Short-time working in manufacturing reduced by over ¾ during 1981 and overtime working has increased.

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

(x) Training. Over next 3 years £4 million to be provided to bring training schemes up to date. New Youth Training Scheme for school leavers to be introduced September 183 represents major step towards comprehensive provision for young people.

(xi) Industrial relations. Number of strikes in 1980 and 1981 less than in any year since 1941 and number of working days lost only a third of average of last ten years.

(xii) Retail prices. Inflation halved since peak in spring 1980 (21.9 per cent). 12 monthly increase in February of 11.0 per cent.

(xiii) Share Ownership Schemes: Number of schemes has increased from 30 in May 1979 to over 400. Number of employees covered roughly doubled between first and second years in office. Profit sharing schemes alone now cover some 270 thousand employees.

(xiv) Examples of export successes reported in the Press include: £160 million contract for construction of two new colleges in the largest ever such contract between Britain and Nigeria (Mitchell Cotts Group); approved tender for veterinary vaccines to Kampuchea (Hoechst UK); supply of 1000 special gearboxes to Istanbul within five weeks of order (Turner-Spicer Transmission); travelling hoists with exceptionally low headroom (550mm) for use in Danish oil and gas exploration platform in North Sea (Tonnes Force); a profiled metal cladding system for a power station in The Gambia (Ash and Lacy Steel); and glazing for the new Financial Complex in Port of Spain - the biggest ever such gained by a UK glass processor (Clark and Eaton with Pilkingtons). New British-designed, managed and partly funded, domestic water supply project in Jordan was opened by King Hussein on 18 February.

(xvii) UK preferred location: US electronics industry survey reports UK most preferred location for establishing new plants.

(xviii) Overseas debt repayments. Official external debt reduced from over $13.3 billion at end-1981.

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

B ECONOMIC ACTIVITY AND PROSPECTS

1. Recent position?

[Q4 1981 figures for GDP (income) and GDP (expenditure) published 22 March]

All three GDP measures were higher in real terms in Q4 1981 then had been earlier in year. GDP (output) in Q4 was nearly 1 per cent up on Q2 - the earlier low point.

[IF PRESSED on apparent weakening of recovery (based on November/December/January industrial production) - see 2 below.

2. Recent manufacturing production figures show resumed decline?

[January figures show further fall in industrial and manufacturing production, now 3 and 4 per cent respectively below October levels, with manufacturing production at lowest point since 1967].

Only to be expected that January's index would show some further weakening. Series of factors (car and rail strikes, bad weather, holidays) have distorted the last three months. Despite this, manufacturing output in Q4 1981 some 2-3 per cent higher than its low point earlier in the year (Q1 1981). Preliminary indications for February suggest a pick up, with steel and car output up 16 and 12 per cent respectively, compared with January.

3. CSO cyclical indicators system shows recovery faltering?

[Coincident indicator, after rising steadily from April to October of last year, has remained broadly unchanged between October and January]

Flattening of coincident indicator reflects effects of strikes and bad weather on industrial production (see 2 above), longer leading indicator has been rising strongly since October.

4. Other evidence of improvement in economy?

Engineering and construction orders and private sector housing starts all well up during 1981 on H2 1980. Productivity (output per head) in manufacturing rising strongly - up 10 per cent in Q3 1981 from Q4 1980. Exports doing well (see K4). (Labour market indicators - see C1).

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	1½	2
Manufacturing output	3	2
Consumers expenditure	½	½
Investment (private sector and public corporation)	4½	5
Exports	3½	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 (7½ per cent) by mid 1983. Further progress depends on continued moderation in domestic costs and restoration of competitiveness.

6. Outside forecasts

[GDP profile in recently released major forecasts:

	NIESR (Feb)	LBS (Feb)	CBI (Nov)	Phillips &Drew (Mar)	OECD (Dec)	FSBR (Mar)
Per cent change 1982 on 1981	+1½	+1½	+1	+1¾	+¾	+1½]

Most recent major independent forecasts assess that low point in activity was reached in first half of 1981, with prospect of some recovery in 1982. As always, a range, with Cambridge forecasts being the more pessimistic. Most outside forecasters have not yet published their post-Budget assessments. Only major forecasters who have (Phillips and Drew) revised their forecasts to show higher output and lower inflation arising from Budget measures and lower oil prices.

C LABOUR

1. Recent unemployment figures?

[March figures to be published Tuesday 23 March. Separate briefing will be supplied to No.10]

2. Effect of Budget on unemployment?

Budget contributes to Government strategy of fostering conditions for sustainable growth. Help to business will lay foundation for more real jobs. Employment will benefit from some further improvement in activity. Proposed new non-profit-making scheme will enable local authorities and voluntary sponsors to provide many new jobs. (100,000 at additional Exchequer cost of £150 million).

3. Unemployment expected to continue rising rapidly?

[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 others are broaddly flat (LBS, St James, P+D); only Liverpool foresee a fall (400,000)].

Unemployment forecasts uncertain; independent forecasters encompass differing views for 1983 - several projecting stabilisation, Liverpool some decline. Rise in unemployment drastically reduced since end 1980. Tentative evidence of further slowing down this year - January/February rise just ¼ than in Q4 1980. Vacancies, short time and overtime all improved last year. Employment situation will benefit from some further recovery in activity this year.

4. 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. Following well-established precedent of previous administrations is 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. PEWP figures consistent with the prospect of some fall in total unemployment before the end of 1982-83. They do not however necessarily imply this. If things go well - eg lower pay settlements, recovery in world trade - then reasonable to hope for fall in unemployment before end 1982-83.

5. Employment continuing to fall?

[Total employment declined 1.9 million or 8 per cent in 2 years to Sept 1981. Q3 figures indicate decline of 150,000 compared with 300,000 per quarter in H1 1981. Manufacturing employment declined by 34,000 a month in Q4, a little more than Q3.]

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

6. Unemployment higher than in other countries?

[On standardised definitions in 3Q 1981 UK employment was 11½ per cent compared with 6¾ per cent OECD rate; a UK doubling compared with an OECD rise of a third 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.

7. Higher Exchequer costs of unemployment. Recent Treasury estimates suppressed?

No 'right' figure. Estimates depend on assumptions and items of 'cost' covered. [IF PRESSED: Estimates have been made of cost of additional registered unemployment (eg for 1980-81 in February 1981 EPR). Attempt made to update to 1981-82 - range of figures has been calculated. But doubts expressed about assumptions used. Work, therefore, continues. No decision whether to publish.] Cannot gross up such figures to produce total cost (in terms of lost taxes and extra benefits) of all the unemployed. Meaningless concept. Implies comparison with an economy with zero unemployment. Can say total expenditure on unemployment and supplementary benefits paid to the unemployed estimated at £4.3 billion in 1981-82 and £5 billion in 1982-83.

8. What is Government doing to provide more jobs?

Illusion to think Government can switch employment off and on like a tap. 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 new measure announced in Budget. (See C2).

D TAXATION

1. Burden of taxation

[Total taxation (i.e including for example income tax, indirect taxes, corporation tax/ rates and NIC ~~rates~~) 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 39½ 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 burden next year compared with 1981-82.

2. Burden of tax has risen since 1978-9 for most households?

/Comparisons given in Parliamentary Answers to Mr Straw 17 Feb and 18 Mar/

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.

3. Burden has fallen for the rich?

Only because of abolition of absurdly high marginal rates and raising of thresholds in 1979 Budget.

4, Burden has risen most for the poor?

Proportion of income paid in income tax and NICs will fall next year (82-3) for the lowest paid.

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

[Full explanation given in Parliamentary Answer 11 May DO 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. [IF PRESSED: percentage paid in income tax plus NIC will rise for most people. But it will fall for the lowest paid (below ½ average earnings (married) and below about 1/3 average earnings (single)). 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 being uprated from November (see F1).]

6. Budget failed to compensate for last year's non-indexation?

Impossible to finance - without grave risks to interest rates and present recovery - the additional £3 billion cost.

7. 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.

8. Income tax cuts only help highest paid?

Not true: those who will gain most are lowest as well as highest paid i.e. gives greatest proportionate benefit to highest and lowest paid taxpayers, who did worst in last year's Budget.

9. No help on poverty trap?

Numbers in Poverty Trap should not be exaggerated. Increases in income tax allowances have a beneficial impact. [IF PRESSED: overall, small increase in numbers in poverty trap (10,000) as result of FIS uprating. But this helps low paid and generally makes employment more attractive than unemployment.]

10. Reduction in NIS not enough?

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, innnovation and enterprise packages plus helpful - and welcomed - improvements in capital tax regime (see also Section N).

11. 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.

12. Petrol/derv/VED increases anti-motorist/industry?

These three duties not singled out; increases as a whole no more than broadly compensate for past year's inflation. 2p smaller increase on derv further shields industry and distribution costs by increasing differential with petrol (10p a gallon) introduced last July.

13. Reduce VAT?

Reduction in standard rate not appropriate. Nearly half consumer expenditure zero-rated or exempt (including necessities like most food, housing, domestic heating). Applies equally to home production and imports. Assistance provided for whole of UK private sector through reduction in NIS.

14. Why no VAT relief for charities?

Not possible: high revenue cost; serious definitional and ádministrative difficulties; would have repercussions in other areas, which could seriously erode VAT revenue base.

15. Not enough to encourage (existing) small firms?

Substantial measures in enterprise package - full year cost about £80 million. (see also N7-8). Many of latest measures (e.g increase in 'small companies' Corporation Tax profits limits, VAT registration thresholds, purchase of own shares) benefit existing small businesses.

16. Government take from North Sea Oil too high?

See R1.

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 for to improve management in public sector and reduce administration expenses continues.

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

Ratios in 1980-81 (43½ per cent) and 1981-82 (45 per cent forecast) remain below the level of 1974-75 and 1975-76 (46 per cent n both years). 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, and would soon lead to more inflation and higher interest rates and inflation. We are responding, within limits of prudence, to needs of current circumstances.

4. 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 the same in 1984-85). So in cost terms [i.e cash inflated/deflated by the general movement in prices] there is an increase in 1982-83, a decrease in 1983-84 and a small decrease in 1984-85.

5. Does Government accept figures for expenditure changes in real terms in Sir Leo Pliatzky's article?

[Financial Times 15 March]

The article uses a different definition of total public expenditure [net debt interest is included, whereas public expenditure planning total in Cmnd 8495 excludes it]. Figures in

Table 1 of the article for future years seem to be 'cost terms', that is cash figures deflated by the GDP deflator. Cost terms figures are not in general an indicator of the level of service provided.

6. Plans unrealistic, given e.g overspending in 1981-82/future rates of inflation?

Total spending in 1981-82 was expected to be only a little [NOT FOR USE: 0.4 per cent] higher than planned a year ago. Major reason for overspending is present level of spending by local authorities; this has been taken into account in plans. Realism, particularly in respect of local authorities and nationalised industries, is one reason why plans for future years are higher than in previous White Paper. Large Contingency Reserves due to greater uncertainty in later years and designed to give realistic planning totals.

7. Higher inflation than allowed for in PEWP may raise public spending?

True that inflation assumption in FSBR slightly higher than in PEWP, but:

- for 1982-83 confident that planning total including Contingency Reserve will hold;
- for later years inflation assumption in FSBR a little higher than cost factors used in building up cash programmes;
- in due course, will consider adequacy of cash provision on programmes.

Meantime, uncertainties due to, for example, inflation, are one reason for large Contingency Reserves in later years; makes for realistic planning totals.

8. NIS reduction: effect on public expenditure?

[Programmes will be reduced to reflect reduction in NIS paid by public sector. First estimates of effect (included in post-Budget revised planning totals) is some £360 million in 1982-83 and £450-500 million in later years.]

Government's intention in reducing the NIS is to help private industry, not public sector. Effect of clawback on public sector wil leave its position broadly unchanged. (See also P2).

9. 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).

10. 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.

11. 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.

12 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 the question of cost.

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

(See J9-12).

14. 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 next year 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 the drive for more efficient management throughout the public sector.

15. Cut staff numbers in public services?

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

But manpower reductions are key to achieving long-term savings, and bigger reductions required to achieve Government's targets for LA current expenditure.

LOCAL GOVERNMENT

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

In order to set local authorities reasonable and realistic targets, we have increased the plans by £1.35 billion. But substantial economies will still be required as plans only allow about 2 per cent more cash spending than latest budgets for this year. [IF NEEDED: Future year's plans allow less cash growth, to get expenditure back on track].

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

[CIPFA forecasts of 15 per cent reported in Press 17 March]

Not at all. If local authorities budget to spend in line with Government's plans, rate increases should be very low. Where they are high, it is because local authorities have chosen to overspend. [NB. FSBR quotes 12 per cent rise in rate income but this takes account of information so far received on actual rate increases.]

18. Effect of NIS reduction on local authorities?

As Chancellor announced in Budget the lower NIS payments by local authorities will be offset by a reduction in RSG. This will mean that local authorities overall are neither worse nor better as a result of the decrease in NIS. [IF PRESSED: we shall be consulting the local authorities about the details.]

19. Control of rates paid by industry

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

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

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

F SOCIAL SECURITY

1. November 1982 uprating?

[Chancellor in Budget statement announced that most benefits are to be uprated by 11 per cent next November - 9 per cent for price protection and 2 per cent to restore shortfall. Social Services Secretary gave details in statement 10 March.]

We have provided for benefits usually uprated to maintain their purchasing power and get back shortfall of 2 per cent which occurred at last uprating. This includes those benefits where we have given no pledge of full price protection. Uprating of benefits next November will cost £1 billion in 1982-83 (nearly £3 billion in full year).

2. Why not restore November 1980 5 per cent abatement now that unemployment benefit is to be brought into tax?

Decision to abate UB was not simply taken as a proxy for tax but to reduce public expenditure and to 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 a full year [net of reduced claims for supplementary benefit, but gross of tax.]

3. Increasing supplementary benefits by less than forecast movement of prices hits at poorest of the poor, and breaks an election pledge?

The benefits will retain their value in real terms. Beneficiaries receive not only their scale rate entitlement but a cash payment to cover their housing costs in full. By uprating scale rates in line with RPI which includes housing costs, there has been some double provision. The change corrects that. The abatement of ½ per cent represents a broadly based adjustment for the likely relative movement of housing costs to November 1982. [NOTE: we do not want to make public a forecast of a housing index.]

4. Increase in capital disregard should have been greater?

[Increase in capital disregard for supplementary benefit from £2,000 to £2,500 announced 10 March.]

Change represents 25 per cent increase in level of disregard since it was set in November 1980; this more than restores its value. No reason to suppose that operation of the disregard causes any general hardship or that it has led to people deliberately disposing of capital in order to qualify.

5. Child Benefit increase too low?

[Increase of 60p to £5.85 in November.]

Uprating will maintain real value of the benefit since November 1980. Not as high in real terms as level set in April 1979, but the increase then is generally recognised to have been out of line - a pre-election move by last Labour Government.

6. Earnings Limit

Earnings limit for pensioners has been increased from £52.00 to £57.00. It remains our intention to abolish the limit entirely. But so far we have not been able to do so; it has been essential to give priority to maintaining purchasing power of benefits.

7. Death grant - increase to realistic level?

[Social Services Secretary announced 10 March intention to publish a consultative document on the death grant.]

Social Services Secretary would welcome comments on his consultative document on death grant which is to be published shortly. As we have always made clear, our aim is to redistribute the resources now devoted to death grant in a more sensible fashion - we cannot afford to add to those resources.

8. Why cut child dependency additions to unemployment benefit?

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

The 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.

G PUBLIC SECTOR BORROWING

1. PSBR in 1981-82 and 1982-83

[1982-83 FSBR published 9 March shows an estimated 1981-82 PSBR outturn of £10½ billion, and a forecast 1982-83 PSBR of £9½ billion.]

PSBR in 1981-82 in line with 1981 Budget forecast and PSBR reduction in 1982-83 broadly in line with 1981 MTFS.

2. Effect of Civil Service dispute on PSBR?

PSBR in both years affected by Civil Service dispute. In 1981-82 some £¾ billion of receipts delayed from March 1981 were collected but some £1 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.

3. CGBR April-Feb press notice implies odd CGBR for March?

[CGBR April-February £8.1 billion - PSBR estimates 1981-82 £8.75 billion.]

The borrowing figures in the red book are consistent with the outturn information available so far this year.

4. PSBR should be higher/lower?

The PSBR reduction in 1982-83 is broadly in line with 1981 MTFS. [IF PRESSED: PSBR 'broad brush' concept. Cannot adjust for every factor. Swings and roundabouts. Main criterion for judging appropriate size is scope for financing it without undue strain on interest rates.]

5. Government seeking credit for fall in PSBR from year to year by over-stating likely 1981-82 outturn?

No. £10½ billion still the best estimate for 1981-82 PSBR. There is normally a surge in borrowing in last quarter of financial year (LA's borrowing, other spending up)

H MONETARY AND FINANCIAL POLICY

1. Lower interest rates?

[Bank base rates reduced by ½ per cent to 13 per cent from 12 March. Have come down by 3 per cent from peak of 16 per cent last autumn. Market rates generally eased in early March but steadied mid-month.]

Interest rates have fallen significantly since the New Year, in the face of rises in the United States, reflecting the markets' confidence in Government's monetary and fiscal policies. However, must proceed cautiously if we are not to jeopardise progress on inflation.

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

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 rates eased against US trend; but cannot insulate ourselves from difficult international background. UK rates have steadied recently while US rates have turned up.

3. Recent fall in interest rates incompatible with strategy

Taking account of all evidence, present levels of interest rates are consistent with policy of continuing downward pressure on inflation.

4. 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 1982-83 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.

5. 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.

6. Increase in target ranges

Ranges in past MTFS were purely illustrative. Did not take account of structural changes. Right to take account of current rate of growth in setting new targets, to avoid unduly sharp brake on monetary growth. 8-12 per cent still implies deceleration from current growth rate ie continued downward pressure on monetary growth.

7. What if aggregates' rate of growth diverge?

Will examine factors underlying divergence. Policy decisions will continue to take account of all available evidence with a view to restraining inflationary pressures.

8. Overshoot of 1981-82 target

[£M3 was little changed during banking February; rate of growth over past 12 months was 14.4 per cent. M1 fell by about ½ per cent in banking February; grew by 8.7 per cent over past 12 months; PSL2 rose by about ½ per cent in banking February; grew by 12.1 per cent over 12 months.]

Growth in £M3 was above top end of 1981-82 target range, even allowing for effects of Civil Service strike. At least part of excess reflects increasing share of banks in housing and consumer lending. Also reflects longer term effects of institutional changes such as ending of corset, abolition of exchange controls and changes in savings behaviour. These factors imply higher monetary growth permissible for same increase in nominal incomes.

9. Monetary conditions too tight?

Behaviour of exchange rate and money GDP as well as monetary aggregates suggest financial conditions have been moderately restrictive as intended. But bank lending still high, despite level of interest rates. Companies' financial position much stronger than a year ago. (See N 4)

10. Bank lending

Still very strong. Part at least is substitution for lending by building societies and other forms of consumer credit. To extent that it is additional, it adds to inflationary pressure, so we must avoid premature relaxation of interest rates.

11. Why more indexed gilts?

[Bank announced new index-linked gilt available to all investors on Budget Day. Restrictions on eligibility to hold existing indexed gilts removed.]

Issue of indexed gilts demonstrates Government's confidence in strategy of reducing inflation. Will allow direct access to indexation benefit to individual investors.

12. Giving money away by derestricting existing stock?

No: price rises not a cost to Exchequer. Over time, broadening of market should benefit Exchequer through reducing yields on new derestricted stocks.

J PRICES AND EARNINGS

1. When will single figure inflation be achieved?

[Year-on-year rate of inflation 11 per cent in February, compared with 21.9 per cent in May 1980 and lowest recent level of 10.9 per cent in July 1981.]

Budget forecast is for year-on-year rate of inflation of 9 per cent by Q4 1982, falling to 7½ per cent by mid-1983.

2. Inflation still higher than when Government took office?

[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 14.1 per cent.]

Average level of inflation will be lower under this Government than under its predecessor. This will be the first Government since the war that has achieved a lower rate of inflation than its predecessor.

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

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

4. Effect of 1982 Budget on RPI?

Compared with full indexation of excise duties, effect of Budget is RPI reduction of 0.1 per cent (or an increase of 0.1 per cent including also the effect of the 2 December measures). [IF PRESSED on non-indexed basis: effect is 0.8 per cent increase in the RPI (or 1.4 per cent including also 2 December measures).

5. Effect of 1982 Budget on TPI?

Compared with full indexation of excise duties, effect of Budget is TPI reduction of 0.4 per cent (or increase of 1.1 per cent including also effect of 2 December measures). [IF PRESSED on non-indexed basis: effect is 1.6 per cent reduction (or a 0.3 per cent increase including also 2 December measures).]

6. Nationalised industry prices

Nationalised industry price rises have been due in part to the ending of the previous Government's policy of artificial and distortionary price restraint. Rate of nationalised industry price rises is now coming more closely into line with the RPI. [See P12]

7. Current level of pay settlements?

In economy generally, settlements in last pay round averaged 8-9 per cent. Negotiators seem to be settling up to about a third lower in this round than they did in previous. And almost all settlements seem to be in single figures.

8. Private sector pay - the CBI's 7 per cent?

[CBI figures published 17 February suggest that manufacturing settlements monitored since 1 August are averaging around 7 per cent.]

Settlements have been lower in recent months, reflecting an increasing sense of realism about pay. But the need is continuing low settlements which are consistent with maintaining economic recovery and improving employment prospects.

9. Public sector pay

Government's approach to pay in the public services must take account of what the taxpayer can afford. Pay negotiations in the nationalised industries and local authorities are a matter for the parties concerned, as are the financial consequences of any settlements reached.

10. 4 per cent pay factor unrealistic/unfair?

Real incomes had risen to unsustainable level and public service pay increased relative to private sector since 1979. 4 per cent is broad measure of what Government thinks reasonable and can be afforded as general allowance in fixing the programme from which public service pay bill has to be met.

11. Nurses broken through the 4 per cent?

The 4 per cent factor is not a norm. Government recognises need for pay settlements to take account of market factors, including effect on recruitment and retention of expensively trained staff in NHS.

12. Government offer to civil service unreasonable?

In framing its offer the Government has placed much more emphasis on market considerations and management objectives than on compability and the cost of living. The unions' emphasis is on the latter two aspects. [Arbitration Tribunal to hold hearing in April.]

13. Average earnings index

[Year on year growth 10.8 per cent in January compared with 10.1 per cent in December, though (unpublished) underlying increase slightly less than in previous 5 months at just under 11 per cent.]

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

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

Yes. But follows growth of 17½ per cent in personal living standards in three years 1977-80.

15. Movement in TPI

Fact that has been increasing faster than RPI (roughly 3½ per cent faster over year to February 1982) reflects measures taken to restrain Government borrowing -essential if inflation is to be controlled.

16. Government aiming to cut living standards?

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

Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

17. Incomes Policy

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

18. Index-linked pensions and the Scott Report?

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

K BALANCE OF PAYMENTS

1. Balance of payments Q4 1981

Current account established to have been £1,541 million in surplus in Q4, including a visible trade surplus of £623 million. Total 1981 current account surplus £8 billion.

2. Invisibles

Q4 invisibles surplus in Q4 1981 is put at £918 million compared with £400 million in Q3. This reflects EC receipts totalling £531 million, including budget refunds of £118 million. Increase in the invisibles surplus for 1981 as a whole largely due to 18 per cent increase in interest, profit and dividends surplus to £1,148 million - demonstrating benefit from investing abroad.

3. Capital flows

Identified capital inflow in Q4 of £70 million. But the large 'balancing item' (£2,100 million) means that all Q4 figures should be treated with caution.

4. Trends in exports

Non-oil exports were 3½ per cent higher in volume terms than in 1980. Exports of intermediate and capital finished manufactured goods are now higher in both value and volume terms than in 1979 and 1980 despite loss of competitiveness. DoI survey of engineering industry suggests export deliveries will continue to rise in 1982, as does CBI Industrial Trends Survey.

5. Trends in imports

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

L EXCHANGE RATE AND THE RESERVES

1. Policy towards the exchange rate

[Since last autumn sterling has remained broadly stable and is currently over 12 per cent below its effective rate peak early last year. Recent lows have been $1.77 on 14 September, DM4.07 on 20 October. Highs were $1.97 on 30 November, DM4.407 on 9 February. Rates at noon on 19 March were $1.8020; DM4.297 and an effective rate of 91.08. Reserves at end February stood at $23.4 billion, compared with $23.2 billion at end January.]

As Chancellor again made clear in his Budget, the exchange rate normally gives useful information on monetary conditions. While we have no target for the exchange rate, its effect on the economy and therefore its behaviour cannot be ignored.

2. Has the Bank intervened to support the rate?

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

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

All the experience in recent years is that exchange rates for major currencies cannot be manipulated by intervention alone. Intervention can help 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 Sterling should join the EMS?

[See M8-9]

5. Exchange rate and competitiveness?

I welcome the improvement in UK cost competitiveness of over 10 per cent in 1981. This has been partly due to a decline in the exchange rate; more importantly because there are signs that our domestic unit labour costs are now growing more slowly than those of our major competitors.

6. <u>Debt repayments</u>

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 \$13½ billion, compared with over \$22 billion when the Government took office.

M EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. 'Mandate negotiations'

It has not been possible hitherto to reach agreement. The main obstacle has been the view of a number of other Member States that refunds to the UK should be arbitrarily and automatically reduced over time, regardless of the scale of the problem. There has also been disagreement about the duration of the new refunds arrangement. Foreign Ministers are considering these problems further at their meeting on 23 March, when they will hear a report from the Presidents of the Council and the Commission.

2. Net UK contribution to community too high?

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

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

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

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

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

5. Do supplementary measures grants lead to additionality?

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

6. Policy for CAP reform

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

7. Costs of CAP to UK consumers

The Minister of Agriculture has dealt with a number of questions on this. Costs to consumers of the CAP as such depend on nature of alternative support system that is envisaged. Arrangements leading to a reduction in the cost of food to the consumer could well involve increased costs to taxpayers.

EUROPEAN MONETARY SYSTEM

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

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

9. When will the conditions be right?

Sterling is an international financial currency and is also particularly affected by oil market factors. These mark sterling out from other Community currencies, and add to the difficulty of the decision on the timing of sterling's participation. The balance of advantages, risks and disadvantages is constantly changing, so that the question of participation remains complex.

N INDUSTRY

1. Budget does not do enough for industry?

Budget measures directed at helping business and will cost £1 billion in 1982-83. On indexed basis over $^2/_3$ of Budget's net revenue cost will go to help businesses. But main help for industry is in pursuing policies that allow for lower inflation and ease pressure on interest rates.

2. Industry's response to Budget?

[Sir Raymond Pennock, CBI President - 'welcome fillip' to business confidence. Sir Terence Beckett, Director General CBI - 'moves in the right direction'. ABCC - 'insufficient and misconceived'. Saturday 13 March Financial Times Marplan survey of industry's reaction reports 77 per cent though it 'fairly good' for the economy and half those polled thought would reduce inflation.]

Have noted the Association of British Chambers of Commerce's adverse comments, but pleased with the generally favourable response from industry, including CBI.

3. Prospects for industry-recovery?

Fall in output has now come to an end. Industrial production in Q4 1981 ½ per cent up on Q3 and some 2 per cent up on H1. Budget forecast suggests there may be 3 per cent increase in manufacturing output in 1982 as a whole.

4. Company sector finances improved?

[Gross Trading Profits of industrial and commercial companies (ICCs) net of stock appreciation rose strongly in H2 1981 (up 23 per cent between H1 and H2) and were 10 per cent higher in 1981 than in 1980. Borrowing requirement of ICCs has improved over year to Q3 1981, and financial deficit turned into surplus. DOI's latest survey of company liquidity (published 4 December) shows further marked improvement in third quarter (particularly in manufacturing) bringing liquidity ratio back to 1979 Q3 level. NB figures difficult to interpret, however, particularly because of uncertain impact of CS dispute.]

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

5. Rate of return still too low?

[Real pre-tax rate of return of non-North Sea ICCs rose marginally to 2½ per cent in 1981 Q3 compared to 2¼ per cent in Q2 (a record low).]

Yes, but Government can only help in limited ways such as reducing burden of NIS and creating the climate for lower interest rates. Further improvements in ICC's profits and real rates of return can be expected, provided recent productivity gains and trend towards moderate settlements continue.

6. 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 should ease pressure on interest rates. 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 H).

7. Government help for small firms

Budget provided further help for small businesses in addition to 75 measures taken previously. 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 this year (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.

8. Response to Loan Guarantee Scheme?

Scheme operating successfully. We have already issued more than 2,700 guarantees - well over half to new businesses. Total lending under scheme is just under £100 million. Ten new banks were admitted to the Scheme in November 1981: a total of twenty-seven financial institutions are now participating. Budget provided for the lending ceiling - in year to May 1982 - to be raised from £100 million to £150 million. A further £150 million will be made available in following year.

9. Progress with setting up Enterprise Zones?

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

10. Response from private sector?

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

P NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83 and future years?

Nationalised industries' total external finance increased by £1.3 billion in 1982-83, £1.7 billion in 1983-84, £1.2 billion in 1984-85 - a total of over £4 billion over the three years of the Survey. Government has given full recognition to problems faced by the industries in a period of recession. Increase in 1982-83 was roughly half what the industries bid for.

2. Unreasonable to reduce EFLs following NIS cut?

Reduction in the National Insurance Surcharge was designed to benefit private sector; not the intention that public sector should gain from it. Reduction in EFLs will simply offset the addition to the industries' internal resources following the NIS cut. No industries will be worse off than previously, and their plans should be unchanged.

3. Pay assumptions?

Government has not set pay or any other assumptions for the industries. Moderate pay settlements - and restraint of current costs generally - essential if investment programmes to be maintained and prices to consumers kept down.

4. External financing outturn for 1981-82 way over original limits?

During 1981-82, five industries had their external financing limits increased by a total of £0.5 billion, met from the Contingency Reserve. In granting these increases, Government recognised problems faced by some industries in a period of recession, and that, in some circumstances, EFLs could not be immutable. Not yet possible to make full assessment of ASLEF strike, but three industries in particular - National Coal Board, British Steel Corporation and British Rail itself - have been adversely affected in short term.

INVESTMENT

5. Investment plans for future years?

Overall, industries' investment plans on a rising trend. [CAUTION: Not true for each individual industry.] Increase in total planned expenditure on fixed assets since last White Paper is £200 million in 1982-83, £600 million in 1983-84 and £700 million in 1984-85, ie an increase of £1.5 billion over the three years. This implies total investment of no less than

£24 billion over the three years. 1982-83 plans allow for 26 per cent more investment than in 1981-82, and 40 per cent more than in 1980-81.

6. How robust are the forecasts of nationalised industry demand/contributions to public expenditure, given the recent track record?

Plans just published are considerably less optimistic than those published last year, when the industries' plans assumed a return to near-total self-financing by 1983-84. In particular, in increasing substantially the external finance available to the industries in each year of the Survey the Government has recognised the effect of lower demand on the industries' internal resources, which are now expected to be well below the levels in last year's White Paper - by about £2 billion in each of the years 1982-83 and 1983-84. The industries' external financing needs are still expected to decline over the Survey period, but from a higher base and at a more gradual rate than forecast last year.

7. Investment plans unlikely to be attained?

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

8. But shortfall in capital spending 1981-82?
[Figures in FSBR imply shortfall of £¾ billion.]

Not easy to establish firm reasons after the event. Such evidence as we have suggests a mixture of reasons. Most important has been a 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.

9. Take nationalised industry investment out of PSBR?

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

10. Private finance for NI investment?

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

We have indicated our willingness to consider new financing proposals. But direct market finance can only be justified if there is a genuine element of performance-related risk for the investor, in order to improve incentives to management efficiency, and if new forms of saving are tapped, so as to avoid adverse monetary consequences. Market financing does not of itself lessen burden on financial markets.

11. Does the Government propose to sell shares in BT?

[Front page FT Monday 15 March.]

Recent press reports are speculative. As the Chancellor announced in his Budget statement, detailed work is proceeding on the Buzby bond. The Government continues to examine ways in which market pressures could be brought to bear on nationalised industries, including BT.

12. 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 is 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

13. Nationalised industries' prices

Nationalised industries' price rises have been due in part to ending of previous Government's policy of artificial and distortionary price restraint rises in 1974 and 1980. But since middle of 1980-81, gap between NI price increases and RPI has narrowed. Artificial price restraint would result in unacceptable increased burden on taxpayer and distortion of market forces.

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

14. Action in Budget to help industrial energy users?

Total benefit to industry estimated at £150 million in 1982-83 from measures in Budget (combined effect this Budget and last is £250 million over two years 1981-83), namely freeze on industrial gas prices from 1 April to end-1982; new tariff arrangements for largest electricity users (and continuation of arrangements on electricity prices announced last year); standstill till next winter on list prices for foundry coke; extension of boiler conversion grants scheme.

PRIVATISATION

15. What further sales expected?

Special sales of assets in 1982-83 are forecast at around £700 million and around £600 million in each of the later years. These figures are 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 - which are to be made possible by Oil and Gas (Enterprise) Bill currently before the House.

16. Net figure for special asset sales this year?

[Public Expenditure White Paper showed net sales of only £50 million in 1981-82; latest estimate published in FSBR is -£100 million - ie £100 net purchases.]

The low net figure is the result of decision not to proceed with a further programme of advance oil sales in a weak market. The gross figure expected to be in line with the £500 million target included in the last White Paper, and will include the proceeds from Cable & Wireless, the sale of Amersham International Limited and the National Freight Company Limited, the sale of the Government's shareholding in the British Sugar Corporation, and further sales of motorway service areas long leases.

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

Of course the cash is welcome, but benefits run wider than that. Not only will any future borrowing by these undertakings be outside the PSBR, so reducing burden on taxpayers, but the organisations concerned will be made more responsive to market forces and thus have greater incentives to improve efficiency.

18. Government running into heavy weather over sale of Wytch Farm?

The British Gas Corporation is complying with the Government's direction to sell its interest in Wytch Farm. It is too early to say when the sales will take place.

19. Special disposals programme just a subsidy for speculators?

[Heavy oversubscription for British Aerospace, Cable and Wireless, Amersham International, followed by large increases in prices where 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 where 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.

R NORTH SEA AND UK ECONOMY

1. In view of recent falls in price of oil, why did HMG not reduce tax burden on North Sea oil producers?

[Budget tax changes included abolition of Special Petroleum Duty, increase in Petroleum Revenue Tax rate from 70 per cent to 75 per cent, and new system for advance payments of PRT (all from 1 January 1983), plus smoothing of PRT payments from July 1983 (this improves HMG's cash flow at companies' expense). Changes reduce the marginal rate of tax (from 90.3 to 89.5 per cent); involve slight fall in Government 'take' (no change 1982-83, costs £70 million 1983-84).]

Recognise need for tax structure robust to both falling and rising prices. Detailed study showed us that under new structure, levels of profitability should still be sufficient to make exploration and development attractive. Hope that new tax structure will provide more secure and stable regime.

2. Government has missed opportunity to simplify North Sea fiscal regime?

The oil industry has made it clear that it would not welcome a structural upheaval. Would create serious uncertainty and major transitional problems.

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

[PM warned in 23 February speech that limited room for manoeuvre in Budget.]

Other things being equal, lower oil prices will reduce Government revenues from the North Sea. Treasury has estimated that each $1 off the price directly reduces revenue, other things being equal, by £250 million in first year and £350 million in full year. But falling world oil prices are good for the world economy. We will benefit from that - not only from impact on activity, but also lower oil prices will help in reducing inflation. Latest revenue projections already incorporate fall to $31 a barrel for Forties oil.

4. Implications of OPEC production limitation agreement for North Sea oil prices?

Remains to be seen whether the agreement will hold.

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. 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

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

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

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.

S WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Government will have no choice but to reverse policies now unemployment has risen to post-war record levels in many Western countries?

[Unadjusted unemployment exceeded 10 million in USA and 1 million in Canada in January. It exceeded 2 million in Italy in September, 2 million in France in October, and 1.9 million in Germany in February. Highest ever unemployment levels in Canada, France, Italy and UK and highest in USA and Germany since 1935.]

No indication of a widespread departure from consensus achieved last year (eg Ottawa Summit, IMF Interim Committee) about need for prudent fiscal and monetary policies to bring down inflation.

2. Anti-inflation policies not working?

[Year on year consumer price inflation in major countries fell to 8.9 per cent in January. Underlying rates falling in US. OECD and IMF expect some decline in 1982.]

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

3. Governments' policies have failed or worsened situation?

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

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

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

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

[Most major countries (US, Japan, Germany, Italy, Netherlands, Belgium, Australia, Sweden) have recently announced measures to cut planned public spending. France has announced the deferral of FF15 billion (£1½ billion) of capital investment. Belgian government has used its special powers to freeze prices temporarily and severely curtail wage increases for rest of 1982.]

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

6. UK is alone in Europe. Even Germany announced investment/employment scheme?

UK far from alone. Almost all European governments working to curb public spending, budget deficits and monetary growth. French government has set limit on its budget deficit for 1983 of 3 per cent of GDP. German government plans to reduce its borrowing in 1982 Budget even in nominal terms by almost 30 per cent. Unlikely investment/employment scheme will entail any significant increase in borrowing - increase in VAT (by 1 per cent to 14 per cent) part of the package from 1 July next year. Impact on employment remains to be seen.

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?

[Industrial production rose 1.7 per cent in February after falling 2.5 per cent in January. Inflation in January was 8.4 per cent compared with a year earlier. Three-month interest rates slower than in February.]

Things are looking a little brighter in the US both on output score and, with lower interest rates, an improving outlook for inflation. And on the industrial relations front, there have been some encouraging settlements in which unions have clearly accepted lower wage increases in exchange for improved job security. [CAUTION: Not too much should be made of this: some upturn in US economy in the spring was expected.]

9. Even US using fiscal deficit to stimulate economy?

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

10. Recent international interest rate developments?

True that US interest rates rose earlier this year. But prime rates are well below their peak of 21½ per cent last summer. [currently 16-16½ per cent]

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.

AIDE MEMOIRE ON THE UK ECONOMY 22 March 1982

PRESENT SITUATION

Most recent major outside forecasts (NIESR, P&D, CBI, LBS, St James) assess fall in output ended in H1 1981, with some recovery thereafter (in range 1-1½ per cent for 1982). ITEM and OECD are more pessimistic; seeing further falls of output into 1982. Year-on-year inflation is forecast by most groups to fall further to a range of 9-10½ per cent in 1982 Q4. Most groups see little possibility of further substantial reductions in 1983; inflation forecast to remain around 10 per cent in 1983. The March FSBR forecast, of a 1 per cent rise in output in 1982, and 10 per cent inflation in Q4 1982 is broadly in line with this consensus for 1982. FSBR sees 2 per cent rise in output in year to H1 1983; 7½ per cent inflation by Q2 1983. Unemployment (UK adult seasonally adjusted) forecast to reach around 3 million by end 1982, with some groups (P&D, LBS, Simon & Coates) expecting stabilisation in 1982, others expecting some further rise.

GDP output estimate rose in both Q3 and Q4 1981. Level in Q4 some 1 per cent above Q2. Recent months' industrial output figures affected by bad weather, car and rail strikes. Nevertheless, Q4 1981 manufacturing output some 2-3 per cent above low point in Q1 1981.

Consumers' expenditure rose about 1 per cent in Q4 1981: the overall level in 1981 was the same as in both 1980 and 1979. Retail sales were virtually unchanged in the 3 months to February 1982. The volume of visible exports in Q4 1981 was at a higher level than at any time since early 1980. The volume of visible imports in Q4 1981 was back to the level of the first half of 1980 and 21 per cent higher than Q1 1981. DI investment intentions survey conducted in October/November suggests volume of investment, by manufacturing, distributive and service industries (excluding shipping) will rise by about 2 per cent in 1982 following a fall of about 5 per cent in 1981. A large rise is tentatively expected in 1983. Investment by manufacturing (including leasing) is expected to rise during 1982, but for the year as a whole it is likely to be 1 per cent lower than 1981. An appreciable rise is expected in 1983. Manufacturers', wholesalers' and retail stocks dropped by £25 million (at 1975 prices) in Q4 1981 the smallest quarterly fall in the last two years of continuous destocking.

Unemployment (UK, seasonally adjusted excl, school-leavers) was 2,836,000 (11.7 per cent) at February count, up 7,000 on January. Vacancies were 113,500 in February.

Wholesale input prices (fuel and materials) rose ½ per cent in February; however the year-on-year increase fell to 12 per cent. Wholesale output prices rose ¾ per cent in February and are 10½ per cent above a year ago. Year on year RPI increase fell to 11.0 per cent in February. Year-on-year increase in average earnings was 10.8 per cent in January. RPDI was flat in Q3 1981 following falls in the previous two quarters and a

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17.5 per cent rise over the 3 years 1977 to 1980. The savings ratio rose 1 per cent to 14½ per cent in Q3 1981.

PSBR £9.7 billion in the first three quarters of 1981-82 and CGBR (unadjusted) £8.1 billion in eleven months to February 1982; but both distorted upwards by the civil service dispute. Underlying PSBR for '81-82 believed in line with 1981 Budget forecast (£10½ billion).

Sterling M3 was little changed in banking February.

Visible trade showed a surplus of £0.6 billion in Q4 1981. Current account surplus of £1.5 billion in Q4 1981; likely surplus of £8 billion in 1981 as a whole. Reserves at end-February rose to $23.4 billion. At the close on 19 March the sterling exchange rate was $1.7995: the effective rate was 91.1.

JACK STRAW, M.P.

HOUSE OF COMMONS
LONDON SWIA OAA

22nd March, 1982.

The Rt. Hon. Sir Geoffrey Howe, QC, MP,
Chancellor of the Exchequer,
Treasury Chambers,
Whitehall,
London S.W.1.

Dear Sir Geoffrey,

In the course of opening your Budget statement on the 9th March, you said (having referred to Britain's relative decline over the previous decade) that:-

> "At the last election, we made all this very clear. We made it plain, too, that reversing this decline would require a major effort - an effort that would need to be sustained over the lifetime of more than one Parliament. And so it will be."
> (Hansard 9.3.82 Co. 727)

You opened your Ministerial radio and television broadcast that evening in similar terms.

I have now read through every speech in the House of Commons Library made by you, and by the Prime Minister during the course of the 1979 General Election campaign. It is possible (though unlikely) that the Library's collection of your speeches is incomplete, but in those that I have read (35 in all) I can find no reference that "the effort" required by the Conservatives' programme would beed to be sustained "over the lifetime of more than one Parliament". Nor is there any specific reference that I can see within the Conservative Party Manifesto to such a time scale of "more than one Parliament".

There are, of course, some general references within both the Manifesto and your speeches to things taking a little time. The Manifesto said at the end "We make no lavish promises ... Too much has gone wrong in Britain for us to hope to put it all right in a year or so". But one of its opening pledges was "We may be able to do more in the next five years than we indicate here. We believe we can".

In a speech in Birmingham on the 19th April, 1979, the Prime Minister said:-

> "It will take time to turn things round." She went on to say:- "There's nothing inevitable about rising unemployment".

And in a speech on the 24th April, 1979, in Whitefield, you said:-

> "We do not claim to be able to work a miracle cure to solve all the problems of the economy."

Cont'd/....

But all the specific indications made by you both during and before the Election which I have found make clear that, while you foresaw some period of difficulty, the time scale of success which you had was <u>within</u> the lifetime of one Parliament.

For example. in a major interview in The Times on the 3rd August, 1978, you said:-

"Of course we should want to alter the whole climate as soon as possible, not least because the benefits will be some time a-coming. That is why we are talking about three to four years...

"Fighting inflation is top priority, with the eventual aim of reducing British inflation to between 2 or 3 per cent in about three years' time...

"Of course, we should not want to proceed in such a way as to produce what some people would call a dramatic short-term recession."

In a speech to the Conservative Party Conference on the 5th October, 1976 (Conference Record, page 24), you said:-

"We shall announce, and shall stick to, clear targets for the control of the money supply. They will be designed to reduce inflation over three years to the level that was acceptable in the 1950's."

(The average level of inflation in the 1950's was 3-4%.)

In a speech at the close of the General Election campaign on the 30th April, 1979, in Pentlands, Edinburgh, you said:-

"Creating secure jobs: the Conservative way ... It's high time for a fresh approach, in Scotland as well as in the rest of the United Kingdom. The next Conservative Government <u>will</u> give Scotland that new approach. <u>We must make sure the next five years are not as bad as the last</u>." (My emphasis)

Moreover, if the idea of the Conservatives' "effort" taking two Parliaments was central to your Election message, one might expect some reference to it to be found in the Prime Minister's Election broadcast on the 30th April, 1979, and her final major speech in Bolton on the 1st May, 1979. But both are silent on this matter.

This Government, like any other, will be judged at the next Election by the degree to which its promise, and the expectation it created, has been matched by its performance. The expectation which I remember you creating at the last Election was one of lower taxes on incomes, less crime, and less unemployment. (The Labour Party are "the Party of unemployment. We are the Party of opportunity" were the Prime Minister's words on the 23rd April, 1979, in Darlington.)

Cont'd/...

So where, during the Election, did you specifically refer to this "effort" needing to be "sustained over the lifetime of more than one Parliament"?

Since you no doubt had the reference to hand when you wrote this part of your Budget speech, I shall look forward to an early reply.

Yours sincerely,

Jack Straw

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Prime Minister

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Michael Scholar Esq
Private Secretary
10 Downing Street
LONDON SW1

19 March 1982

Dear Michael

... I am enclosing a copy of the latest Pay Brief.

Copies also go to the Private Secretaries to Members of E, E(PSP) and E(EA).

Yours

Marie Fahey

MISS M C FAHEY
Private Secretary

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PAY BRIEF: POSITION AT MID-MARCH

SETTLEMENTS

1 Since the February pay brief 114 settlements covering 295,000 employees have been recorded. In the private sector (111 settlements covering 254,000 employees) the weighted average level of settlements in the last month was just over 6%. The average in the public sector (3 settlements covering 41,000 employees) was just under 7½%. The principal settlement was Furniture Manufacture (70,000) at between 4.0% and 5.0% on earnings.

2 The cumulative average level of monitored settlements for the whole economy this pay round - 495 settlements covering 3,515,000 employees - is just over 7%, similar to the two previous months.

3 In the private sector the cumulative average remains unchanged at just over 6½% for the third successive month (480 settlements covering 1,955,000 employees). For manufacturing the average level is 6% and in non-manufacturing is just over 7%.

4 In the public sector (15 settlements covering 1,561,000 employees) the cumulative average remains at just over 7½%. LA manuals (1,077,000) at 6.9% dominates the average. There is little difference between the averages in both the public trading and public services sectors.

5 Coverage: The Department monitors settlements covering about 90% of employees in the public sector and about 40% of employees in the private sector. Coverage in the private sector is not based on statistical sampling and may not therefore be entirely representative. The Department also monitors Wages Council agreements, which cover at least a further 15% of the private sector; but, as the way these agreements affect earnings is difficult to estimate, they are excluded from the settlement figures.

APPRAISAL OF THE ROUND

6 The trend: Some 28% of employees monitored have now settled - about 32% of the private sector and about 24% of the public sector. Most Wages Councils have also settled.

7 In the private sector the first half of the round saw a continuation in the gradual fall in settlement levels which had been discernible since the earlier rapid fall abated in the autumn of 1980; and virtually all settlements in this round have been below the level for the same group in the previous round. However in recent months this decline has tailed off and it now looks as if a plateau has been reached. This is particularly true of the manufacturing sector where the

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monthly average level of settlements has been broadly stable since November 1981 and where there are even some tentative indications of a slight upwards move.

8 In the public trading sector the settlements for coalmining (7.44%) and water (8.8%) dominate the averages; and as yet no reliable trend is apparent.

9 Nor is a trend yet discernible in the public services. Apart from the index-linked cases of the police and the firemen early in the pay round, the only major settlement has been for the local authority manuals. (6.9%).

10 Characteristics The dispersion of settlements in the private sector is narrower than in the previous round. Most settlements are between 5-8%; and very few are below 5% or above 10%.

11 Settlements in non-manufacturing are generally above those in manufacturing although there are dispersions within both sectors. Above average settlements have been reached, or are expected, in agriculture, food and drink, insurance, banking and finance, distribution and construction. Below average settlements have been reached in vehicle manufacture, clothing and textile. Wages Council agreements, which increase minimum rates, average about 8% ranging from 5% for clothing manufacture (from £54.42 to £57.14) to 11.8% for hairdressing (from £51 to £57).

12 A substantial number of employees have benefited from a reduction in hours agreed in previous rounds. About $\frac{1}{3}$ of private sector employees have secured a reduction, generally of 1 hour, in this round's agreements, as have the local authorities manuals. About $\frac{1}{5}$ of private sector employees have also secured holiday improvements.

13 Pressures The main upward pressure continues to be the attempt by unions to secure pay increases to match the RPI year on year increase, which has been close to 12% throughout the round (11% Feb). The TPI, which has been about $3\frac{1}{2}$% above the RPI since last November, has had little discernible influence as such on negotiations, although naturally changes in real disposable income, which started to decline in April 1981, and had fallen by $3\frac{1}{2}$% by December 1981, must have affected attitudes. Expectations in the private sector have also been influenced to some extent by the highly visible settlements for miners, water and local authority manuals. The main downward pressures in the private sector, according to a recent confidential report by the CBI, have been the continuing low level of profits (although this started to improve about half way through 1981); the inability of companies to pass on pay increases in the form of price increases; and the fear of redundancy by employees.

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14 Prospects The general shape of the round, except for the public services, where the position may not be clear for sometime, is now reasonably clear. A momentum has been established and any likely changes in the economy will probably not affect the outcome of the round significantly. Employees' expectations are likely to remain low - although a recent Gallup survey shows that they are increasing slightly. Taking into account the affects of the budget, the year-on-year increase in the RPI may be expected to decline gradually to about 10% by April. This would be helpful. But the decline is likely to be too gradual, and too late, to affect negotiations in this round to any great extent. The year-on-year increase in the TPI is expected to fall quite sharply in April, when it may be only a little higher than the RPI. But again this is unlikely to affect the round significantly.

15 The Department estimates that for the economy as a whole the average level of settlements in this round will turn out to be in the range of 6-8%, which compares with 8½% in the previous round.

16 The actual increase in earnings, as measured by the monthly Average Earnings Index, will, as a consequence of wage drift, be higher than the data on the level of settlements would suggest. Drift may be expected to be between 1-2%. Thus earnings may be expected to increase by between 7½-9½%. This compares with 10½% for the previous round. The actual increase in earnings will probably not be completely known until the September Average Earnings Index, which should fully reflect this round's settlements, is published in November.

17 The above estimate for drift needs to be treated with some caution as its level is inherently difficult to predict. There are three main components in drift:-

(a) Changes in economic activity may cause earnings to increase more or less, usually more, than settlement levels. For example, the number of hours worked may change; the level of output will affect earnings under payment by results systems; and the composition of the labour force may change.

(b) The data supplied to the Department may be inaccurate or incomplete. This is particularly likely as regard data about settlements.

(c) The statistical basis and coverage of our settlement data are different from the basis and coverage of the data used for the monthly Average Earnings Index. For example the coverage of the latter is more extensive; it reflects staged increases only once they have become operative and it takes no direct account of non-cash improvements (eg longer holidays) in employees' terms and conditions of employment.

18 Only the effects of the third component can be predicted with confidence.

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NEGOTIATIONS

19 In the PUBLIC SECTOR, unions representing Gas Supply manuals (17 January - 41,300) have rejected an offer of 7.5% to 8.0% on basic rates plus minor improvements, worth 7.6% overall on average earnings. The claim is for increases in rates in line with inflation, consolidation of bonus and other benefits. Unions threaten industrial action. Electricity Supply manuals (17 March - 94,000) have rejected an offer of £4.97 to £10.62 on basic rates plus a shift enhancement of £3.73, worth 6% on the paybill and 6.1% overall on average earnings. The unions are pressing for 8% on basic rates. Next meeting 8 April. British Shipbuilders (1 April - 68,000) have reached provisional agreement on a 6½% increase in earnings, plus 1 hour reduction in the working week agreed last pay round. Subject to ratification by individual yards. Unions on behalf of British Rail Clerical and Conciliation Grades (20 April - 150,000) have submitted a claim (uncosted) for substantial increases. Negotiations are unlikely to begin before the current productivity issue is resolved. The Non-Industrial Civil Service Unions (1 April - 520,000) have rejected an offer of no increase for some staff and between 1% and 5½% for others, together with improvements in skill and responsibility allowances and the introduction of certain other benefits including season ticket loans. The cost is estimated at £170m or about 4% on the pay bill. The claim is estimated to be worth on average about 14% on basic pay rates plus 1% for leave improvements. The unions formally requested arbitration and this will probably take place 19 April. Primary and Secondary Teachers E & W (1 April - 460,000) have rejected an offer of 3.4% on the paybill in response to a claim for increases in line with inflation. The employers have stated that the offer cannot be improved but are divided over referal to arbitration. Industrial action is taking place in some areas. Revised offer of 3.9% to 6.7% (4% on paybill) has been rejected by Primary and Secondary Teachers (Scot)(1 April - 58,000). It has been agreed to refer the claim to arbitration. Local Authority Building Trade Operatives (6 November - 76,000) have rejected an offer of £4.60 (5.5%) on basic rates - estimated at about 4% on earnings - and are seeking increases of up to 7.8% on rates, the same as LA manuals. Next meeting 25 March. The Review Body for Doctors and Dentists (1 April - 85,000) is expected to report in April. The doctors and dentists are claiming 12½% and 13% respectively, 3% of which is due from the previous award. NHS Nurses and Midwives (1 April - 492,000) have submitted a claim for a 12% increase in basic rates, reduced hours and other benefits. An additional £63 million above the 4% target figure has been made available. Negotiations have opened on the basis of 4% for all grades plus improvements in incremental scales for clinical nurses and those nurses in teaching. Next meeting 23 March. NHS Ancillaries (1 April - 210,000) and NHS Admin and Clerical (1 April - 125,000) have presented similar claims to that for nurses. Unions have rejected 4% offers. No extra cash has been made available for these groups.

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20 In the PRIVATE SECTOR, all 21 areas of the Road Haulage Industry (Nov/March - 97,000) have been made offers in the range of 5.6% to 8.6% on basic rates. Eighteen areas have accepted the offers and the other areas are still negotiating. An improved offer of 8.5% plus holiday improvements for London Clearing Bank Clericals (1 April - 146,000) has been accepted by the Clearing Banks Union but is to be put to a ballot of members by the Banking, Insurance and Finance Union. Scottish Banks Clericals (1 April - 17,000) have recorded a failure to agree in their negotiations following rejection of a 7.5% offer. The claim is for a 15% increase. Next meeting 22 March. Unions on behalf of Newspaper Publishers Association Production Workers (1 January - 33,000) have balloted members on a 5% 'final' offer. NATSOPA, NGA and SLADE have accepted. SOGAT and EETPU have rejected the offer. SOGAT may ballot members again. British Printing Industries Federation Employees (24 April - 128,000) have submitted claims for substantial increases, an extra week's holiday and other benefits. An improved offer of £5.50 to £6.25, according to grade, is to be put to union members All three unions involved are recommending acceptance. A settlement is expected for Biscuit Manufacture (1 January - 39,000). Agreement on an offer of 8.3% plus 1 extra day's holiday has been reached subject to ratification by the unions.

PRICES AND EARNINGS INDICES

PRICES

21 In February the year on year increase in retail prices was 11% compared with 12.0% in January.

EARNINGS

22 In January the year on year increase in average earnings for the whole economy was 10.8% compared with 10.1% in December; this reflects the underlying position as temporary factors broadly offset each other.

REAL DISPOSABLE INCOME

23 The real disposable income - taking account of the changes in earnings, prices and taxes - of a married man on average adult male earnings with a non-working wife and two children under 11 (with noother tax liabilities or allowances and not contracted out of the State Pension Scheme) fell by about 3½% in the year to December.

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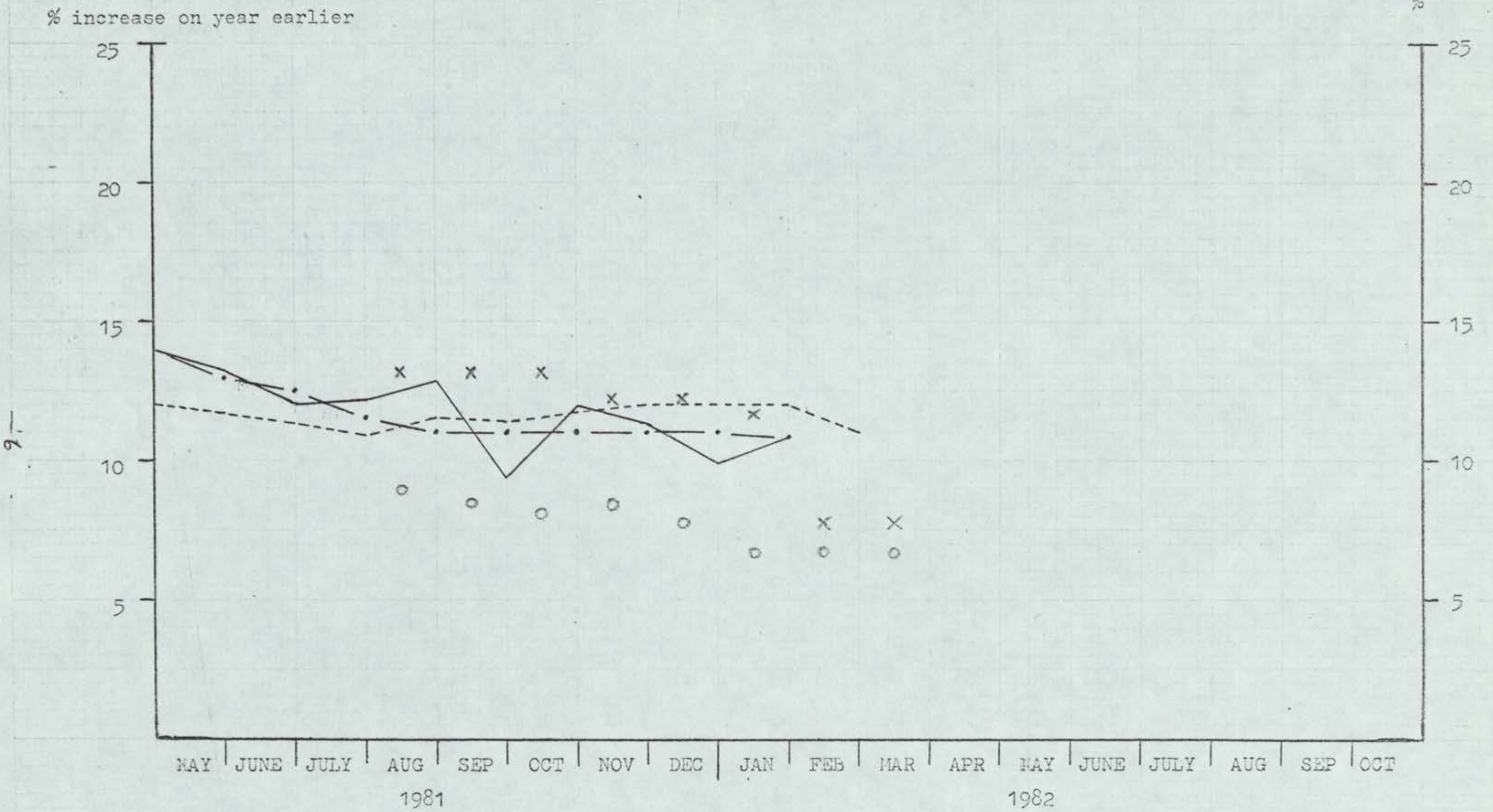
APPENDIX 1

TRENDS IN EARNINGS AND PRICES



- - - - - Retail Price Index

———— Average Earnings Index (whole economy)

. ——— . Underlying rate of increase in earnings

× Public Sector Settlements)
○ Private Sector Settlements) Cumulative Average Increase in Earnings

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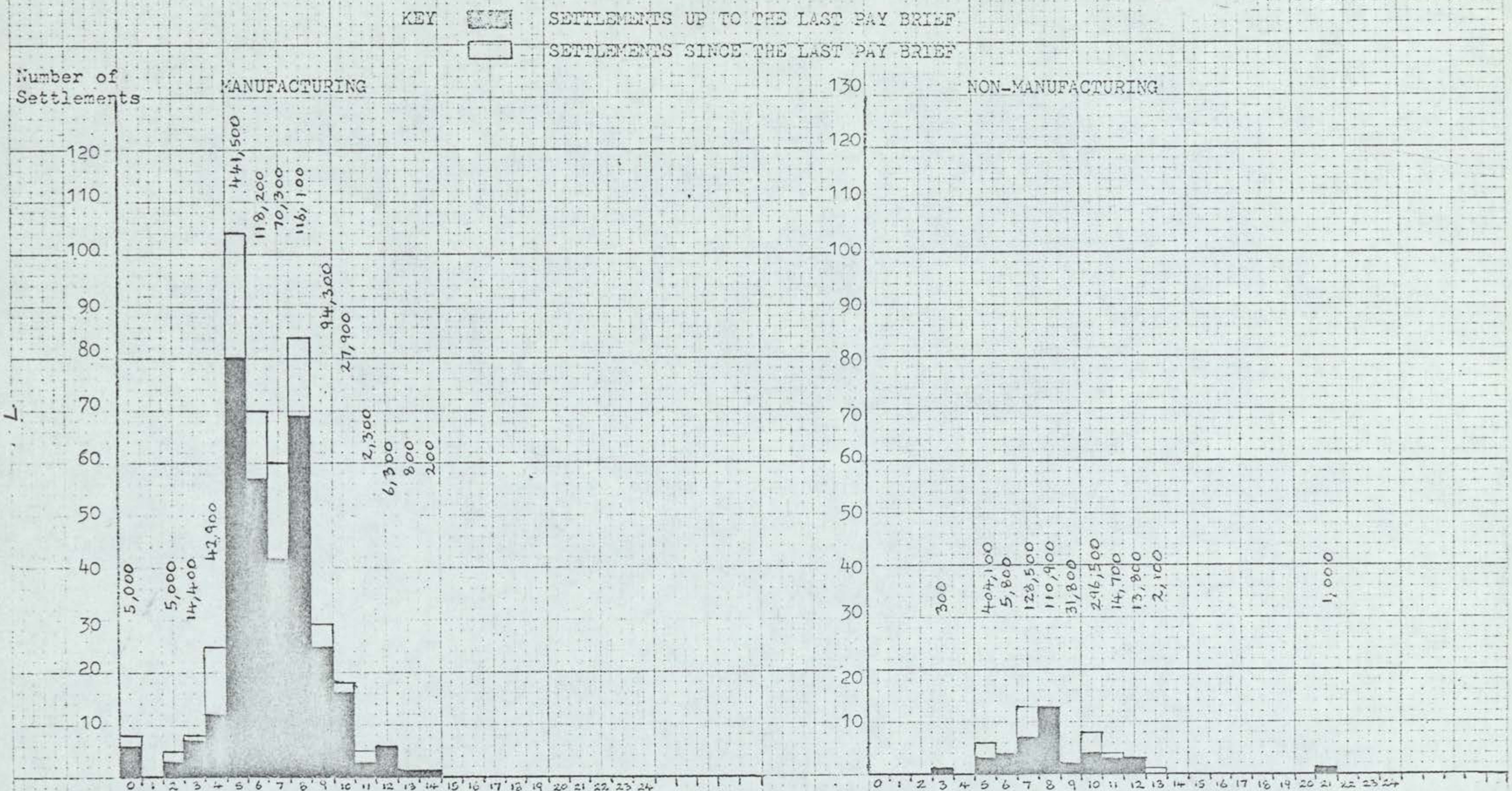
APPENDIX 2

DISTRIBUTION OF SETTLEMENTS IN THE PRIVATE SECTOR BY LEVEL OF SETTLEMENT FROM 1 AUGUST 1981



LEVEL OF SETTLEMENT (ROUNDED TO THE NEAREST WHOLE NUMBER)

NOTE - THE NUMBER OF WORKERS (ROUNDED TO THE NEAREST HUNDRED) AFFECTED BY THE SETTLEMENT IS GIVEN ABOVE THE APPROPRIATE INDICATOR.

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PS/Secretary of State for Energy
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PS/Secretary of State for Employment
PS/Paymaster General
and officials in HMT, Revenue Departments and other Departments in Whitehall

TREASURY WEEKLY ECONOMIC BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 7 March, are sidelined. Some Sections appear in typescript because of temporary problems attending re-location and re-equipment of the Word Processing Unit.

M M Deyes

M M DEYES

RA

R I G ALLEN

15 March 1982

EB Division
HM Treasury
01-233-3364

ECONOMIC BRIEF: CONTENTS

6. Budget not expansionary enough?

Growth depends not on tax handouts or higher public spending, but on lower inflation and better competitiveness. Budget is directed at these. Lower world oil prices have similar effects on industrial costs as cut in NIS and reduce need for additional measures. [IF PRESSED: Budget should be seen in context of December measures - £5 billion increase in planning total for 1982-83.]

7. Budget far too expansionary?

Changes relative to some hypothetical alternative pretty meaningless. What matters is that in planning PSBR for 1982-83, Government has stuck closely to MTFS.

8. Reflationary/deflationary/effect on demand?

Oversimple questions. Wrong to talk about what government is "putting into" or "taking out" of economy. Ignores links between fiscal and monetary policy and their effects through financial behaviour (interest rates and exchange rate), on economy. Budget's overall effect is to support sustainable recovery.

9. Not enough help for industry?

Glad to see (from FT Survey) that most industrialists pleased with Budget (see N2). Main help for industry is in pursuing policies that allow for lower inflation and ease pressure on interest rates. But in addition, Budget measures aimed at industry and business with cost over £1 billion in 1982-83. Setting aside revalorization of personal tax allowances etc and specific duties, over two thirds of net revenue cost of Budget changes go to help business. Minor measures aimed where do most good. Also remember protection for industry from 2 years of employees' NIC rate increases, worth £1 billion a year (or another 1 per cent off NIS).

10. Fiscal policy should be based on 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.

11. Fiscal policy should be based on cyclically adjusted PSBR.

Actual not hypothetical PSBR has to be financed. Real test is pressure on interest rates. Adjusted PSBR calculations provide only limited and partial help in assessing direction of policy.

12. Another Budget pushing up prices?

No. Changes in excise duties slightly less than required for full revalorisation. 12-monthly inflation rate forecast to fall to 9 per cent by November 1982.

13. Effect of Budget on personal incomes, incentives etc?

See Section D.

14. Does more for industry than for people?

Help to industry is help to people. Higher allowances and thresholds more than compensate for inflation in last year and make up some of ground lost last year. Many other smaller changes (eg on charities) will help particular groups of people.

15. Not keeping to commitments to reduce expenditure?

Increases announced in Budget offset by reductions leaving totals still around £115 billion. FSBR shows declining ratio to GDP in future years.

16. Armstrong/unified Budget?

Proposals have wide implications. Need careful consideration. Government does take account of tax and expenditure when taking decisions on each. Await TCSC report with interest.

17. MTFS abandoned?

[Mr Heath's claim (Weekend World 14 March) that 'monetarism is dead']

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.

BULL POINTS

As at 15.3.82 (Tape 455)

(i) Signs of recovery

- Total output (GDP) rose in both 3Q and 4Q 1981. Level in 4Q some 1 per cent above 2Q.
- Short time working in manufacturing fell in 1981 to below 1/4 its January peak;
- 1981 figures show volume of engineering and construction orders up about 17 and 9 per cent respectively on 2H 1980.
- Private sector housing starts in 1981 up by 37 per cent on 2H 1980.
- Most recent major independent forecasts assess low point in activity reached in 1H 1981; prospect of some recovery in 1982.

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

(iii) Productivity. Output per head in manufacturing rose 10 per cent during 1981. Investment in plant and machinery holding up well.

(iv) Unit labour costs: Pay moderation and higher productivity has meant dramatically slow increase in manufacturers unit wage costs over last year - just 2½ per cent in year to 4Q 1981.

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

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

(vii) Exports holding up well; non-oil export volumes in 4 months to December up 3½ per cent on 1980. 1981 figures (incomplete) show engineering export orders up 20 per cent on 2H 1980.

(viii) Unemployment. Rate of increase in unemployment since mid 1981 about half that in 1H and 1/3 that in 4Q 1980. Vacancies improving since mid 1981. Short-time working in manufacturing reduced by over ¾ during 1981 and overtime working has increased.

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

(x) Training. Over next 3 years £4 billion to be provided to bring training schemes up to date. New Youth Training Scheme for school leavers to be introduced September 1983 represents major step towards comprehensive provision for young people.

(xi) Industrial relations. Number of strikes in 1980 and 1981 less than in any year since 1941 and number of working days lost only a third of average of last ten years.

(xii) Retail prices. Inflation almost halved since peak in spring 1980 (21.9 per cent). 12 monthly increase in January of 12.0 per cent. [NB Progress affected by lower exchange rate.]

(xiii) Share Ownership Schemes: Number of schemes has increased from 30 in May 1979 to over 400. Number of employees covered roughly doubled between first and second years in office. Profit sharing schemes alone now cover about ¾ million employees.

(xiv) Loan Guarantee Scheme. Over 2700 guarantees issued so far on loans totalling just under £100 million. Well over half of loans going to new businesses.

(xv) Enterprise Zones. 10 out of 11 zones already in operation. Last one (Isle of Dogs) expected to start in April.

(xvi) Examples of export successes reported in the Press include: £160 million contract for construction of two new colleges in the largest ever such contract between Britain and Nigeria (Mitchell Cotts Group); approved tender for veterinary vaccines to Kampuchea (Hoechst UK); supply of 1000 special gearboxes to Istanbul within five weeks of order (Turner-Spicer Transmissions); travelling hoists with exceptionally low headroom (550mm) for use in Danish oil and gas exploration platform in North Sea (Tonnes Force); a profiled metal cladding system for a power station in The Gambia (Ash and Lacy Steel); and glazing for the new Financial Complex in Port of Spain - the biggest ever such gained by a UK glass processor (Clark and Eaton with Pilkingtons). New British-designed, managed and partly funded, domestic water supply project in Jordan was opened by King Hussein on 18 February.

(xvii) UK preferred location: US electronics industry survey reports UK most preferred location for establishing new plants.

(xviii) Overseas debt repayments. Official external debt reduced from over $22 billion, when Government took office, to $13.3 billion at end-1981.

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

B ECONOMIC ACTIVITY AND PROSPECTS

1. Recent position?

Recovery confirmed by second successive quarterly rise in total output. Output in Q4 1 per cent up on Q2 - the earlier low point.

[IF PRESSED on apparent weakening of recovery (based on November/December/January industrial production) - see 2 below.

2. Recent manufacturing production figures show resumed decline?

[January figures show further fall in industrial and manufacturing production, now 3 and 4 per cent respectively below October levels, with manufacturing production at lowest point since 1967]

Only to be expected that January's index would show some further weakening. Series of factors (car and rail strikes, bad weather, holidays) have distorted the last three months. Despite this, manufacturing output in Q4 1981 some 2-3 per cent higher than its low point earlier in the year (Q1 1981). Preliminary indications for February suggest a pick up, with steel and car output up 16 and 12 per cent respectively, compared with January.

3. Other evidence of improvement in economy?

Engineering and construction orders and private sector housing starts all well up during 1981 on H2 1980. Productivity (output per head) in manufacturing rising strongly - up 10 per cent in Q3 1981 from Q4 1980. Exports doing well (see K4). (Labour market indicators -see C1).

4. 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	1½	2
Manufacturing output	3	2
Consumers expenditure	½	½
Investment (private sector and public corporations)	4½	5
Exports	3½	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 (7½ per cent) by mid 1983. Further progress depends on continued moderation in domestic costs and restoration of competitiveness.

5. Outside forecasts

[GDP profile in recently released major forecasts:

	NIESR	LBS	CBI	Phillips & Drew	OECD	FSBR
	(Feb)	(Feb)	(Nov)	(Mar)	(Dec)	(Mar)
Per cent change 1982 on 1981	+1½	+1½	+1	+1¼	+¼	+1½]

Most recent major independent forecasts assess that low point in activity was reached in first half of 1981, with prospect of some recovery in 1982. As always, a range, with Cambridge forecasts being the more pessimistic. Most outside forecasters have not yet published their post-Budget assessments. Only major forecasters who have (Phillips and Drew) have revised their forecasts to show higher output and lower inflation arising from Budget measures and lower oil prices.

C LABOUR

1. Recent unemployment figures?

[February total count was 3,045,000 (12.6 per cent) down by 26,000 on January. Seasonally adjusted excluding school leavers figure was 2,836,000 (11.7 per cent), a rise of just 7,000 on January.]

Figures so far this year distorted by severe weather. Average monthly increase in January and February together about 30,000 (after allowance for over 60's transferring to long term Supplementary Benefit). Compared with 40,000 a month in H2 1981 this suggests a further slowing down in rate of increase (but figures have been affected for almost half a year by series of distortions - bad weather, civil service strike).

2. Effect of Budget on unemployment?

Budget contributes to Government strategy of fostering conditions for sustainable growth. Help to business will lay foundation for more real jobs. Employment will benefit from some further improvement in activity. Proposed new non-profit-making scheme will enable local authorities and voluntary sponsors to provide many new jobs. (100,000 at additional Exchequer cost of £150 million).

3. Unemployment expected to continue rising rapidly?

[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. others are broadly flat (LBS, St James, P+D); only Liverpool foresee a fall (400,000)]

Unemployment forecasts uncertain; independent forecasters encompass differing views for 1983 - with several projecting stabilisation and Liverpool some decline. Rise in unemployment drastically reduced since end 1980. Tentative evidence of further slowing down this year - January/February rise just ¼ than in Q4 1980. Vacancies, short time and overtime all improved last year. Employment situation will benefit from some further recovery in activity this year.

4. 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. 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 the conventional assumption adopted by previous Administration. PEWP figures consistent with the prospect of some fall in total unemployment before the end of 1982-83. They do not however necessarily imply this. If things go well - eg lower pay settlements, recovery in world trade - then reasonable to hope for fall in unemployment before end 1982-83.

5. Employment continuing to fall?

[Total employment declined 1.9 million or 8 per cent in 2 years to Sept 1981. Q3 figures indicate decline of 150,000 compared with 300,000 per quarter in H1 1981. Manufacturing employment declined by 34,000 a month in Q4, a little more than Q3.]

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

6. Unemployment higher than in other countries?

[On standardised definitions in 3Q 1981 UK employment was 11½ per cent compared with 6¾ per cent OECD rate; a UK doubling compared with an OECD rise of a third 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.

7. Higher Exchequer costs of unemployment. Recent Treasury estimates suppressed?

No "right" figure. Estimates depend on assumptions and items of "cost" covered. Estimates have been made of cost of additional registered unemployed (eg for 1980-81 in February 1981 EPR). Attempt made to update to 1981-82 - range of figures has been calculated. But doubts expressed about assumptions used. Work, therefore, continues. No decision whether to publish. Cannot gross up such figures to produce total cost (in terms of lost taxes and extra benefits) of all the unemployed. Meaningless concept. Implies comparison with economy with zero unemployment. Can say total expenditure on unemployment and supplementary benefits paid to the unemployed estimated at £4.3 billion in 1981-82 and £5 billion in 1982-83.

8. What is Government doing to provide more jobs?

Illusion to think Government can switch employment off and on like a tap. Governemnt pursuing sensible fiscal and monetary policies to curb inflation and creating conditions for enterprise. These are 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 new measure announced in Budget. (See C2.)

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

Have taken action on a number of points:

Training: extra spending on 16-17 year olds; plans to reform apprenticeship system; White Paper on New Training Initiative sets out action required in industry and education as well as lead from Government to bring system of industrial training up to date.

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

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

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

Employment Bill 1982 designed to bring about further improvement in labour relations.

D TAXATION

1. Burden of taxation

[Total taxation (i.e. including for example indirect taxes, income tax, NIC, corporation tax and rates) 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 39½ per cent in 1982-83.]

This has inevitably increased during a time when the recession has been adding to public spending. My Rt Hon Friend the Chancellor has now been able to propose changes which will reduce the burden next year compared with 1981-82.

2. Personal Tax burden increased when NICs taken into account?

The real increase in personal allowances and tax thresholds will reduce income tax as a percentage of income at all levels of incomes. If pressed the percentage paid in income tax plus NIC will rise for most people. But it will fall for the lowest paid (below ½ average earnings (married) and below about ⅓ average earnings (single)). Those over pension age who are taxpayers will benefit from the income tax changes and will be unaffected by the NIC rise, and, of course, National Insurance retirement pensions are also being uprated.

My Rt Hon Friend the Chancellor explained fully the effect of tax and National Insurance Contribution changes in answer to the Hon Member for Edinburgh, Central on 11 March (OA Col. 955).

3. 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.

4. Failed to compensate for last year's non-indexation?

Impossible to finance - without grave risks to interest rates and present recovery - the additional £3 billion cost.

5. Income tax cuts only help highest paid?

Not true : those who will gain most are lowest as well as highest piad; i.e. gives greatest proportionate benefit to highest and lowest paid taxpayers who did worst in last year's budget.

6. No help on poverty trap?

Numbers in Poverty Trap should not be exaggerated. The increases in income tax allowances have a beneficial impact. [If pressed: overall there is a small increase in numbers in the poverty trap (10,000) as a result of the FIS uprating. FIS uprating helps low paid and generally makes employment more attractive than unemployment.]

7. Reduction in NIS not enough?

Cut welcomed by CBI and industry generally. Provides substantial help on business costs. The 1 per cent reduction the 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

8. 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 including supplementary increase last July on tobacco/Scotch whisky industry/need to shield industry as a whole by smaller increase on derv and no increase on fuel oil.

9. Petrol/derv/VED increases anti-motorist/industry

These three duties not singled out; increases as a whole no more than broadly compensate for past year's inflation. 2p smaller increase on derv further shields industry and distribution costs by increasing 10p a gallon differential with petrol introduced last July.

10. Changes in basis of VED on lorries unexpected/add to costs?

Restructuring of VED on lorries proposed from October will allow distribution between lorry-types of unchanged overall burden to better reflect relative shares of road track costs. Endorsed by Armitage Committee and forshadowed by 1981 Transport Act. Detailed rates in Finance Bill.

11. Reduce VAT?

Reduction in 15% standard rate not appropriate. Nearly half consumer expenditure zero-rated or exempt (including necessities like most food, housing, domestic heating). Applies equally to home-production and imports. Assistance provided for whole of UK private sector through reduction in NIS.

12. Why no VAT relief for charities?

Not possible: high revenue cost; serious definitional and administrative difficulties; would have repercussions in other areas, which could seriously erode VAT revenue base.

13. Not enough to encourage (existing) small firms?

Measures in the enterprise package substantial - full year cost of about £80 million. Moreover, third successive Budget to contain such measures. Many of the latest measures (for example, increase in "small companies" Corporation Tax profits limits, VAT registration thresholds, purchase of own shares) benefit existing small businesses.

14. Government take from North Sea Oil too high?

No. Slight reduction in the Government take is justified to preserve the North Sea as an attractive investment : a greater reduction would have tipped the balance too far in the industry's favour and reduced Government take below an acceptable level

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. Additional spending, for example, to help the young unemployed. Drive for more efficient management in the public sector and reduced administrative expenses continues.

[Ratio to GDP: see Q16]

2. Increase spending in recession?

Not Government's intention to try to spend its way out of recession. Any benefits would be very short-term, and would soon lead to more inflation and higher interest rates and inflation. But we are responding, within limits of prudence, to needs of current circumstances.

3. Real terms comparisonns

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 the same in 1984-85). ~~So~~ in cost terms [ie cash inflated/deflated by the general movement in prices] there is an increase in 1982-83, a decrease in 1983-84 and a small decrease in 1984-85.

4. Plans unrealistic, given eg overspending in 1981-82/future rates of inflation?

Total spending in 1981-82 was expected to be only a little [NOT FOR USE: 0.4 per cent] higher than planned a year ago. Major reason for overspending is present level of spending by local authorities and this has been taken into account in plans. Realism, particularly in respect of local authorities and nationalised industries, is one reason why plans for future years are higher than in previous White Paper. Planning totals for 1983-84 and 1984-85 include Contingency Reserves of £4 billion and £6 billion. These are large to allow for the greater uncertainty about later years and are designed to give realistic planning totals in a cash regime.

5. Inflation assumption - higher in FSBR than in PEWP?

			Per cent
	1982-83	1983-84	1984-85
[1981 Survey/PEWP cash factors	pay 4	6	5
	non-pay 9		
1982 MTFS: GDP deflator	8	7	6]

Yes but:

(a) coverage by GDP deflator does not equate to movement of public sector costs (eg pay forms a greater percentage of costs in public service than in economy as a whole);

(b) cash factors for Survey were not forecasts but provision which Ministers chose to make for general pay and price movements in public sector when starting 1981 Survey; decisions then taken on cash provision to make for each programme;

(c) in due course, will consider adequacy of cash provision on programmes. This is to take into account a number of factors, including estimates of likely course of inflation. But other factors also important (eg individual needs of programmes, proportion of programme spent on pay, savings from greater efficiency). In meantime, uncertainties due to, eg, inflation are one reason for the large contingency reserves in later years; makes for realistic planning totals.

6. NIS reduction: effect on public expenditure?

[Programmes will be reduced to reflect reduction in NIS paid by public sector. First estimates of effect (included in post-Budget revised planning totals) is some £360 million in 1982-83 and £450-500 million in later years. Central government cash limits, nationalised industries' EFLs, and RSG will be reduced by full amount of reduction. Supply Estimates will be adjusted in due course.]

Government's intention in reducing the NIS is to help private industry, not public sector. Effect of clawback on public sector will leave its position broadly unchanged.

7. Not enough capital expenditure?

Government prepared to give priority to worthwhile capital projects wherever this can be done within overall spending totals. To increase the totals would be beneficial only in the short-term. Plans do allow for changes between 1981-82 and 1982-83: as follows:

- public sector spending on new construction increase by 14 per cent;

- nationalised industries investment to rise by 26 per cent;
- increase in housing investment output (especially following Chancellor's announcement about housing improvement grants). [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).

8. 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 (eg roads, schools). Planned spending should not jeopardise future standards and availability of public amenities and services.

9. Three million unemployed indefinitely?

See C4.

10. Cash planning means concentration on first year, not enough on services in later years (Plowden being abandoned)?

Government recognises case for medium-term planning. But planning must be in relation to availability of finance as well as in relation to prospective real resources. Illusion to suppose there can be an unconditional commitment to forward plans for services. Volume plans formerly had to be cut frequently because no allowance made for financial constraints - eg after IMF intervention in 1976.

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

Government last year concluded that provision for 1982-83 should be made on basis of a 4 per cent pay factor overall. This remains its view. Some public servants may get more than 4 per cent, some may get less. But no automatic entitlement. Every settlement will have to be justified on rigorous assessment of its merits. That position is unchanged. (See also J9-12)

12. Preferential treatment for Civil Service?

Mechanisms for dealing with expenditure on public service pay apply to the Civil Service as they do to others. An offer has been made to the non-industrial civil servants (grades up to

Principal) which averages 4.05 per cent. The unions have asked to go to arbitration and we have agreed in accordance with our undertaking to the Civil Service unions last year that if agreement could not be reached in this year's negotiations we would be prepared to go arbitration. The award will be subject if necessary, to override-with the approval of this House. (See also J 13-14)

13. Contingency reserve and pay

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

[NOTE: one third of cost of increased pay offer to nurses and certain other NHS staff will be met by health authorities. The remainder, less offset from NIS clawback, will be met from Contingency Reserve.]

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

Only one third of current expenditure is on wages and salaries and much of that is for nurses, teachers, members of armed forces, police and so on. We have limited the provision for public service pay increases next year to 4 per cent. Administrative costs are not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain the drive for more efficient management throughout the public sector.

15. Cut staff numbers in public services?

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

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

Ratios in 1980-81 (43½ per cent) and 1981-82 (45 per cent forecast) remain below the level of 1974-75 and 1975-76 (46 per cent in both years). 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.

LOCAL GOVERNMENT

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

In order to set local authorities reasonable and realistic targets, we have increased the plans by £1.35 billion. But substantial economies will still be required as plans only allow about 2 per cent more cash spending than latest budgets for this year. [IF NEEDED: Future years' plans allow less cash growth, to get expenditure back on track.]

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

Not at all. If local authorities budget to spend in line with Government's plans, rate increases should be very low. Where they are high, it is because local authorities have chosen to overspend. [NB. FSBR quotes 12 per cent rise in rate income but this takes account of information so far received on actual rate increases.]

19. Effect of NIS reduction on local authorities?

As my rHF announced in his Budget the lower NIS payments by local authorities will be offset by a reduction in RSG. This will mean that local authorities overall are neither worse nor better as a result of the decrease in NIS. [IF PRESSED: We will be consulting the local authorities about the details.]

20. Control of rates paid by industry

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

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

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

F SOCIAL SECURITY

1. November 1982 uprating?

[Chancellor in Budget statement announced that most benefits are to be uprated by 11 per cent next November - 9 per cent for price protection and 2 per cent to restore shortfall. Secretary of State for Social Services gave details in his statement on 10 March.]

We have provided that all benefits usually uprated will maintain their purchasing power and will have restored the shortfall of 2 per cent which occurred at the last uprating. This includes those benefits where we have given no pledge of full price protection. The uprating of benefits next November will cost £1 billion in 1982-83 and nearly £3 billion in a full year. We could not afford to do more.

2. - Why not restore November 1980 5 per cent abatement now that unemployment benefit is to be brought into tax?

Decision to abate UB was not simply taken as a proxy for tax but to reduce public expenditure and to improve incentives to find and keep work. (Chancellor's Budget statement in March 1980 made that perfectly clear.) Those reasons remain valid. Earnings are not at present moving ahead faster than prices. Rates of benefit already announced constitute a guarantee of protection against forecast movement of prices over the two years to November 1982. Any improvement on that would seriously worsen incentives. Cost too would be high - £60 million in a full year [net of reduced claims for supplementary benefit, but gross of tax.]

3. Increasing supplementary benefits by less than forecast movement of prices hits at poorest of the poor, and breaks an election pledge?

The benefits will retain their value in real terms. Claimants of supplementary benefit receive not only their scale rate entitlement but a cash payment to cover their housing costs in full. The recent large increases in housing costs have tended to make increases in the RPI higher than they otherwise would have been; supplementary benefit rates have accordingly been higher and there has been some double provision for claimants. The change corrects that. The abatement of ½ per cent represents a broadly based adjustment for the likely relative movement of housing costs to November 1982. [NOTE: we do not want to make public a forecast of the housing index].

4. Increase in capital disregard should have been greater?

[Secretary of State announced a increase in capital disregard for supplementary benefit from £2,000 to £2,500.]

Change represents a 25 per cent increase in level of disregard since it was set in November 1980; this more than restores its value. No reason to suppose that the operation of the disregard causes any general hardship or that it has led to people deliberately disposing of capital in order to qualify.

5. Child Benefit increase too low?

[Child Benefit is to be increased by 60p, to £5.85 next November.]

That uprating will maintain the real value of the benefit since November 1980. It is not as high in real terms as the level set in April 1979, but the increase then is generally recognised to have been out of line - a pre-election move by the last Labour Government.

6. Earnings Limit

Earnings limit for pensioners has been increased from £52.00 to £57.00. It remains our intention to abolish the limit entirely. But so far we have not been able to do so, it has been essential to give priority to maintaining the purchasing power of benefits.

7. Death grant - increase to realistic level?

[Secretary of State for Social Services announced his intention to publish a consultative document on the death grant some time in week beginning 15 March.]

I know my Rt Hon Friend Secretary of State for Social Services would welcome comments on his consultative document on death grant which [EITHER: has just been published] [OR: is to be published later this week]. As we have always made clear, our aim is to redistribute the resources now devoted to death grant in a more sensible fashion - we cannot afford to add to those resources.

G PUBLIC SECTOR BORROWING

1. PSBR in 1981-82 and 1982-83

[1982-83 FSBR published 9 March shows an estimated 1981-82 PSBR outturn of £10½ billion, and a forecast 1982-83 PSBR of £9½ billion.]

PSBR in 1981-82 in line with 1981 Budget forecast and PSBR reduction in 1982-83 broadly in line with 1981 MTFS.

2. Effect of Civil Service dispute on PSBR?

PSBR in both years affected by Civil Service dispute. In 1981-82 some £¾ billion of receipts delayed from March 1981 were collected but some £1 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.

3. CGBR April-Feb press notice implies odd CGBR for March?

[CGBR April-February £8.1 billion - PSBR estimates 1981/82 £8.75 billion]
The borrowing figures in the red book are consistent with the outturn information available so far this year.

4. PSBR should be higher/lower?

The PSBR reduction in 1982-83 is broadly in line with 1981 MTFS
[IF PRESSED: the 1982-83 PSBR is really much higher than £9½ billion. The delayed tax receipts of £1 billion, the sales of extra assets of £½ billion, etc. imply a 'true' PSBR figure nearer £11 billion.]

5. Others have used Treasury model to show larger PSBR would be beneficial

Using Treasury model does not endow such claims with respectability. Results depend on judgements and assumptions rather than pressing buttons. Often key factors such as interest rates and exchange rates are assumed fixed at some "desired" level. Interest rates cannot simply just be lowered at will. Effects on confidence very real and important but difficult to allow for. Reported analyses often are very short term.

H MONETARY AND FINANCIAL POLICY

1. Lower interest rates ?

/Bank base rates reduced by ½ per cent to 13 per cent with effect from 12 March . Have come down by 3 per cent from peak of 16 per cent last autumn. Market rates generally have been falling ./

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

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

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 rates eased against US trend; but cannot insulate ourselves from difficult international background.

3. Recent fall in interest rates incompatible with strategy

Taking account of all evidence, present levels of interest rates are consistent with policy of continuing downward pressure on inflation.

4 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 1982-83 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.

5 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.

6 Increase in target ranges

Ranges in past MTFS were purely illustrative. Did not take account of structural changes. Right to take account of current rate of growth in setting new targets, to avoid unduly sharp brake on monetary growth. 8-12 per cent still implies deceleration from current growth rate i.e. continued downward pressure on monetary growth.

7 What if aggregates' rate of growth diverge?

Will examine factors underlying divergence. Policy decisions will continue to take account of all available evidence with a view to restraining inflationary pressures.

8 Overshoot of 1981-82 £M3 target

/ Preliminary information suggests £M3 was little changed during banking February; rate of growth over past 12 months (i.e. the target period) was 14.4 per cent. M1 fell by about ½ per cent in banking February; grew by 8.7 per cent over past 12 months; PSL2 rose by about ½ per cent in banking February; grew by 12.1 per cent over past 12 months. 7

Growth in £M3 was above top end of target range, even allowing for effects of Civil Service strike. At least part of excess reflects increasing market share of banks in housing and consumer lending. Also reflects longer term effects of institutional changes such as ending of corset, abolition of exchange controls and changes in savings behaviour. These factors imply higher monetary growth permissible for same increase in nominal incomes.

9 Monetary conditions too tight?

Behaviour of exchange rate and money GDP as well as monetary aggregates suggest financial conditions have been moderately restrictive as intended. But bank lending still high, despite level of interest rates. Companies' financial position much stronger than a year ago.

10 Bank lending

Still very strong. Part at least is substitution for lending by building societes and other forms of consumer credit. To extent that it is additional, adds to inflationary pressure, it must avoid premature relaxation of interest rates.

11 Why more indexed gilts?

[Bank announced new index-linked gilt available to all investors on Budget Day. Restrictions on eligibility to hold existing indexed gilts removed.]

Issue of indexed gilts demonstrates Government's confidence in strategy of reducing inflation. Will allow direct access to indexation benefit to individual investors.

12 Giving money away by derestricting existing stock?

No: price rises not a cost to Exchequer. Over time, broadening of market should benefit Exchequer through reducing yields on new derestricted stocks.

J PRICES AND EARNINGS

1. When will single figure inflation be achieved?

[Year-on year rate of inflation unchanged in January at 12 per cent, compared with 21.9 per cent in May 1980 and lowest recent level of 10.9 per cent in July 1981.]

Budget forecast is for year-on-year rate of inflation of 9 per cent by Q4 1982, falling to 7½ per cent by mid-1983.

2. Inflation still higher than when Government took office?

[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 14.7 per cent.]

Average level of inflation will be lower under this Government than under its predecessor. This will be the first Government since the war that has achieved a lower rate of inflation than its predecessor.

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

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

4. Effect of 1982 Budget on RPI?

Compared with full indexation of excise duties, effect of Budget is RPI reduction of 0.1 per cent (or an increase of 0.1 per cent including also the effect of the 2 December measures). [IF PRESSED on non-indexed basis: effect is 0.8 per cent increase in the RPI (or 1.4 per cent including also 2 December measures).]

5. Effect of 1982 Budget on TPI?

Compared with full indexation of excise duties, effect of Budget is TPI reduction of 0.4 per cent (or increase of 1.1 per cent including also effect of 2 December measures). [IF PRESSED on non-indexed basis: effect is 1.6 per cent reduction (or a 0.3 per cent increase including also 2 December measures).]

6. Nationalised industry prices

Nationalised industry price rises have been due in part to the ending of the previous Government's policy of artificial and distortionary price restraint. Rate of nationalised industry price rises is now coming more closely into line with the RPI. [See P12]

7. Current level of pay settlements?

In economy generally, settlements in last pay round averaged 8-9 per cent. Negotiators seem to be settling up to about a third lower in this round than they did in previous. And almost all settlements seem to be in single figures.

8. Private sector pay - the CBI's 7 per cent?

[CBI figures published 17 February suggest that manufacturing settlements monitored since 1 August are averaging around 7 per cent.]

Settlements have been lower in recent months, reflecting an increasing sense of realism about pay. But the need is for continuing low settlements which are consistent with maintaining economic recovery and improving employment prospects.

9. Public sector pay

Government's approach to pay in the public services must take account of what the taxpayer can afford. Pay negotiations in the nationalised industries and local authorities are a matter for the parties concerned, as are the financial consequences of any settlements reached.

10. The 4 per cent pay factor

The 4 per cent factor announced on 15 September [for calculations in Public Expenditure Survey] is not a pay norm. It is a broad measure of what the Government thinks reasonable and can be afforded as a general allowance for increases in pay, at this stage of fixing the programme from which the public service wage bill has to be met.

11. 4 per cent cash factor unrealistic/unfair?

Real incomes had risen to unsustainable level and public service pay increased relative to private sector since 1979. 4 per cent is broad measure of what Government thinks reasonable and can be afforded as general allowance in fixing programmes from which public service pay bill has to be met.

12. Nurses broken through the 4 per cent?

The 4 per cent pay factor is not a norm. Government recognises need for pay settlements to take account of market factors, including effect on recruitment and retention of expensively trained staff in NHS. [See also E13 on public expenditure implications.]

13. Application to the Civil Service?

After two negotiating meetings with the non-industrial civil service trade unions no agreement reached. Unions have asked to go to arbitration. Government have agreed, in accordance with undertaking given last July. Case will be heard (by Civil Service Arbitration Tribunal) in April.

14. Government offer to civil service reasonable?

In framing its offer the Government has placed much more emphasis on market considerations and management objectives than on comparability and the cost of living. The unions' emphasis is on the latter two aspects.

15. Average earnings index

[Fall in year on year growth from 11.3 per cent in November to 9.9 per cent in December may attract attention, though (unpublished) underlying increase, broadly unchanged at, just over 11 per cent]

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

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

Yes. But follows growth of 17½ per cent in personal living standards in three years 1977-80.

17. Movement in TPI

Fact that has been increasing faster than TPI (roughly 3½ per cent faster over year to January 1982) reflects measures taken to restrain Government borrowing - essential in inflation is to be controlled.

18. Government aiming to cut living standards?

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

Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

19. Incomes Policy

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

20. Index-linked pensions and the Scott Report?

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

K BALANCE OF PAYMENTS

1. Balance of payments Q4 1981

[1981 Q4 figures for invisibles and capital transactions published 10 March]

Current account estimated to have been £1541 million in surplus in Q4, including a visible trade surplus of £623 million. Total 1981 current account surplus £8 billion.

2. Invisibles

Q4 invisibles surplus in Q4 1981 is put at £918 million compared with £400 million in Q3. This reflects EC receipts totalling £531 million, including budget refunds of £118 million. Increase in the invisibles surplus for 1981 as a whole largely due to 18 per cent increase in interest, profit and dividends surplus to £1148 million - demonstrating benefits of investing abroad.

3. Capital flows

Identified capital in flow in Q4 of £70 million. But the large 'balancing item' (£2100 million) means that all Q4 figures should be treated with caution.

4. Trends in exports

Non-oil exports were 3½ per cent higher in volume terms than in 1980. Exports of intermediate and capital finished manufactured goods are now higher in both value and volume terms than in 1979 and 1980 despite loss of competitiveness. DoI survey of engineering industry suggests export deliveries will continue to rise in 1982, as does CBI Industrial Trends Survey.

5. Trends in imports

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

L EXCHANGE RATE AND THE RESERVES

1. Sterling and the Budget

[Sterling was slightly weaker before the Budget in anticipation of a cut in UK interest rates, but recovered after the Speech, which was broadly in line with market expectations.]

As Chancellor again made clear in Budget, the exchange rate normally gives useful information on monetary conditions. While we have no target for the exchange rate, its effect on the economy and therefore its behaviour cannot be ignored.

2. Sterling still too high?

[Since last September, sterling has remained broadly stable and is currently over 12 per cent below its effective rate peak early last year. Recent lows have been $1.77 on 14 September, DM4.07 on 20 October. Highs were $1.97 on 30 November, DM4.407 on 9 February. Rates at close on 12 March were $1.7986; DM4.274 and an effective rate of 90.07. Reserves at end February stood at $23.4 billion, compared with $23.2 billion at end January.]

The effective exchange rate is only slightly higher than when the Government took office. Manipulating the rate is no answer to problems in the real economy.

3. Has the Bank intervened to support the rate?

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

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

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

5. Sterling should join the EMS?

[See M8-9]

6. Exchange rate and competitiveness?

I welcome the improvement in UK cost competitiveness of over 10 per cent in 1981. This has been partly due to a decline in the exchange rate; more importantly because there are signs that our domestic unit labour costs are now growing more slowly than those of our major competitors.

7. Debt repayments

We have made substantial progress with our plans to reduce the burden of external debt substantially during this Parliament. We aimed to reduce official external debt to $14 billion by the end of 1981. This has been more than achieved - external debt is now around $13½ billion, compared with over $22 billion when the Government took office.

M EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. 'Mandate negotiations'

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

2. Net UK contribution to community too high?

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

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

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

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

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

5. Do supplementary measures grants lead to additionality?

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

6. Policy for CAP reform

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

7. Costs of CAP to UK consumers

My rhF, the Minister of Agriculture, has dealt with a number of questions on this. Costs to consumers of the CAP as such depend on nature of alternative support system that is envisaged. Arrangements leading to a reduction in the cost of food to the consumer could well involve increased costs to taxpayers.

EUROPEAN MONETARY SYSTEM

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

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

9. When will the conditions be right?

Sterling is an international financial currency and is also particularly affected by oil market factors. These mark sterling out from other Community currencies, and add to the difficulty of the decision on the timing of sterling's participation. The balance of advantages, risks and disadvantages is constantly changing, so that the question of participation remains complex.

N INDUSTRY

1. Budget does not do enough for industry?

Budget measures directed at helping business and will cost £1 billion in 1982-83. On indexed basis over $^2/3$ of Budget's net revenue cost will go to help businesses. But main help for industry is in pursuing policies that allow for lower inflation and ease pressure on interest rates.

2. Industry's response to Budget?

[Sir Raymond Pennock, CBI President - "welcome fillip" to business confidence. Sir Terence Beckett, Director General CBI - 'moves in the right direction'. ABCC - 'insufficient and misconceived'. Saturday 13 March Financial Times Marplan survey of industry's reaction reports 77 per cent thought it 'fairly good' for the economy and half those polled thought would reduce inflation.]

Have noted the Association of British Chambers of Commerce's adverse comments, but pleased with the generally favourable response from industry, including CBI.

3. Prospects for industry-recovery?

Fall in output has now come to an end. Industrial production in Q4 1981 ½ per cent up on Q3 and some 2 per cent up on H1. Budget forecast suggests there may be 3 per cent increase in manufacturing output in 1982 as a whole.

4. Company sector finances improved?

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

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

5. Rate of return still too low?

[Real pre-tax rate of return of non-North Sea ICCs rose marginally to 2½ per cent in 1981 Q3 compared to 2¼ per cent in Q2 (a record low)].

Yes, but Government can only help in limited ways such as reducing burden of NIS and creating the climate for lower interest rates. Further improvements in ICC's profits and real rates of return can be expected, provided recent productivity gains and trend towards moderate settlements continue.

6. <u>High interest rates damaging for industry and investment?</u>

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

Budget measures should ease pressure on interest rates. 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 H).

SMALL FIRMS

7. <u>Government help for small firms</u>

Budget provided further help for small businesses in addition to 75 measures taken previously. 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 this year (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.

8. <u>Response to Loan Guarantee Scheme?</u>

Scheme operating successfully. We have already issued more than 2,700 guarantees - well over half to new businesses. Total lending under scheme is just under £100 million. Ten new banks were admitted to the Scheme in November 1981: a total of twenty-seven financial institutions are now participating. Budget provided for the lending ceiling - in year to May 1982 - to be raised from £100 million to £150 million. A further £150 million will be made available in following year.

ENTERPRISE ZONES

9. <u>Progress with setting up Enterprise Zones?</u>

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

10. Response from private sector?

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

P NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83 and future years?

Nationalised industries' total external finance increased to £1.3 billion in 1982-83, £1.7 billion in 1983-84, £1.2 billion in 1984-85 - a total of over £4 billion over the three years of the Survey. Government has given full recognition to problems faced by the industries in a period of recession. Increase in 1982-83 was roughly half what the industries bid for.

2. Unreasonable to reduce EFLs following NIS cut?

Reduction in the National Insurance Surcharge was designed to benefit private sector; not the intention that public sector should gain from it. Reduction in EFLs will simply offset the addition to the industries' internal resources following the NIS cut. No industries will be worse off than previously, and their plans should be unchanged.

3. Pay assumptions?

Government has not set pay or any other assumption for the industries. Moderate pay settlements -and restraint of current costs generally - essential if investment programmes to be maintained and prices to consumers kept down.

4. External financing outturn for 1981-82 way over original limits?

During 1981-82, give industries had their external financing limits increased by a total of £0.5 billion, met from the Contingency Reserve, not an increase in expenditure. In granting these increases, Government recognised problems faced by some industries in a period of recession, and that, in some circumstances, EFLs could not be immutable. Not yet possible to make full assessment of ASLEF strike, but three industries in particular -National Coal Board, British Steel Corporation and British Rail itself - have been adversely affected in short term.

INVESTMENT

5. Investment plans for future years?

Overall industries' investment plans on a rising trend. [CAUTION: Not true for each individual industry.] Increase in total planned expenditure on fixed assets since last White Paper is £200 million in 1982-83, £600 million in 1983-84 and £700 million in 1984-85, ie. an increase of £1.5 billion over the three years. This implies total investment of no less than £24 billion over the three years. 1982-83 plans allow for 26 per cent more investment than in 1981-82, and 40 per cent more than in 1980-81. The industries will be financing a relatively high proportion - roughly two-thirds - of their fixed asset spending from their own internally generated funds, compared with the private sector where industrial and commercial companies finance four-fifths of their investment.

6. 1981-82 investment plans not fulfilled? Planned increase in 1982-83 investment simply 1981-82's plans deferred? Shortfall bound to recur?

[Latest estimate of shortfall published in FSBR is £750 million].

Shortfall this year disappointing, although latest estimates still suggest increase in real terms over 1980-81. Some reductions caused by need to live within EFLs. But at least as great a factor has been downward revision of investment plans by the industries in face of falling consumer demand. [IF PRESSED: We do not expect this to be as large a factor in 1982-83. But no Government can unconditionally guarantee a given level of nationalised industry investment for future, and it would be irresponsible to plough ahead with investment regardless of demand. The approved levels set out in the White Paper are consistent with the industries' increased external financing requirements, agreed for the industries.]

7. 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.

8. Private finance for NI investment?

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

We have indicated our willingness to consider new financing proposals. But direct market finance can only be justified if there is a genuine element of performance-related risk for the investor, in order to improve incentives to management efficiency, and if new forms of saving are tapped, so as to avoid adverse monetary consequences. Market financing does not of itself lessen burden on financial markets.

9. Finance for British Telecom?

Work has been taking place on proposals for BT to raise capital on the market by issuing a new type of bond on which the return to the investor would be based on the profits earned by the Corporation. Further work will now go ahead on preparing a prospectus. Government will want to satisfy itself, in light of market conditions nearer the time, that the bond represents good value to Government and BT, as well as the investor, but, subject to that condition, aim will be to go ahead with an initial sale in autumn 1982 in an amount to be decided, probably £100-£150 million. This will be an important experiment in exposing the performance of a nationalised industry to the judgement of the market place. But above all it remains our purpose to transfer to the private sector assets which can be better managed there.

10. Does the Government propose to sell shares in BT?

[Front page FT Monday 15 March.]

Recent press reports are speculative. As the Chancellor announced in his Budget, detailed work is proceeding on the Buzby bond. The Government continues to examine ways in which market pressures could be brought to bear on nationalised industries, including BT.

11. 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 is 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

12. Nationalised industries' prices

Nationalised industries' price rises have been due in part to ending of previous Government's policy of artificial and distortionary price restraint rises in 1974 and 1980. But since middle of 1980-81, gap between NI price increases and RPI has narrowed. Artificial price restraint would result in unacceptable increased burden on taxpayer and distortion of market forces.

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

13. Action in Budget to help industrial energy users?

Total benefit to industry estimated at £150 million in 1982-83 from measures in Budget (combined effect this Budget and last is £250 million over two years 1981-83), namely freeze on industrial gas prices from 1 April to end-1982; new tariff arrangements for largest electricity users (and continuation of arrangements on electricity prices announced last year); standstill till next winter on list prices for foundry coke; extension for 1 year of boiler conversion grants scheme.

PRIVATISATION

13. What further sales expected?

Special sales of assets in 1982-83 are forecast at around £700 million and around £600 million in each of the later years. These figures are 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 - which are to be made possible by Oil and Gas (Enterprise) Bill currently before the House.

14. Net figure for special asset sales this year?

[Public Expenditure White Paper showed net sales of only £50 million in 1981-82; latest estimate published in FSBR is -£100 million - ie £100 net purchases.]

The low net figure is the result of decision not to proceed with a further programme of advance oil sales in a weak market. The gross figure expected to be in line with the £500 million target included in the last White Paper, and will include the proceeds from Cable & Wireless, the sale of Amersham International Limited and the National Freight Company Limited, the sale of the Government's shareholding in the British Sugar Corporation, and further sales of motorway service areas long leases.

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

Of course the cash is welcome, but benefits run wider than that. Not only will any future borrowing by these undertakings be outside the PSBR, so reducing burden on taxpayers, but the organisations concerned will be made more responsive to market forces and thus have greater incentives to improve efficiency.

16. Government running into heavy weather over sale of Wytch Farm?

The British Gas Corporation is complying with the Government's direction to sell its interest in Wytch Farm. It is too early to say when the sale will take place.

17. Special disposals programme just a subsidy for speculators?

[Heavy oversubscription for British Aerospace, Cable and Wireless, Amersham International, followed by large increases in prices where 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 where 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.

R NORTH SEA AND UK ECONOMY

1. In view of recent falls in price of oil, why did HMG not reduce tax burden on North Sea oil producers?

[Budget tax changes included abolition of Special Petroleum Duty, increase in Petroleum Revenue Tax rate from 70 per cent to 75 per cent, and new system for advance payments of PRT (all from 1 January 1983), plus smoothing of PRT payments from July 1982 (this improves HMG's cash flow at companies' expense). Changes reduce the marginal rate of tax (from 90.3 to 89.5 per cent); involve slight fall in Government 'take' (no change 1982-83, costs £70 million 1983-84).]

Recognise need for tax structure robust to both falling and rising prices. Detailed study showed us that under new structure, levels of profitability should still be sufficient to make exploration and development attractive. Hope that new tax structure will provide more secure and stable regime.

2. Government has missed opportunity to simplify North Sea fiscal regime?

The oil industry has made it clear that it would not welcome a structural upheaval. Would create serious uncertainty and major transitional problems.

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

[PM warned in 23 February speech that limited room for manoeuvre in Budget.]

Other things being equal, lower oil prices will reduce Government revenues from the North Sea. Treasury has estimated that each $1 off the price directly reduces revenue, other things being equal, by £250 million in first year and £350 million in full year. But falling world oil prices are good for the world economy. We will benefit from that - not only from impact on activity, but also lower oil prices will help in reducing inflation. Latest revenue projections already incorporate fall to $31 a barrel for Forties oil.

4. 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 £8.06 billion in 1984-85. Lower than last year's projections, principally because of downward revision to oil price expectations. Contribution of North Sea to GNP estimated at 3¾ per cent of GNP in 1981. Projected to rise to about 4½ per cent by 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. Only one-twentieth of total general government receipts in 1981-82.

5. <u>Government revenues from the North Sea should be used to finance cheap energy for industry</u>?

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

6. <u>North Sea revenues should be channelled into a special fund to finance new investment, particularly in energy</u>?

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.

S WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Governments will have no choice but to reverse policies now unemployment has risen to post-war record levels in many Western countries?

[Unadjusted unemployment exceeded 10 million in USA and 1 million in Canada in January. It exceeded 2 million in Italy in September, 2 million in France in October, and 1.9 million in Germany in February. Highest ever unemployment levels in Canada, France, Italy and UK and highest in USA and Germany since 1935.]

No indication of a widespread departure from consensus achieved last year (eg Ottawa Summit, IMF Interim Committee) about need for prudent fiscal and monetary policies to bring down inflation.

2. Anti-inflation policies not working?

[Year on year consumer price inflation in major countries fell to 9.4 per cent in December. Underlying rates falling in US. OECD and IMF expect some decline in 1982.]

Takes time to squeeze inflation out of system. Year-on-year consumer price inflation in major economies down from peak of 13 per cent in April 1980 to around 8.9 per cent in January: some decline expected 1982.

3. Governments' policies have failed or worsened situation?

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

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

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

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

[Most major countries (US, Japan, Germany, Italy, Netherlands, Belgium, Australia, Sweden) have recently announced measures to cut planned public spending. France has announced the deferral of FF15 billion (£1½ billion) of capital investment. Belgian government has used its special powers to freeze prices temporarily and severely curtail wage increases for rest of 1982.]

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

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

UK far from alone. Almost all European governments working to curb public spending, budget deficits and monetary growth. German government plans to reduce its borrowing in 1982 Budget even in nominal terms by almost 30 per cent. Unlikely investment/employment scheme will entail any significant increase in borrowing - increase in VAT (by 1 per cent to 14 per cent) part of the package from 1 July next year. Impact on employment remains to be seen.

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?

[Report in FT Monday 15 March.]

Things are looking a little brighter in the US both on output score and, with lower interest reates, an improving outlook for inflation. And on the industrial relations front, there have been some encouraging settlements in which unions have clearly accepted lower wage increases in exchange for improved job security. [CAUTION: Not too much should be made of this: some upturn in US economy in the spring was expected.]

9. Even US using fiscal deficit to stimulate economy?

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

10. Recent international interest rate developments?

True that US interest rates rose earlier this year. But prime rates are well below their peak of 21½ per cent last summer and have fallen in the last few weeks. [Prime rates are currently 16-16½ per cent.]

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.

AIDE MEMOIRE ON THE UK ECONOMY 15 March 1982

PRESENT SITUATION

Most recent major outside forecasts (NIESR, P&D, CBI, LBS, St James) assess fall in output ended in H1 1981, with some recovery thereafter (in range 1-1½ per cent for 1982). ITEM and OECD are more pessimistic; seeing further falls of output into 1982. Year-on-year inflation is forecast by most groups to fall further to a range of 9-10½ per cent in 1982 Q4. Most groups see little possibility of further substantial reductions in 1983; inflation forecast to remain around 10 per cent in 1983. The March FSBR forecast, of a 1 per cent rise in output in 1982, and 10 per cent inflation in Q4 1982 is broadly in line with this consensus for 1982. FSBR sees 2 per cent rise in output in year to 1H 1983; 7½ per cent inflation by Q2 1983. Unemployment (UK adult seasonally adjusted) forecast to reach around 3 million by end 1982, with some groups (P&D, LBS, Simon & Coates) expecting stabilisation in 1982, others expecting some further rise.

GDP output estimate rose in both Q3 and Q4 1981. Level in Q4 some 1 per cent above Q2. Recent months' industrial output figures affected by bad weather, car and rail strikes. Nevertheless, Q4 1981 manufacturing output some 2-3 per cent above low point in Q1 1981.

Consumers' expenditure rose 1½ per cent in Q4 1981: the overall level in 1981 was only very slightly higher than 1980. Retail sales were virtually unchanged in the 3 months to February 1982. The volume of visible exports in Q4 1981 was at a higher level than at any time since early 1980. The volume of visible imports in Q4 1981 was back to the level of the first half of 1980 and 21 per cent higher than Q1 1981. DI investment intentions survey conducted in October/November suggests volume of investment, by manufacturing, distributive and service industries (excluding shipping) will rise by about 2 per cent in 1982 following a fall of about 5 per cent in 1981. A large rise is tentatively expected in 1983. Investment by manufacturing (including leasing) is expected to rise during 1982, but for the year as a whole it is likely to be 1 per cent lower than 1981. An appreciable rise is expected in 1983. Manufacturers', wholesalers' and retail stocks dropped by £20 million (at 1975 prices) in Q4 1981 the smallest quarterly fall in the two years of continuous destocking.

Unemployment (UK, seasonally adjusted excl, school-leavers) was 2,836,000 (11.7 per cent) at February count, up 7,000 on January. Vacancies were 113,500 in February.

Wholesale input prices (fuel and materials) rose ½ per cent in February; however the year-on-year increase fell to 12 per cent. Wholesale output prices rose ¾ per cent in February and are 10½ per cent above a year ago. Year-on-year RPI increase remained at 12.0 per cent in January. Year-on-year increase in average earnings was 9.9 per cent in December. RPDI was flat in Q3 1981 following falls in the previous two quarters and a 17.5 per cent rise over the 3 years 1977 to 1980. The savings ratio rose 1 per cent to 14½ per cent in Q3 1981.

PSBR £9.7 bn in the first three quarters of 1981/82 and CGBR (unadjusted) £8.1 bn in eleven months to February 1982; but both distorted upwards by the civil service dispute. Underlying PSBR for '81/82 believed in line with 1981 Budget forecast (£10½ bn).

Sterling M3 was little changed in banking February.

Visible trade showed a surplus of £0.6 bn in Q4 1981. Current account surplus of £1.5 bn in Q4 1981; likely surplus in 1981 as a whole of £8 bn. Reserves at end-February rose to $23.4 bn. At the close on 12 March the sterling exchange rate was $1.7995: the effective rate was 90.1.

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SHADOW OPEN MARKET COMMITTEE

Policy Statement and Position Papers

March 14-15, 1982

PPS-82-1

1. Shadow Open Market Committee Members - March 1982
2. SOMC Policy Statement, March 14, 1982
3. Position Papers prepared for the March 1982 meeting:

The Politics of Uncertainty - Karl Brunner, University of Rochester

Fiscal Outlook, March 1982 and The 1983 Budget Testimony - Rudolph G. Penner, American Enterprise Institute

Statement to the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs and Appendix - H. Erich Heinemann, Morgan Stanley & Co., Incorporated.

The Behavior of the Monetary Aggregates: The Predictability of the Past and Some Prognostications for the Future - James M. Johannes and Robert H. Rasche, Michigan State University

Sources of Financing for the Government Deficit - Robert H. Rasche, Michigan State University

Economic Prospects Through 1983 and Business Outlook-Monthly Update - Robert J. Genetski, Harris Trust and Savings Bank

Economic Projections - Burton Zwick, Prudential Insurance Company of America

SHADOW OPEN MARKET COMMITTEE

The Committee met from 2:00 p.m. to 8:00 p.m. on Sunday, March 14, 1982.

Members:

PROFESSOR KARL BRUNNER, Director of the Center for Research in Government Policy and Business, Graduate School of Management, University of Rochester, Rochester, New York.

PROFESSOR ALLAN H. MELTZER, Graduate School of Industrial Administration, Carnegie-Mellon University, Pittsburgh, Pennsylvania.

DR. ROBERT J. GENETSKI, Vice President and Chief Economist, Harris Trust and Savings Bank, Chicago, Illinois.

MR. H. ERICH HEINEMANN, Vice President, Morgan Stanley & Co., Incorporated, New York, New York.

DR. HOMER JONES, Retired Senior Vice President and Director of Research, Federal Reserve Bank of St. Louis, St. Louis, Missouri.

DR. JERRY L. JORDAN, Anderson Schools of Management, University of New Mexico, Albuquerque, New Mexico.*

DR. RUDOLPH G. PENNER, American Enterprise Institute, Washington, D.C.

PROFESSOR ROBERT H. RASCHE, Department of Economics, Michigan State University, East Lansing, Michigan.

DR. ANNA J. SCHWARTZ, National Bureau of Economic Research, New York, New York.

DR. BERYL SPRINKEL, Executive Vice President and Economist, Harris Trust and Savings Bank, Chicago, Illinois.**

DR. BURTON ZWICK, Vice President, Economic Research, Prudential Insurance Company of America, Newark, New Jersey.

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*On leave from the SOMC; currently a member of the Council of Economic Advisers.

**On Leave from the SOMC; currently Under Secretary of the Treasury for Monetary Affairs.

POLICY STATEMENT

Shadow Open Market Committee

March 15, 1982

All the market economies of the world are in the throes of a persistent decline in productivity growth that has produced stagflation everywhere. Now, hesitant and uncertain steps to slow inflation have imposed a mild recession and intensified the underlying problem. The peak-to-trough decline in output for the United States during the current recession is likely to be below the average for postwar recessions, and the recession seems likely to end in the next few months. Yet, discussion of a worldwide depression has become common, and proposals for the reinflation are widespread.

There are two principal reasons for this wide gulf between the facts about the current recession and the rhetoric about a major depression. The first is the position of major industries such as steel, autos, and trucks in all the industrialized countries. The second is the pervasive uncertainty about the future fiscal policy and current and future monetary policy.

High unemployment in autos, steel and related industries, can be found in countries like France with expansionist policies and rising inflation and in countries with declining inflation. All over the world these industries are suffering more from declines in competitiveness than from the effects of cyclical contraction. The problem for many countries is to shift resources from declining to expanding industries. A return to stop and go policies is not a solution.

Continuation of programs to reduce the growth of public spending and to reduce inflation is the only lasting solution. We offer a program to lower rates and reduce uncertainty.

A PROGRAM TO REDUCE INTEREST RATES

Pressures are rising, as in prior recessions, to pump up the money supply in an effort to lower interest rates. Proposals of this sort will fail in 1982 as they have in all prior business cycles. In fact, a return to rapid money growth would quickly and inevitably lead to higher, not lower, credit costs.

The present level of interest rates does, indeed, represent a severe burden on the economy. Interest rates must be reduced promptly in a non-inflationary manner that sets the foundation for sustained real growth in the economy and a lasting reduction in unemployment. To do so, we propose the following program:

* The rate of increase in Federal expenditures must be cut substantially below the levels proposed by the Administration. To do this, cost-of-living adjustments in Federal entitlement programs must be limited and the growth of national defense purchases cut back.
* Tax increases should be limited to Federal excises and/or a surcharge on imported oil. The principal problem in the Federal budget has been, and continues to be, excessive expenditures, not the reductions in tax rates enacted last year.
* Stable, predictable, and believable reductions in money growth —long promised by the Federal Reserve — must be implemented. Elected officials can contribute to the achievement of this goal by insisting that the Federal Reserve keep the money supply well within the targets that have been announced. Such insistence will lower uncertainty and help to reduce the risk premium in interest rates.
* The Federal Reserve should move promptly to stabilize the growth in money along its preannounced path by implementing the procedural reforms which this committee has long advocated and which are outlined once again in this statement.

The four elements of this program are complementary and will reinforce each other. All four work toward lower interest rates and sustained non-inflationary growth of output. They should be adopted promptly by the Administration, Congress, and the Federal Reserve.

FEDERAL RESERVE POLICY

The main problems with Federal Reserve policy arise because, despite statements full of good intentions and worthy goals, the Federal Reserve does not make any of the changes that would improve monetary control and remove current high risk premiums in interest rates. No one can have any confidence in Federal Reserve statements that reaffirm its commitment to slower money growth and lower inflation. The Federal Reserve misleads the public and the Congress by talking as if its main objective were control of bank reserves and money. In practice, the Federal Reserve seeks to hold the daily Federal funds rate within a narrow range, and ignores the broad limits it announces.

The Federal Reserve continues to promulgate target growth rates for several monetary aggregates without recognizing that such ranges are not independent of one another. The Federal Reserve should either publish consistent target ranges for the several aggregates or restrict targeting to one aggregate, preferably M-1. There is no evidence that financial innovation, apart from regulatory changes, has rendered the relative behavior of the various monetary aggregates unpredictable. Currently, as in the recent past, a wide gulf separates Federal Reserve statements and Federal Reserve actions.

Table 1 shows the discrepancy between Federal Reserve announcements and achievements for the six years in which it has announced targets for money growth.

TABLE 1

Money Growth 1975-1981

Year Ending in 4th Quarter	Percent Growth: Target Announced by Federal Reserve	Target Mid-point	Actual	Error
1976 (M-1)	4.5 - 7.5%	6.0%	5.8%	-0.2%
1977 (M-1)	4.5 - 6.5	5.5	7.9	2.4
1978 (M-1)	4.0 - 6.5	5.2	7.2	1.9
1979 (M-1)	3.0 - 6.0	4.5	5.5	1.0
1980 (M-1B)	4.0 - 6.5	5.2	7.3	2.0
1981 (M-1B)	6.0 - 8.5	7.2	5.0	-2.2
1982 (M-1)	2.5 - 5.5	4.0		

In four of the most recent six years, the Federal Reserve failed to keep money growth within the preannounced target band. Since 1979, the Federal Reserve has claimed to be more concerned about money growth, and has given greater emphasis to money growth in its statements, but monetary control has worsened. Annual errors have been larger, and short-term variability has increased. Better procedures, endorsed by virtually all monetary economists, including Federal Reserve staff, are available, but they have not been adopted.

Recent Federal Reserve policy has been more variable than in the past. Sudden, sharp downswings in monetary growth were a principal cause of the two recessions in 1980 and 1981-82. Wide swings in monetary growth from zero to double-digit annual rates bewilder financial markets. The high variability of annual rates of growth of total reserves, the monetary base, and money also causes frequent revisions of the expected rate of monetary growth and future inflation. These frequent revisions are reflected in interest rates at all maturities. They produce high risk premiums and high rates of interest.

The relationship between the annual rates of growth of total reserves and/or the monetary base and interest rates leaves little doubt that interest rates rise and fall directly with growth in reserves and base money. While the current level of interest rates is influenced by many factors, including the prospect of deficits, recent changes in interest rates appear to be dominated by changes in the growth of monetary aggregates.

The message of Figure 1 seems clear. Interest rates can be reduced and stability of interest rates can be increased. To do so, the Federal Reserve must stabilize the growth of monetary aggregates.

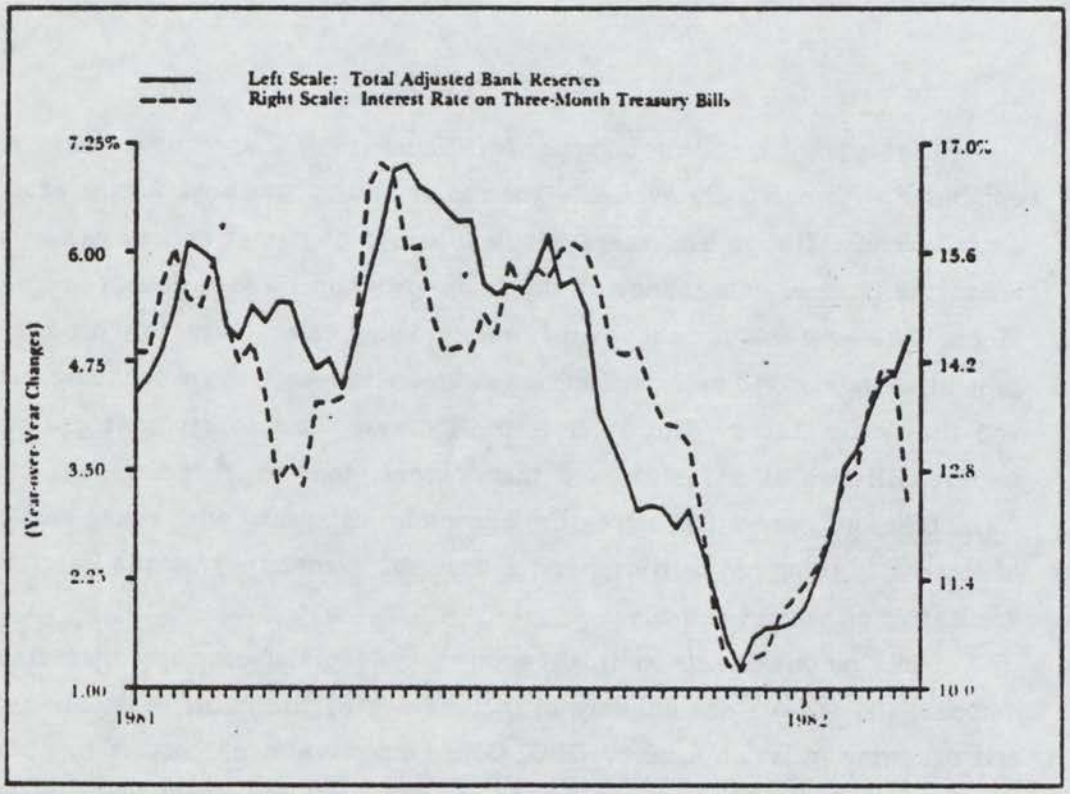
To control either total reserves or the monetary base, the Federal Reserve must control the size of its balance sheet. This is not difficult, but to do so the Federal Reserve must adopt the procedural changes that we and many other economists advocate. These include elimination of seasonal adjustment, an end to interest rate targeting, restoration of contemporaneous reserve accounting, and simplification of the reserve requirement structure. Chairman Volcker's recent statement to the Senate Budget Committee suggests that some of these long delayed changes may finally be adopted.

Federal Reserve spokesmen repeatedly claim that money is difficult to control. Recently the Vice Chairman of the Federal Open Market Committee, in a widely publicized address, claimed that the growth of money substitutes increases the problem of control in 1981. Such statements are without any basis in fact. The problems that the Federal Reserve experienced in 1981 result, mainly, from the use of inefficient and improper methods of control including continued attempts to manage short-term interest rates.

At our September meeting, we urged the Federal Reserve to expand the monetary base at a 5 percent annual rate in 1982 to reach $180-billion by fourth quarter 1982. The annual growth rate of the base fell below our target in the

Figure 1

Bank Reserves and Short-Term Interest Rates



Reserve data are four-week moving averages.

Sources: Econalyst Data Base; Morgan Stanley Research

fourth quarter of 1981, but the decline was short-lived. Since last Fall, growth in the base and money has surged well above the levels consistent with disinflation.

Slower growth of the base and money made an important contribution to the reduction in inflation — and in the rate of money wage increases — that is now widely recognized. The task for monetary policy is to keep the gains that have been achieved.

We repeat our recommendation for monetary policy in 1982. The Federal reserve should control the monetary base, return to a sustained 5 percent growth path, and aim for a target of about $180-billion in fourth quarter 1982, as we urged six months ago.

BUDGET POLICY

The Administration's budgets for fiscal 1983 and future years, when combined with currently available guesses or estimates about future economic activity and inflation and fears about future debt monetization, raise doubts about the internal consistency of the fiscal program. These doubts are of two kinds. One concerns the success of the promising effort to restore productivity growth to its historic path and increase personal incentives by reducing current and future tax rates. The other is the increased probability that the budget deficit will rise at a faster rate than output, thereby reducing real capital formation and generating increasing economic instability with rising real rates of interest, falling productivity, and a chain of events that no one can foresee accurately or predict reliably.

While no one can be confident about the effects of continuously increasing deficits, the effects are unlikely to include any of the paths of stable growth and declining inflation used by CBO, OMB, and private forecasters to generate budget data for the next five fiscal years. There is therefore likely to be an inconsistency between the projections for the economy and for future deficits. The result may be deficits larger than forecast, leading to a decline in real income and standards of living and an economic crisis. Or, the economy may continue to limp along the path characterized by low productivity growth, rising real transfer payments and a rising size of government.

If there are no changes in tax rates and spending levels, our projections of possible ranges for total budget and off-budget financing are:

TABLE 2

Fiscal Year	Projected Range On- Plus Off-Budget Deficit
1982	$100 - 150-billion
1983	150 - 200-billion
1984	200 - 250-billion
1985	225 - 275-billion

There is nothing certain about future deficits. We have no prior experience on which to base a reliable judgment because there is no example in which a large economy — the largest economy — has incurred deficits of this relative magnitude for an indefinite period. There is great uncertainty. Prudence requires that this uncertainty be lessened promptly. Everyone knows what needs to be done to reduce the deficit: We must spend less.

We continue to believe that the Administration's strategy is correct. Reducing the growth of government spending, reducing the share of output spent by government, and reducing tax rates is the best way to increase incentives to save, work, and invest. The problem is not in the policy conception or design but in its implementation. The Administration's reductions in spending are too small relative to the projected reductions in tax collections. To achieve the promised gains from tax reduction requires additional cuts in the growth of spending. The principal reason is that current policy does not reduce the share of output spent by government and may, instead, lead to increases in that share.

While the share of output spent by government is a more reliable measure of applicable tax rates than the revenue share, no single measure summarizes the incentive and disincentive effects of government programs. Nevertheless, when the Administration proposed its fiscal reform program, and when the Congress adopted the Humphrey-Hawkins Act in 1978 and subsequently passed the 1981 fiscal program, the intention was to reduce the share of output spent by government to 20 percent of GNP or less. Currently, government spending remains between 23 percent and 24 percent of output.

CONCLUDING COMMENTS

Current fiscal and monetary problems pose a challenge to representative government. The problems are easy to state. Solutions are not hard to find.

None are easy to implement. None are costless. None can be chosen on technical grounds alone. The problem is political; leadership is needed to gain public approval of the changes that must be made.

At issue is the ability of representative government to put an end to the current fiscal crisis and the rising instability brought about by the destabilizing Federal Reserve operations. The alternatives to a change in policy are less attractive. We run the risk of sliding into immobilism and instability or of moving to some other less desirable solution that no one can now forsee.

THE POLITICS OF UNCERTAINTY

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I. STRATEGY AND TACTICS DURING THE 1970'S AND THE RECORD OF PERFORMANCE

On October 6, 1979 the Chairman of the Board of Governors of the Federal Reserve System announced a change in tactical procedures. Monetary policy was formulated since the later years of the 1960's in terms of a money demand equation linking money stock (or monetary growth) with the federal funds rate and the projected value of gross national product. This formulation served the Fed for two alternative monetary strategies. It could guide a strategy of interest control but also be exploited, as the Fed maintained, for the purpose of a monetary control strategy. The tactical operations centered in either case on the federal funds rate. The two strategies differed essentially in terms of the role assigned to the federal funds rate. This rate and its expected relation to other interest rates formed the immediate centerpiece of an interest control strategy. A monetary control strategy, in contrast, used the federal funds rate as an instrument producing the desired path of monetary growth.

The formulation organizing the Fed's policy process was thus consistent with either strategy. It allowed subtle and rapid shifts in strategic emphasis difficult to recognize by outside observers. The conception was moreover well designed to protect the heritage of "discretionary policymaking". It offered an effective defense against increasing pressures for a commitment to a predictable policy of systematic monetary control. The analytic framework provided the appearance of monetary targeting, whenever desired, and still offered an opportunity to pursue the old conceptions and adhere to the accustomed pattern of a "discretionary policy". Lastly, it yielded an important and useful source for the supply of excuses on the political market. The consequences of neglecting a monetary control strategy, or of failures in the actual execution of such a strategy, could always, and usually were, attributed to unexpected shifts of an essentially unstable money demand. A poorly informed Congress and ignorant media could hardly be expected to cope effectively with such "explanations" advanced by "authority". This policy conception increasingly operated with an inflationary bias in response to the political realities emerging over the postwar period. It produced the record of a rising and erratic inflation accompanied by rising interest rates. This dismal record was "enriched" by repeated declines of the dollar on the foreign exchange markets.

II. THE APPEARANCE OF A CHANGE IN POLICYMAKING

The international response to the failure of the dollar ultimately forced the Federal Reserve Authorities to reexamine its policy in the fall of 1979. The Chairman's statement acknowledged the Federal Reserve's ambivalent strategy over the past decade. It also acknowledged that tactical procedures need be modified in order to assure a more reliable monetary control yielding more success in the battle against inflation. The new procedure claims to use non-borrowed reserves as an instrument directed to the control of monetary growth.

The policy conception corresponding to the new procedure can be described by an analytic framework consisting of two relations. The first is the money demand equation which expressed for years the previous strategic and tactical situation. But this money demand equation was supplemented with a reserve equation, relating the sum of non-borrowed and free reserves with required reserves. The volume of required reserves in any week are predetermined under current arrangements by the money stock prevailing two weeks earlier. The volume of free reserves depends on the other hand on the current federal funds rate, the Fed's discount rate and the institutions governing the "discount window". This dependence of free reserves (or essentially borrowed reserves) coupled with the predetermination of required reserves by the past characterize the crucial features of the Fed's "new" policy conception. They involve a remarkable revival of free reserves in the Fed's thinking. These reserves form according to the new framework a centerpiece in the Fed's conception of the control process.

The steps required under the new operational procedures may be described as follows: First, a monetary target need be set. This in conjunction with the projected value for gross national product determines in the context of the money demand equation a federal funds rate consistent with the targeted monetary growth. This federal funds rate can be fed subsequently into the reserve relation in order to project the expected volume of free reserves. The Fed may frequently just extrapolate however the most recent value of free reserves for their tactical purposes. This expected value together with the predetermined volume of required reserves determines the required amount of non-borrowed reserves needed to produce in the average the planned monetary target.

The new framework and its associated procedures substantially strengthens the Fed's political defenses. It defines a control process involving, in contrast to the earlier tactical procedure, the possibility of using a reserve magnitude as an instrument for the execution of control. But this possibility need not be exploited. The modified framework still allows the Fed to slip into an interest control strategy or to fall back on the federal funds rate as the actual instrument of monetary control. These options are all subsumed under the new framework. It allows thus in particular shifting combinations of reserve and federal funds targeting. The amended framework introduced after October 1979 thus serves the political purpose of the Fed even better than the prior concentration on the money demand equation. It combines the opportunity to emphasize the possible use of a reserve instrument in the monetary control process with the actual pursuit of the traditional pattern of a "discretionary policy" expressed by ambivalent strategies and shifting tactical combinations. The new framework and the related operational procedure yield thus no clear promise bearing on the course and nature of monetary policy. It emerged as a natural evolution of the Federal Reserve's traditional strategic thinking and tactical executions in response to public critique and the votes of no confidence cast by exchange and financial markets. But the very fact that it appears to offer better and more subtle justifications for the Fed's traditional commitment to undefined "discretionary policies, flexibility and judgment" should warn us that the basic problem posed by our policymakers in the Fed persists to this day.

III. THE FED'S TRADE-OFF THESIS

The framework used by the Fed supplemented by a standard Keynesian analysis implies that a closer control of monetary growth would have "to be purchased" by greater variability of interest rates. The Fed traditionally maintained that there occurs a trade-off between the variability of monetary growth and the variability of interest rates. Two major flaws in the Fed's traditional analysis condition this view. The response structure of the system is assumed to be invariant under changes of the policy regime or changes in the behavior patterns characterizing a Central Bank. Moreover, the shocks operating on the economic or financial system are usually treated as transitory events. The implications bearing on a possible trade-off are crucially affected by these assumptions. A different pattern emerges once we recognize the sensitivity of behavior patterns governing financial markets to variations in the policy regime and the operation of shifting mixtures of permanent and transitory shocks. A credible policy of monetary control, effectively executed and thus lowering substantially the variability of monetary growth, will not raise under these circumstances the variability of new interest rates over the maturity spectrum. The remaining variability will be understood to occur as a transitory event and thus hardly affect interest rates beyond the short end of the yield curve. The adjustment of financial behavior to this regime can be expected furthermore to moderate also movements of short rates over periods beyond one or a few days. Lastly, even a larger variability of daily short rates poses no serious economic problem when agents fully understood their transitory character. Recent developments in monetary analysis thus deny the relevance of the Fed's trade-off thesis.

IV. THE RECORD UNDER THE NEW REGIME AND THE POLITICS OF UNCERTAINTY

The experience made under the Fed's new operational procedure offers remarkable clues about the fundamental problem afflicting our policymaking. Two crucial patterns emerged over the past two years contrasting sharply with the trade-off thesis. We note first that <u>both</u> monetary growth and interest rates exhibit a substantially <u>larger</u> variability than in previous periods. Secondly, the correlation between interest rates over the maturity spectrum was significantly higher than in earlier times. The Federal Reserve authorities explained this variability in market rates of interest with the change in tactical procedures. They add that this variability was the cause of the prevailing uncertainty and confusion exhibited by the financial markets. The causation asserted by the Federal Reserve's view thus runs from the shift in operational procedure over an increased variability of interest rates to more pervasive and larger uncertainty.

V. AN ASSESSMENT OF THE RECORD OF UNCERTAINTY

The explanation offered by the Fed naturally corresponds to its basic positions. It also fits well with the usual political defense of "discretionary, flexible and judgmental policy". It fails however to account for the joint increase in the variability of both monetary growth and interest rates. The line of causation argued is moreover difficult to reconcile with the remarkable correlations between interest rates observed over the whole range of maturities.

The explanation of recent patterns observed on financial markets does indeed involve the element of a pervasive and diffuse uncertainty. This uncertainty is however of a very different nature than suggested by the Federal Reserve Authorities. Our financial markets suffered over the past two years under an increasing uncertainty about the future course of our financial policies. The announcement of October 1979 was difficult to interpret unambiguously. Its meaning remained vague, most particularly when it was considered in the context of supplementary interpretations offered by various Federal Reserve officials. By this time agents on financial markets had also learned since 1965 that all promises of an anti-inflationary policy were usually broken within a short time. Such promises were usually followed over the subsequent one or two years by even more prounced inflationary policies. By late 1979 the credibility of the Fed had already sunk to low levels and the October announcement deepened the confusion on the markets. The response of the bond market to the announcement at the time revealed this state quite clearly.

Subsequent events enlarged the uncertainty and made the markets' expectation even more diffuse. The increased variability of monetary growth raised more questions about the Fed's longer-run policy. We frequently hear that larger accelerations (or decelerations) of the money stock lasting at most six months can be disregarded and impose no problem on the economy. In the absence of credible policymaking larger variability of monetary growth entrenches however the prevalent uncertainty even further. It is this uncertainty which fosters the overheated attention to weekly data. Under a diffuse uncertainty agents grope for every possible clue and sign yielding some information about the future course of policy. The observed variability in monetary growth contributed thus to sudden and irregular shifts in the distribution of expectations among market agents.

One last element contributed to broaden the prevalent uncertainty. Speeches by Federal Reserve officials made over the past two years on various occasions reflected the persistent commitment to a traditional policy conception attuned to the Fed's political interests. These speeches, most significantly exemplified by President Solomon's speech delivered in early January 1982, signal a strong opposition to an effective strategy of monetary control. The general uncertainty produced by our monetary policymaking as a result of the history of broken promises, larger variability of monetary growth and the often revealed preference for the traditional "discretionary flexibility" dominated the behavior of interest rates over the past two years. The observed levels and variability cannot be explained in terms of the basic real rate on default-risk free securities or the inflation premium. The large real rates emerging in the recent past contain a substantial risk premium which hardly ever entered in the past history of our financial markets. This risk premium reflects the prevailing uncertainty imposed by our policymakers on the U.S. economy. This uncertainty explains both the level and the recent variability of nominal interest rates. Rapidly moving signals and clues watched by market agents induce shifts in expectational patterns expressed by sudden changes in interest rates. An array of signals suggesting adherence to an anti-inflationary policy induces a fall of interest rates over the whole spectrum. A wave of opposite clues produces rising interest rates. This pattern explains the positive association observed between monetary growth and interest rates. The market's behavior essentially denies the assertion that monetary expansions will produce lower interest rates.

VI. THE ROLE OF THE BUDGET DEFICIT

Our explanation of observed market behavior disregarded thus far the European's and "Wall Street" favorite villain. It is frequently argued that the behavior of interest rates is dominated by the budget deficit. The prevalent argument asserts such a connection irrespective and independent of monetary policy. But the argument is fundamentally flawed. The budget deficit, per se, cannot explain the observed behavior of interest rates. One strand of the argument derives the behavior of interest rates directly from an interaction between savings and the government sector's deficit. This view is however inconsistent with the core of economic analysis. Interest rates (or prices) on the bond and money markets emerge minute to minute from the interaction between the existing stock of securities and the private sector's stock demand (i.e. willingness to hold in portfolios). The latter is conditioned by the public's wealth and current or expected market conditions. The assessment of future market conditions substantially influences and frequently controls the shifts in the public's stock demand dominating the rapid changes of interest rates. These expectations are moreover crucially influenced by the public's evaluation of the future course of financial policies.

Budgetary deficits operate on interest rates under the circumstances not via any direct mechanism linking savings, investment and deficits, but via the public's assessment of future market conditions. This means in particular that sustained deficits are expected to raise over time the stock of securities to be absorbed in portfolios. This expectation tends to lower the <u>current</u> price of bonds and consequently raises the current interest rates. Savings on the other side raise wealth and expand over time the stock demand for securities. This tends to raise their expected price and will be discounted partly in the current price of bonds.

The correction of the prevalent argument bearing on the mechanism determining interest rates also affects the relevant order of magnitudes. We need to recognize first that savings and deficits modify the nominal rate of interest along the lines traced above by changing the <u>real</u> rate of interest. This elementary fact should warn us about the fallacy involved in the standard argument. The latter essentially discounts the inflation premium which dominated over the past years the average level of interest rates.

We also note that neither the magnitude of last year's deficit nor the existing real volume of Federal (marketed) debt can explain the observed nominal rates of interest. The deficit is comparatively smaller (relative to gross national product) than in 1975 and the real debt outstanding absorbed in private portfolios is still smaller than in the 1950's. These facts cannot be reconciled with the contention of a dominant deficit effect expressed by interest rates over the past two years. There is however still the potentially large deficit of an intractable budget accumulating over the next four to six years. Suppose that the real Federal debt in the context of a really bad scenario increases by 70 percent per unit of output over the next three years. How much would the basic real rate on default-risk free securities be raised as a result? Such estimates must be advanced with great caution and reservation. The empirical examinations accumulated over the past decades yield however no support for assertions claiming increases of the basic real rate by more than three percentage points. This figure seems already an improbably large upper bound on the relevant responses. An increasing volume of research suggests that the response to the government's financial decisions, given the magnitude of the budget and the expenditure programs, is substantially smaller. It follows that the removal of the inflation premium, achieved by a credible and sustained anti-inflationary policy, would dominate the increase in real rates due to budget deficits persisting over the next five years. The decisive strand in the future movements of interest rates is thus the monetary policy pursued by the Fed.

This does not quite exhaust our story bearing on budget deficits. The increasing uncertainty about the budget contributed and reenforced the uncertainty produced by monetary policy. The financial markets became increasingly apprehensive over the past two years about the future course of our budgetary policies. We do not know at the moment how much expenditures will be curtailed or what taxes will be raised. We do not know to which extent "the inflation tax" will be reinstated as large budget deficits persist. Neither do we know what combination of other taxes will be favored by Congress. But different combinations of taxes affect asset prices on capital markets very differently. The inflation tax raises the inflation premium and a variety of other taxes affect the gross real rate of interest. A diffuse and shifting uncertainty about the budget thus contributes directly to the uncertainty about monetary policy and reenforces the effect of this uncertainty on interest rates.

VII. THE CRUCIAL POLICY ISSUE: THE INSTITUTIONALIZATION OF UNCERTAINTY

The assessment of the problems confronting us in the recent past and at the moment directs our attention to the crucial policy issue. We know at this stage that the Federal Reserve actually has, in the average over the past two years, pursued an anti-inflationary course. We never knew it during these past months, neither did most of the agents operating on financial markets. Nor do we know at this point in time with any sense of certainty that the Fed will effectively deliver an anti-inflationary policy. If a large segment knew this with any sense of conviction interest rates would behave very differently indeed. Their behavior is after all the best indicator of the prevalent uncertainty. So far, the Federal Reserve Authorities made no clear and unambiguous commitment to a strategy of monetary control coupled with an effective tactical procedure. Our progress remains under the circumstances, at the very best, slow and erratic. The transition to a non-inflationary state of the economy will therefore be associated with comparatively high social costs. the most important contribution to be made by the Federal Reserve Authorities at this point in time is a convincing and generally understood commitment to an effective tactical procedure for the execution of a strategy of monetary control. This would be the most useful political measure to remove the burden of uncertainty on financial markets. It does not require any Congressional actions with the uncertainties facing the battle about the budget. The Federal Reserve Authorities can initiate an institutionalization of monetary control by their own initiative and political decision.

The Shadow has urged such a policy for almost nine years. If our monetary authorities had accepted our proposal in 1975/1976 or followed the recommendations repeatedly advanced by Congress or Congressional Committees, inflation in the past two years would have been low indeed with interest rates substantially below 10 percent. But the Federal Reserve disregarded all these urgent proposals and persisted with a policy producing both inflation and increasing uncertainty about its course. There is really no excuse for such a policy. We have formulated our tactical procedure on previous occasions and the Federal Reserve Authorities know our proposal. The proposal has moreover been tested over several years by James Johannes and Robert Rasche. The results of these tests have been published and were also included every six months in the minutes of the Shadow Open Market Committee. The record is very clear. It shows that monetary control over one year with a tolerance band not more than plus or minus one percentage point is technically quite feasible. This tolerance band is really quite small relative to the order of magnitude of the problem inherited from past years of monetary mismanagement. Even within the year an improvement over past performance seems feasible.

The tactics proposed would require that the Fed set a target path for M-1B (or M2) lowering monetary growth to a non-inflationary benchmark level (about 2 percent p.a.) over the next three years. This target path is maintained by suitable adjustments in the monetary base in the light of the expected profile for the monetary multiplier linking base and money stock. The studies prepared by the Federal Reserve Board's own staff establish that monetary control with an adequate tolerance level relative to the size of the problem is technically feasible. These studies thus confirmed the Shadow's argument and proposal. Axilrod, among others, recognizes moreover in the last issue of the Federal Reserve Bulletin that the monetary base is fully controllable by the monetary authorities. Any change in the base reflects dollar for dollar actions of the Fed changing its total assets or modifying its non-money liabilities. Its control over its balance sheet determines the Fed's potential control over the monetary base. the frequent allusion to the proportion of currency in base money outstanding is thus quite irrelevant in this context.

Beyond the record of the statistical tests presented by the Shadow lies a mass of evidence from "disinflationary policies" produced by various countries on different occasions. They all involved in one form or another a radical change in the regime governing the behavior of the monetary base. Such changes in regime are quite accessible to the policymakers, if they so desire. The central issue becomes thus the political will and the political interest of the Central Bank. But the political market offers unfortunately little appeal to reveal this interest so directly. The protection of inherited positions and interests (i.e. discretionary policies) is more effectively assured by a supply of judicious sounding reservations about monetary control and our proposal in particular. None of these reservations or objections survives any closer examination. My position paper cannot address however the whole array of imaginative objections advanced. A few major arguments need to suffice for our purposes.

Federal Reserve officials maintained on repeated occasions that our procedure anchored by the monetary base involves substantially more slippage than their tactical procedure developed since October 1979 and centered with non-borrowed reserves. This statement is particularly remarkable, as it is not supported by the Board's empirical examination of this issue. The empirical results produced by Johannes-Rasche established furthermore that the instrumental use of the monetary base for purposes of monetary control yields more reliable results and a smaller tolerance level than the instrumental use of non-borrowed reserves. We understand of course that our tactical proposal involves a radical break with the Fed's traditional strategic conception. We noted above that the tactical arrangements made in recent years should be understood as a political adaptation to existing pressures with corresponding adjustments in rhetoric without sacrificing an opportunity for the exercise of discretionary policies.

Financial innovations including claims about an increasingly unstable or unpredictable money demand are abundantly cited in arguments opposing monetary control. Financial innovations seem to make monetary control either impossible, irrelevant or both. My tentative survey of all these arguments found little, if any, analytic or empirical support for these contentions. Moreover, these contentions are usually advanced without any reference to the literature which has actually explored this issue, and apparently without any knowledge of these scholarly investigations. All the contentions in question can be expressed in one way or another as statements about the behavior of the monetary multiplier (i.e. link between monetary base and money stock) or velocity (i.e. link between money stock and gross national product). They assert in particular that financial innovations substantially modified the pattern exhibited by either multiplier, velocity or both. Such conjectures are fortunately assessable in terms of the observed data. The reports regularly prepared by Robert Rasche for the Shadow, included in all the minutes made publicly available, present evidence thoroughly disconfirming any assertions claiming changes in multiplier patterns. This result supports in particular our view that the Fed's emphasis on money demand shocks is misleading and false. Whatever money demand has done, there is no evidence in the multiplier patterns observed until this year that they eroded monetary control. There is also no evidence supporting President Solomon's (Federal Reserve Bank of New York) allegations that the relative movements of M-1B and M-2 observed in 1981 describe "actually a unique situation". Robert Rasche shows in his statement prepared for our current session that the new observations are quite consistent with the patterns observed over previous years. The last observations introduce no problem for monetary control. The same multiplier patterns also demonstrate that many other contentions invoking the Euro-dollar market or addressing other phenomena to claim erosion of monetary controllability are similarly unfounded.

Consider lastly the range of assertions claiming radical changes in velocity behavior. A preliminary investigation based on time series analysis offers so far no support for the contention of an increasing "looseness" of the link between money stock and national income. The stochastic term in the velocity process, i.e. the so-called innovation, exhibits for M-2 velocity an increase of 10 percent in its standard devision in the 1970's compared to the 1950's. The velocity associated with M-1B shows in contrast a <u>decline</u> of about 30 percent in the standard deviation of its innovation over this period. Lastly, the standard deviation of the innovation of base velocity <u>declined</u> over the same period by about 10 percent.

An investigation of the years 1979-1981 usefully supplements our evaluation. We can compute the probabilities associated with the most recent observations beyond the sample used to infer the properties of a velocity process. Very low probabilities under the maintained hypotheses would suggest that we accept the conjecture of a shift in velocity patterns. We find that the recent observations of base velocity should be expected one out of ten times under a maintained hypothesis. The corresponding results are slightly more than four out of ten times for M-1B velocity and also for M-2 velocity. These probabilities offer no support for the dramatic assertion about the changes in velocity behavior. These results do not deny the occurrence of financial innovations, but their effects on various aspects of the velocity process may hardly justify the reservations and objections voiced without much supportive evidence. The tentative and preliminary evidence suggests no problems for monetary control beyond the range of our experience. There is, once again, no substantive reason for the continued refusal of our monetary authorities to commit their policy to a predictable and effective strategy of monetary control. We have experienced the consequences of their game for the past decade and the most recent two years. The American public surely deserves better service.

FISCAL OUTLOOK, MARCH 1982

Rudolph G. Penner
American Enterprise Institute

In place of my usual report I am attaching my testimony before the Senate Budget Committee. The CBO estimates, discussed there, use economic assumptions that are only slightly more optimistic than those that will be used by the SOMC.

The attached testimony, of course, discusses what should be done and does not attempt to guess what will actually be done. This year's politics are as volatile as the economics.

While there may be a small chance of putting a majority coalition together behind a Domenici-Hollings type proposal, it would be necessary to do that quickly to save much money in fiscal 1983. For example, any change in the social security cost of living adjustment must be decided by the end of April to allow time to reprogram the computers for the July check. Accomplishing that will be quite a trick without Presidential support. Indeed, accomplishing anything will be quite a trick without Presidential support. Therefore, I assume a do-nothing policy for the following estimates while feverently hoping that I am wrong.

A do-nothing policy plus the SOMC economic assumptions provides something like:

	FISCAL YEARS		
	1981 actual	1982	1983
Outlays	660	745	816
Receipts	603	625	645
Unified deficit	58	120	171
Off-budget deficit	21	20	19
Total deficit	79	140	180

THE 1983 BUDGET

TESTIMONY

before the

SENATE BUDGET COMMITTEE

March 5, 1982

I would like to thank the Committee for this opportunity to testify. The views expressed in this testimony are my own and do not necessarily reflect the views of the staff, advisory panels, officers or trustees of the American Enterprise Institute.

I shall base my analysis of the 1983 budget on Congressional Budget Office (CBO) documents which are more realistic in their economic assumptions than is the Administration and in their estimates of spending rates and program costs for any given economic outlook.

ADJUSTED BASELINE DEFICIT

The CBO begins the analysis by projecting spending commitments and the tax laws as they existed at the end of 1981. Their analysis assumes that all programs are adjusted for inflation, including those that are not explicitly indexed.

To view the problem as it must be viewed by the Congress, I shall make three adjustments to CBO figures. First, the President's recommended defense program will be added to the outlay figures. Second, inflation-adjustments to non-indexed non-defense programs will be subtracted. I do not believe that the Congress has ever presumed that such programs must be held constant in real terms. After these two adjustments the budget projections through fiscal 1985 are as follows:

FISCAL YEARS
(billions of dollars)

	1981 actual	1982	1983	1984	1985
Outlays	600	740	806	885	972
Receipts	603	631	952	701	763
Unified deficit	58	109	154	184	209
Off-budget deficit	21	20	19	18	18
Total deficit	79	129	173	202	227

While the CBO economic assumptions are more reasonable than the administration's, they do assume a rather high rate of nominal income growth if the Federal Reserve System carries out its enunciated monetary policy and gradually slows the rate of growth of the money aggregates. For example, if the top end of the Fed's target range for M-1 growth of 5.5 percent for 1982 is lowered by one-half of one percentage point per year and if the amount of economic activity that can be financed by a given money supply continues to grow at the same rate experienced since 1970, the nominal GNP in 1985 would have to be lowered by slightly over 5 percent. If all of that reduction was the result of lower inflation, the 1985 deficit would have to be increased by about $15 billion. To the extent that real growth is also slower than assumed by CBO, the deficit increase would be larger.

I shall not attempt to make a precise adjustment for the relatively small change in economic assumptions suggested by the above analysis, but will instead use the following ranges for the horrendous on-plus off-budget deficit problem faced by the Congress.

FISCAL YEAR	ON PLUS OFF-BUDGET DEFICIT RANGE
1982	$100 - $150 billion
1983	150 - 200 billion
1984	200 - 250 billion
1985	225 - 275 billion

It should be re-emphasized that these estimates depend crucially on the assumptions regarding monetary policy. Monetary policy and fiscal policy are intimately entwined. Inflation can be used to raise tax burdens and to reduce deficits. That will be true even if personal tax brackets are indexed after 1984, but, of course, much less true than it is today.

OPTIONS FOR CUTTING OUTLAYS

The size of the future deficit problems suggests that the Congress will have to alter the old saw, "tax, tax, tax, and spend, spend, spend," to "tax, tax, tax, and cut, cut, cut."

This short paper cannot explore all of the possible options for taxing and cutting, but will have to confine itself to discussing a few main points and basic principles. When confronting the spending side of the budget, it is necessary to begin with the unpleasant fact that defense, social security (OASDI), and net interest outlays will comprise almost 60 percent of the 1982 budget. Without some reduction in defense and social security growth, prospects for controlling total spending in the long-run look bleak. Unfortunately, in both cases, large immediate reductions would be either unwise or unfair. But the emphasis must be on the long-run because the deficit is now a long-run problem.

With regard to defense, it is necessary to be cautious about compromising the readiness of our forces. Savings should be focused on long-run weapons procurement and military retirement pay. The CBO has suggested eleven options for defense cuts, all of which appear reasonable. For example, the B-1 program would be scrapped in favor of the advance technology bomber. Naval forces would be deployed somewhat differently than envisioned by the Administration and production runs of the M-1 tank would be limited in favor of the much less expensive M60A3. Retirement pay would be restructured in a number of ways to compensate for overindexing in the past. Admittedly, the savings from the CBO options are negligible in 1983 and 1984 but rise to $10 billion in 1985 and $15 billion by 1987. Perhaps more dramatic cuts could be found, but the modesty of the CBO suggestions is, at least, interesting in an area where many believe that cuts could resolve a high proportion of the deficit problem.

Social Security presents an enormous challenge to our political system. It is an extremely popular program and the smallest change in the benefit structure is perceived to be a threat to the entire system by the program's multitude of constituents. Yet, because of the system's huge size, even small reductions in its growth rate would save massive amounts in the long-run. Moreover, it is hard to justify holding social security benefits sacrosanct when the recipients have recently been faring better than the average worker and we have been significantly cutting other less affluent recipients of government transfers.

One change which may be saleable politically would be to index benefits to the lower of wage or price increases. I do not believe that the population thinks it fair for social security recipients to do better than wage earners. It could be understood that if this technique caused a significant shrinkage in real benefits over the long run, there would be periodic upward discretionary adjustments in benefits. If the same principle were applied to the indexing of the formula determining future benefits (the formula is now linked to wage growth), large amounts could be saved in the long-run. Again, it must be emphasized that it is the long-run which counts. It is not short-run deficits which are scaring financial markets. It is the fear that they will continue to rise for the forseeable future that is so troublesome. If some signal could be given that social security, the most important component of the non-defense outlay growth problem, was being controlled, it would, in my view, have a significant impact on expectations.

The precise savings implied by the above options depends on the relationship between wages and prices which has been erratic in the recent past. If the system had been in effect between 1975 and 1981, the savings in the latter year would have been $10 billion, largely because of a significant fall in real wages in 1980.

Other indexing options have been suggested and are reasonable given that recent cost-of-living adjustments have been excessive due to upward biases in the CPI. Martin Feldstein has suggested that cost-of-living adjustments compensate for only that inflation in excess of 2 percent per year. Given CBO inflation assumptions this option would save $10 to $15 billion in 1985. Others have suggested delaying the cost-of-living adjustment to September 1. That would save over $3 billion in 1985. The savings would expand significantly if the same options were used in all the other indexed programs of the government.

The suggestions made above imply that relatively minor changes in social security indexing might save $15 billion or more by 1985. To provide some notion of the enormous size of social security relative to other transfer programs, it can be noted that $15 billion in 1985 will be sufficient to finance the entire food stamp program.

The CBO has outlined options for over $25 billion in cuts of non-defense, non-social security programs. All deserve serious consideration. The Administration has suggested further efficiencies in medicare and medicaid which are also worthy of note because without some economizing these two programs will grow by about 14 percent per year between 1981 and 1985. The Administration has also suggested numerous reasonable options for cutting housing assistance and other programs. It would be a shame if the admittedly serious estimating problems within the President's budget prevented any of it from being taken seriously.

There is, however, one category of Administration cuts which should be rejected. The Reconciliation Act of 1981 concentrated its welfare cuts on the working poor. Many of the Administration's 1983 proposals in the welfare programs would go further in this direction by increasing the rate at which benefits fall as earnings rise. The end result is little incentive for one to work oneself off welfare. The Administration would substitute regulations requiring work for economic incentives. Such regulations have not been effective in the past, and it can be noted that in all other areas of policy the Administration has emphasized increased economic incentives and reduced regulation.

While there is no shortage of options for cutting defense, social security, and other spending, it is difficult, given political and time restraints, to imagine cutting more than $50 billion from 1985 outlays by examining the options one at a time. It would take an effort comparable to that enacted in the Reconciliation Act of last year, and that seems implausible two years in a row.

Because a $50 billion cut would leave a 1985 deficit in the range of $200 billion given my economic assumptions, more extreme action is desirable. Such extreme action generally involves a set of arbitrary cutting rules.

Senators Domenici, Hollings, and others have suggested various combinations of generalized rules and freezes which have considerable appeal. While it must be admitted that any general rule is bound to create numerous inequities and inefficiencies, a generalized approach may be the only practical way to make a severe dent in the strong upward trend in spending which was barely affected by the strong measures of last year.

If all that is possible on the outlay side is $50 billion or less in cuts, it is my judgment that about $100 billion in receipts increases are required to start bringing the deficit down to tolerable levles by 1985. By tolerable levels, I mean something in the range of $100 billion. Obviously, even this is nothing to brag about and a lower deficit would be preferable, but unless some action on the outlay side more dramatic than anything undertaken in past history occurs, I see no way of getting there from here which does not involve extremely disruptive tax increases.

Again, all of this assumes that the Fed adheres to its targets. While inflation can be used both as an implicit tax and as a means of raising explicit taxes, most observers would agree that inflation is the worst possible approach to deficit reduction.

OPTIONS FOR INCREASING RECEIPTS

If we are embarking on a path involving $100 billion in extra revenue, it would be desirable, in the ideal, to follow certain basic principles in raising that much money. First, if it can be avoided, there should be no tax increase in calendar 1982. the economy is in a tenuous position and significant tax increases this year increase the risk that the recession will deepen and that the initial stages of the recovery will be sluggish.

Second, increases in the tax burden should take the form of broadening the tax base instead of raising marginal tax rates. Moreover, base broadening measures should be aimed at enhancing economic efficiency. Some examples of such base broadening efficient measures are as follows: Tax employer paid health insurance to reduce the incentive to buy inefficient insurance (raises $6 billion in 1985). Eliminate the interest deduction on consumer loans other than mortgages ($8 billion in 1985). Tax workman's compensation and unemployment insurance to reduce the work disincentives inherent in those programs ($6 billion in 1985). Other examples can be found in the CBO report on Reducing the Deficit.

Third, base broadening measures should avoid increasing the tax on capital income. There is one important exception to this rule. The depreciation law passed last year becomes very much more generous in two steps scheduled for 1985 and 1986. Given the inflation and interest rate assumptions inherent in this analysis, the tax burden on new equipment investments will become negative, i.e., the tax system will provide outright subsidies for investing. This goes too far. Those two steps should be eliminated unless inflation and interest rates rise above current levels. That would raise about $2 billion in fiscal 1985, $10 billion in fiscal 1986, and $20 billion in fiscal 1987.

Fourth, there are good, long-term national security reasons for increasing the taxation of the consumption of energy in this country. In particular, recent weaknesses in the price of oil may dampen our conservation efforts and should be countered. This could be accomplished with a tax on imported oil which aimed at eliminating reductions in the real price of oil. If nominal prices remain constant, a tariff of about $5 per barrel could be justified in 1985. This would bring in about $17 billion including its impact on windfall profit tax receipts. Alternatively, raising the gasoline tax to 10 cents per gallon would raise about $5 billion by 1985.

Fifth, whenever practical, user fees should be charged to the beneficiaries of government goods and services. CBO suggests options which would raise $6 billion by 1985.

Although the principles suggested above could be used to raise large amounts of revenue by 1985, the step-by-step approach on the tax side faces the same practical problems as the step-by-step approach on the spending side. A score of legislative changes would be required and each would involve an enormous political battle over a few billion. Since there is a pressing need for more receipts and quick action is required, it may be necessary to eliminate the 10 percent tax cut in personal income taxes scheduled for July 1, 1983 and to delay indexing one year. This violates my second principle that marginal rate increases be avoided. But only one political battle would be required and if successful, it would raise $52 billion by 1985.

It may be time to begin a debate on a brand new tax such as a value added tax or a national sales tax. Every rate point would raise $10 to $15 billion if the base was kept fairly broad.

I would prefer to avoid such a tax, since once implemented, it would be too easy to increase. However, absent a drastic reduction in the deficit following the outlay cutting and receipts raising approaches discussed above, a new broad based tax may be essential.

THE IMPACT OF DEFICITS

Why is it so important to reduce the deficit? Even if deficits approach $250 billion in 1985, that will only amount to about 6 percent of the GNP and other countries have continued to grow and have controlled inflation while running such deficits.

In my view a deficit of that size has four negative impacts. First, there is the traditional crowding out effect. Usually, it is discussed as though the only important crowding out involves business capital investment. It is said further that that will be mitigated by increased personal savings inspired by the tax cut and by an inflow of foreign saving. However, things are not quite that simple. First, the prospective deficits are very large relative to personal saving. Personal saving was only $100 billion in fiscal 1981. It may be increased greatly by the tax cut, but it will also be increased by the deficit itself as higher interest rates crowd out consumption, especially spending on interest-sensitive durables such as autos.

In other words, crowding out is a widespread phenomenon and does not only affect capital formation.

For example, inflows of foreign saving will require the development of a current account deficit since the balance of payments has to balance. This will be accomplished by bidding up the value of the dollar which will crowd out export and import competing industries. Again autos get clobbered. Housing is also very sensitive to crowding out and the recovery of that sick industry will also be delayed by larger deficits.

In any case, it will be a close race to see whether personal saving catches up with the deficit. If they remain approximately equal, it means that all capital formation must be financed using business saving which, while increased by the tax cut, is being hurt by low profits during the recession; state and local saving, which will be hurt by the recession and major cuts in grants; and foreign saving which has the negative impacts discussed before.

The second negative effect of the deficit involves inflationary expectations. Deficits are not inflationary unless the Federal Reserve System buys Treasury bonds by creating new money. This is called monetizing the debt. There is no technical need to monetize, but the political pressures to do so are enormous as people complain about the high interest rates caused by the deficits. In fact, several empirical studies suggest that money creation has tended to accelerate in the past whenever deficits rise. Even if investors believe that there is only a small chance of that happening in the near future, the results of monetization would be so devastating that investors increase the risk premium demanded on loans. Thus real interest rates may be raised by more than the amount which would result from the crowding out effect working alone.

Third, there are adjustment problems involved in suddenly adjusting to a high deficit strategy. In part, we shall suffer some costs because we have been a relatively low deficit country in the past. Suddenly, investors must be persuaded to increase their holdings of government debt at a much higher rate than was experienced in the past. Investor habits and perhaps some institutions will have to be changed. For example, imagine that we can hold debt creation to the $150 billion per year level in the period 1983 through 1985. The Fed would have to buy about $8 billion per year to implement their targets. Debt in the hands of private investors would have to rise at 16 percent per year or about 8 1/2 percent in real terms given CBO inflation assumptions. Nothing approaching this rate of increase has occurred since World War II. The previous high occurred in the '72-'76 period when the nominal debt rose at 11 percent per year or about 4 percent in real terms. Persuading investors to begin absorbing this much debt suddenly may take a larger rise in interest rates than if they had been absorbing it at such levels over a long period.

The last impact of the deficit involves the interest bill itself. With high deficits it becomes a driving force on the outlay side of the budget. Net interest will already constitute 12 percent to 13 percent of outlays in 1983 compared to about 7 percent ten years earlier. The increase in the interest bill between 1981 and 1983 will far exceed all of the budget cuts occuring in 1981. Interest payments may not have the same negative impact on the economy as other government spending but they do have to be financed and they can be expected to keep growing.

CONCLUSION

We face an extraordinarily difficult situation. The long-run tax cuts of last summer mortgaged our future because they were not countered by sufficient budget cuts. The prospect of huge deficits is causing much uncertainty which, in my view, is delaying recovery from the current recession. It is important quickly to show some resolve in reducing the deficit. At this point, we should not waste much time debating the fine points about exactly the right kind of spending cut or tax increases. Speed is important because there is a considerable risk of entering a British type recession if interest rates are not brought down quickly. The recent substantial fall in long rates is reassuring. A more sensible fiscal policy would help greatly to maintain and extend that decline thus increasing the chances of a healthy economic recovery beginning before mid-year. If we wait to see more economic data before taking unpleasant actions that data itself may be very unpleasant.

STATEMENT TO THE SUBCOMMITTEE ON DOMESTIC MONETARY POLICY OF THE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS, UNITED STATES HOUSE OF REPRESENTATIVES

March 4, 1982

H. Erich Heinemann

Morgan Stanley & Company, Incorporated

Mr. Chairman, members of this distinguished Subcommittee: I am pleased to have the opportunity to present my personal views on the conduct of monetary policy. The Subcommittee is to be congratulated on its line of inquiry. The way in which we as a nation deal with the issues you have raised, while they are admittedly technical, will have an important effect on our quality of life. The definition of the money supply, the manner in which bank reserve requirements are established, the impact of changes in the financial system must all be dealt with in our quest to eliminate inflation and to reestablish sustainable real growth. At the same time, they should also be seen within a larger public policy context. Most critical, we must recognize that fiscal policy is now, as always, inextricably intertwined with the conduct of monetary affairs. However, taxes and spending are not the subject of these hearings; therefore, to the best of my ability I will resist temptation and not dwell on such matters.

In my judgment, analysis of the issues concerning monetary control that are to be considered in these hearings should include the following points:

* The Congress and the Administration have no practical alternative other than to support the efforts of the Federal Reserve system to achieve a credible, stable, and predictable deceleration in the long-run rate of monetary expansion. Indeed, elected officials can make a great contribution to economic stabilization and lower interest rates by insisting that the monetary authorities actually implement their announced anti-inflationary goals. This process has not been, will not

be, cannot be, cost free. But the costs will be far lower — in terms of lost output and the potential threat to the workings of a democratic society — than would be the case should the adjustment be delayed. Any sustained or systematic effort to push interest rates down by pumping up the money supply would quickly and inevitably backfire. Anticipated and, eventually, actual rates of inflation would soon rise, thus confirming the worst fears of participants in the financial markets. Interest rates would rocket far higher than at present, and a major crisis would be threatened. As it is, the cost of credit today represents a severe disequilibrium both for the domestic and the world economy. Tight money, and only tight money, will bring interest rates down to establish the foundation for stable expansion in the real economy.

* Financial innovations — which Chairman Fauntroy in his very kind letter of invitation indicated are to be the primary concern of these hearings — are in my opinion simply a normal and expected market response. They reflect the interaction of high inflation, high nominal interest rates, and counterproductive governmental controls on deposit interest rates.

  If, as, and when inflation and interest rates are reduced, and the controls are eliminated, the dominant role played by these innovative practices will quickly diminish. Financial innovation, which is an ongoing process, will not cease, but its pace and importance should be attenuated. In the meantime, money market mutual funds, NOW accounts, the all-savers certificate, IRA accounts, and the like appear to have had little or no effect on the basic monetary process. However great the difficulties these changes may have posed for the statisticians who must measure the money supply, the underlying linkages have not been seriously disturbed. Sustained movements in the monetary base, which is the only aggregate the Federal Reserve can control directly, continue to be reflected in the money supply (measured as M-1) and, after a lag, in the behavior of total spending and prices. The level of short-term interest rates, by contrast, has proven to be unreliable as a guide for Federal Reserve policy actions.

* This Subcommittee should take the lead in reexamining the basic premises on which the present scheme for the maintenance of bank reserves has been founded. Ultimately, Congress should consider a simplified, uniform reserve requirement applied equally to all liabilities of all financial institutions. The Depository Institutions Deregulation and Monetary Control Act of 1980 established new ground rules governing the way in which financial organizations hold reserves against their deposits. Reserve requirements, of course, lie at the very core of the monetary control process. The specific form in which this legislation was adopted has been little debated — either before or after its passage. The present procedures may in fact prove to be a retrogressive step that could ultimately weaken the basic linkage between Federal Reserve actions, the money supply, and the economy. My own preference, which I will outline in my testimony today, would be for an approach to bank reserve requirements that would emphasize the twin principles of uniformity and simplicity — neither of which are characteristic of the legislation that is now being gradually placed into effect.
* Short-run variance in reported rates of monetary growth represents a significant problem with which the Federal Reserve ought to deal. But the nature of the concern is almost certainly different from the popular impression. Significant and unpredictable changes in the money supply have, of course, been commonplace. As a case in point, the reported level of M-1 declined slightly between April and October last year but rose at an annual rate of roughly 18 percent between November and January. All this occurred within the context of a policy "committed to restraining growth in money and credit to exert continuing downward pressure on the rate of inflation." Market participants have learned from bitter experience that unstable monetary policy can lead to wide swings in inflationary expectations, big changes in both short- and long-term interest rates, shifts in the pace of real economic activity, and large social costs. To be sure, in theory short-run changes in monetary growth should be ignored by the marketplace and should have no impact on the economy. The problem lies in the fact that the volatile pattern in the money stock has been

far from random, but rather has had a systematic inflationary bias. Thus, when the money supply took a big jump in the first week of this year, market participants quickly extrapolated this change into a long-term trend.

It is for this reason that I have long advocated — along with the other members of the Shadow Open Market Committee — reforms that would tighten the Federal Reserve's short-run control over monetary movements. The principal elements in this program include adoption of contemporaneous reserve accounting, market-oriented discount rate, and explicit targeting of the monetary base. But it is important to understand the nature of these proposals — what they would do, and what they would not do. They would not eliminate short-run volatility in the money supply. In fact, it is probably not desirable to do so — even assuming that such were possible (which is doubtful). What such reforms would accomplish is a sharp reduction in both the actual and the perceived risk that week-to-week blips in the money supply may be translated into very systematic — and highly inflationary — accelerations in monetary expansion.

To repeat, random and temporary fluctuations in money growth are, in the first instance, inevitable, and, in the second, not a problem so long as they do not become part of a longer run pattern. The Federal Reserve should take the initiative to tighten its short-run control over the money supply —not to prevent week-to-week changes, but to assure that random fluctuations remain just that. Actions of this sort should help lower the risk premium that is now embedded in the interest rate structure. At the same time, interest rates — except on very short-term obligations of, say, no more than a few days' duration — should also be more stable.

BACKGROUND TO CRISIS

In a very real sense, the fact that these hearings are being held here today is symptomatic of the turmoil with which participants in the financial markets are now confronted. Roughly two decades of accelerating inflation and rising transfer payments have produced deep distortions in the economy. Governmental policies which (1) reward present rather than future consumption, (2) favor the non-producer at the expense of the producer, and (3) emphasize the redistribution and not the expansion of income and wealth lie behind the long-term trends of inflation and lower real growth. To an observer sitting in the capital markets, it would appear that there is now a national consensus that this deterioration must end. But it is certainly not surprising that there is little agreement on the manner in which a change of this sort ought to be effected.

This is very plain in the debate over fiscal policy. I like to use a simple political model to illustrate the diversity of interests involved in the governmental spending process, and their relationship to monetary policy and the financial markets. There are, obviously, three major constituencies to be considered:

* First, there are beneficiaries of governmental programs, who will seek to obtain as much as possible. This is a very populous group that consists of individuals who believe they have a compelling need to spend income earned by someone else — whether in the form of a transfer payment, a defense contract, or any other purchase of goods and services by the Government.
* Second, there are taxpayers, mainly the broad middle class, who will seek to pay as little as possible. This second group is in practice clearly not mutually exclusive from the first, but its self interest is sharply divergent.
* Third, and finally, there are savers who must make voluntary decisions whether, and at what price, to purchase Government securities to bridge the gap between what the former group wants and what the latter group is willing to pay.

It is natural that public attention should have focused primarily on the obvious clash between beneficiaries and taxpayers who are numerous and whose conflicting desires are translated quickly into votes. The savers' position in the governmental process may be less evident, but it is no less vital. The impact of the unlegislated tax on savings which inflation represents comes in a stream of individually small but cumulatively large negative effects that stretch indefinitely into the future. In part because most fixed-income investments — which are particularly vulnerable to the inflation tax and which comprise the bulk of individual wealth in the United States — are held indirectly through banks, thrift institutions, insurance companies, and pension plans, the nature of this erosion in value is not well perceived. Nonetheless, savers vote, not so much at the polls (though they do that, too) as every day in the capital market.

Today, after 20 years of irregular increases in the unlegislated inflation tax, savers are demanding a "risk premium" before they will play in the Treasury's game. Indeed, the premium is now so high that the rest of the economy is finding it difficult to live with the resulting rise in real interest rates.

In my judgment, it is against this background that we must examine the appropriate course for monetary policy. The figures that have been presented with this testimony (and in particular Figure 1, which traces the course of the monetary base and bank reserves) make clear that the underlying pattern of federal Reserve actions has already shifted decisively toward restraint. This means that the ball has now moved largely to the fiscal policy court, even as the monetary authorities work to achieve further reductions in the rate of growth in the money stock. Any other course would quickly and inevitably exacerbate the tensions now evident in financial markets.

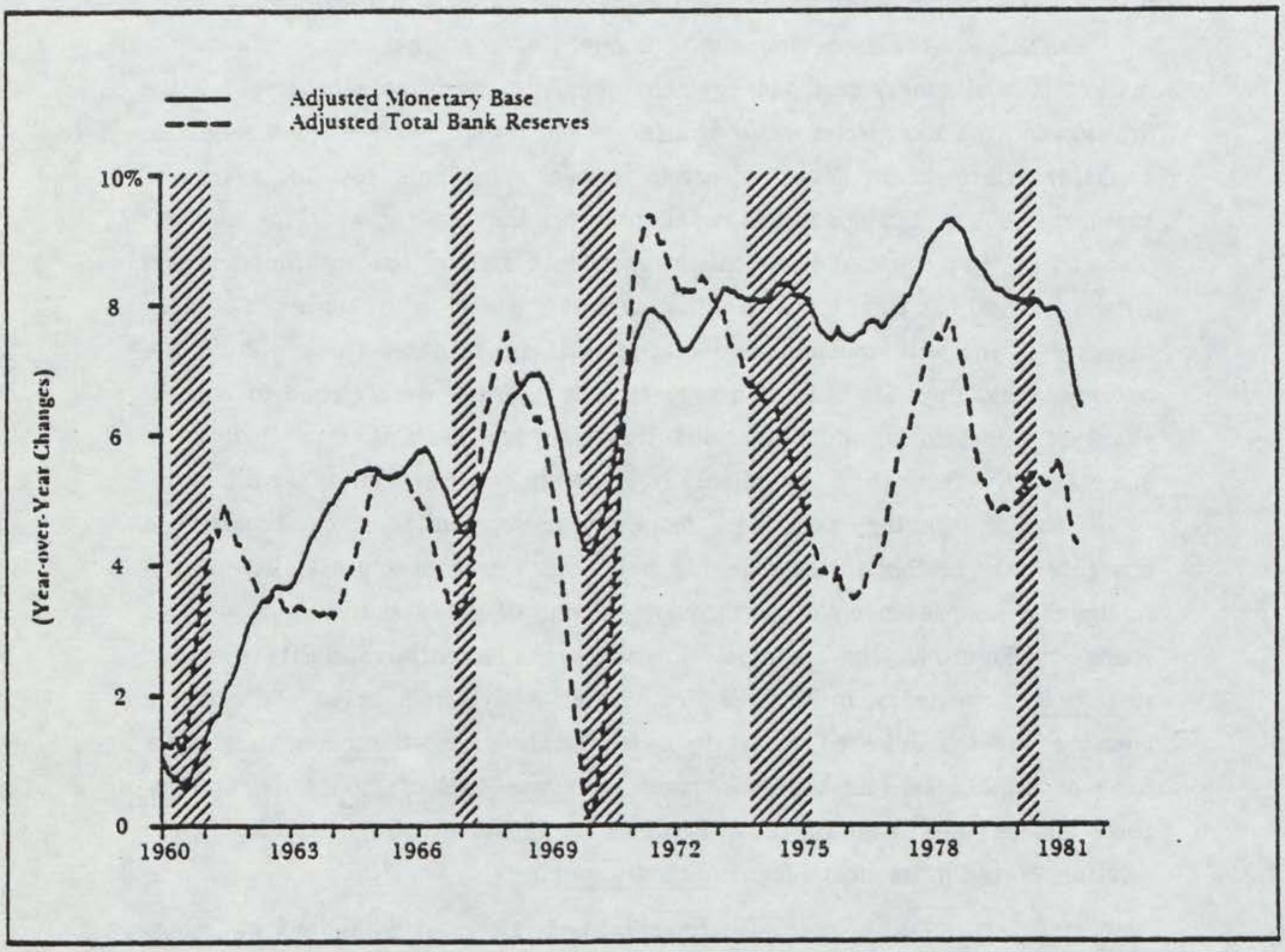
THE MORE THINGS CHANGE . . .

I have been active as a chronicler and analyst of this nation's financial structure for almost a quarter of a century. It is fair to say, I think, that over this span there has been a tale no more enduring than that of the distortions produced by, and the breakdown of, the limits placed by Congress during the Depression on the payment of interest on bank deposits. With the innovation of the negotiable certificate of deposit and premium rates on Federal funds approximately 20 years ago, it was plain that this regulatory structure was beginning to disintegrate.

At the same time, the continued existence of a tattered regulatory umbrella encouraged thrift institutions — which are designated in the law as the principal source of home financing — to maintain portfolios of long-term, fixed-rate assets and short-term, much more market sensitive liabilities. The severe mismatch that resulted of course led to recurring "crises" when deposits flowed out of savings organizations coincident with cyclical peaks in interest rates. there is little doubt in my mind that Government's desire in each cycle to "do something" to alleviate the plight of the housing industry has played an important role in the progressive acceleration in monetary growth, the continuing increases in inflation, as well as the successively higher peaks in interest rates and lower rates of real growth.

Figure 1

Monetary Policy Has Tightened



Data are 12-month moving averages centered on the sixth month.

Shaded areas, except for the mini-recession of 1966-1967, represent periods of recession as designated by the National Bureau of Economic Research.

Sources: Federal Reserve Bank of St. Louis; Econalyst Data Base; Morgan Stanley Research

The rationale for controls on interest rates is often cited as a desire to limit the cost of credit. But to the extent that the controls have encouraged a distorted structure among thrift institutions and recurring Federal Reserve attempts to "help" in difficult circumstance, this has not been the result. Thus, as so often happens in such cases, governmental intervention in the market process designed to force feed the supply of funds for housing and keep the cost of mortgage finance down has in practice had the opposite consequence.

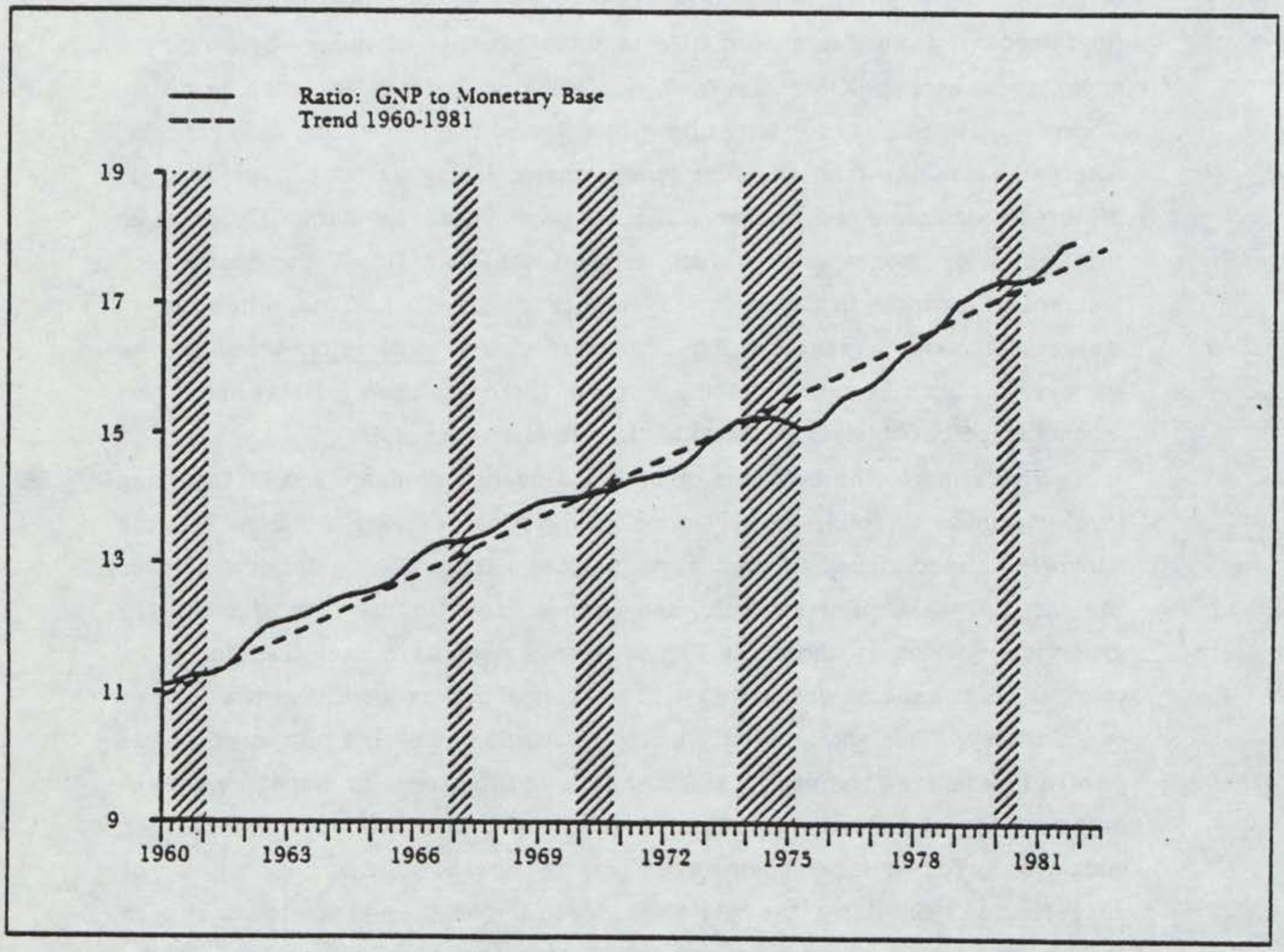
Turning to the more immediate concern of these hearings — the money market mutual funds, cash management accounts, negotiable orders of withdrawal, and the like, which have proliferated in recent years — I can see little to differentiate recent developments in form or substance from the events of the early 1960's. Indeed, it seems fair to argue that the repeal in the marketplace (if not in Congress) of deposit interest rate ceilings (on both demand and time accounts) has finally reached the level of the man in the street. Ordinary savers — if you will, the members of this country's yeoman stock who do the nation's work, pays its bills, and save for its future — were ripped off during years of accelerating inflation, but they are now coming into their own. Increasingly, a fair return is available to the small saver as well as the big one.

From the vantage point of a monetary technician, the most remarkable characteristic of this entire saga has been the extraordinary stability of the financial response mechanism through an era of truly dramatic structural changes. Figure 2, for example, illustrates the essential stability between <u>sustained</u> movements in the Federal Reserve System's balance sheet (as measured by the adjusted monetary base calculated by the Federal Reserve Bank of St. Louis) and the subsequent <u>sustained</u> level of money demand for goods and services in the United States. As the President's Council of Economic Advisers stated in its most recent <u>Annual</u> <u>Report</u>:

> "It is often stated that such financial innovations as money market funds undermine the conduct of monetary policy. Statistical support for this assertion is dubious. What would have to be demonstrated is that financial innovation — which is to a large extent the result of policy-imposed constraints on the financial system in an inflationary environment — has made it more difficult to achieve a given monetary target, and that the link between changes in nominal GNP and changes in the monetary

Figure 2

The Trend of Velocity Has Been Stable



Data are trailing four-quarter moving averages. Monetary base has been lagged two quarters.

Shaded areas, except for the mini-recession of 1966-1967, represent periods of recession as designated by the National Bureau of Economic Research.

Sources: Econalyst Data Base; Morgan Stanley Research

aggregates — that is, changes in velocity — has become less predictable. The evidence does not seem to support either proposition."

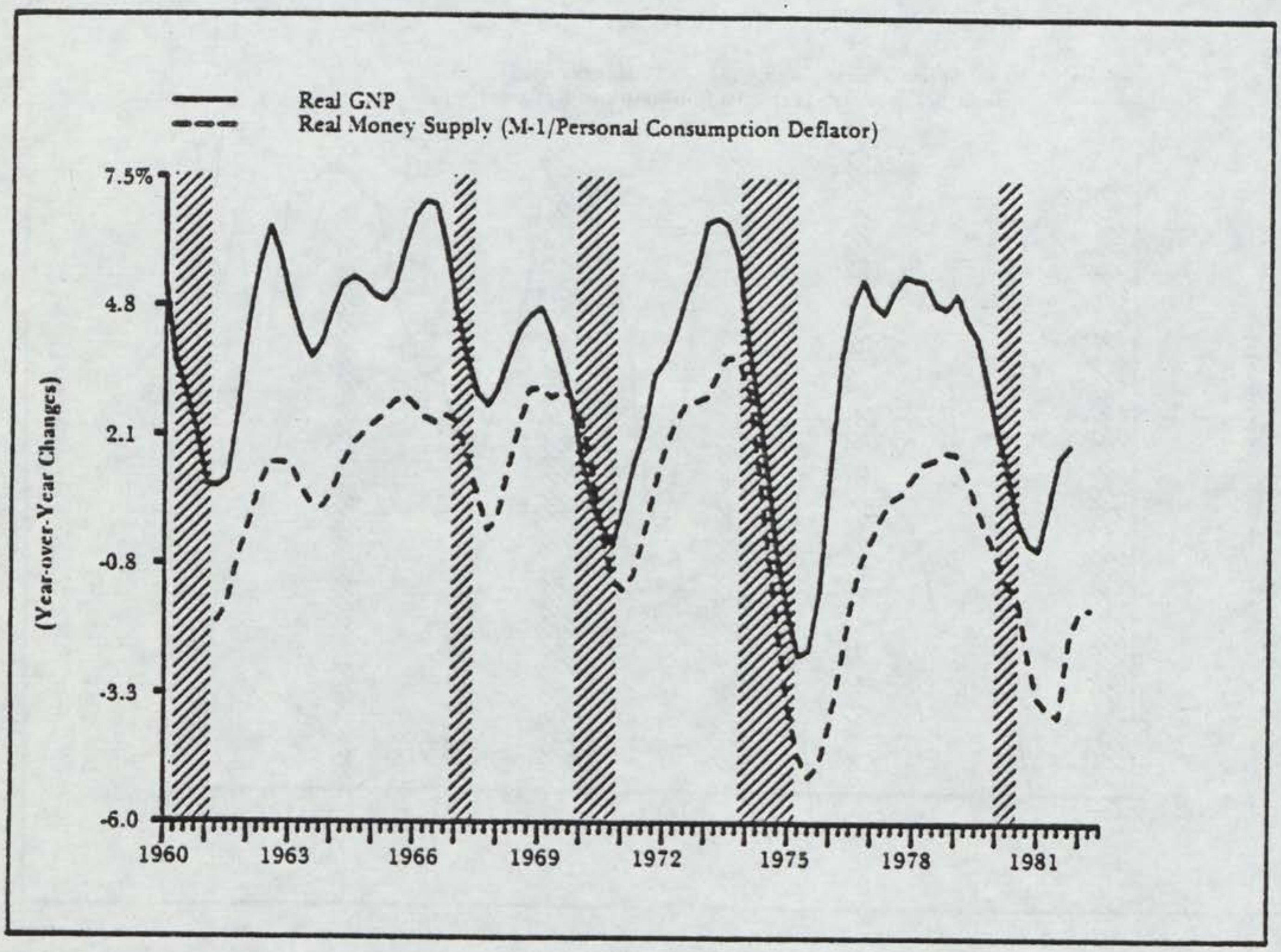
Moreover, so far as money market mutual funds are concerned, there are some important tehcnical considerations to keep in mind. The shares of such funds are of course not "money" in the generally accepted sense of being in and of themselves assets that would serve as both a medium of exchange and a store of value. Rather, if I desire to purchase shares in my money market mutual fund account, I must surrender title to some quantity of money by sending a check or a wire transfer drawn on an M-1 type balance in order to do so. Conversely, when I pay for someting with a money market mutual fund "check," I actually give the fund an order to sell shares in my account. The fund, in effect, obtains some M-1 for me so that my payment can be made. The point is, that while my money market fund account ebbs and flows, the quantity of transaction balances in the banking system is not affected. Thus, while money market funds may create a significant effect on <u>transaction</u> velocity (the turnover of deposits in the banking system), there has been far less impact on <u>income</u> velocity (which is the ratio of GNP to money supply).

What's more, the behavior of both the overall economy and of the price level continues to follow closely prior changes in the monetary base and the narrowly defined money supply. Figures 3 and 4 trace these relationships over the past 20 years. For example, short-run changes in the rate of monetary expansion — which is shown in Figure 3 on a real basis, adjusted for price changes — are generally reflected with a lag of about six months in the pace of real activity. This shows clearly in the figure, including the blip in economic growth in late 1980 and early 1981 that followed the surge in monetary growth between May and November 1980. (Because the data in Figure 3 have been computed as four-quarter moving averages, the current business downturn is not yet reflected.) Similarly, the rate of change in the price level started to slow in the spring of 1981, almost exactly two years after parallel slowdown in the underlying rate of monetary growth in mid-1978 (see Figure 4).

In sharp contrast, Morgan Stanley's measure of the "expanded" money supply — which includes in addition to M-1, overnight repurchase agreements and Eurodollars, as well as 50 percent of money mutual funds outstanding — has shown a sharp acceleration over the past year, owing to the rapid growth of money market funds. On the assumption that there are systematic associations

Figure 3

The Synchronous Movement of Money and the Economy



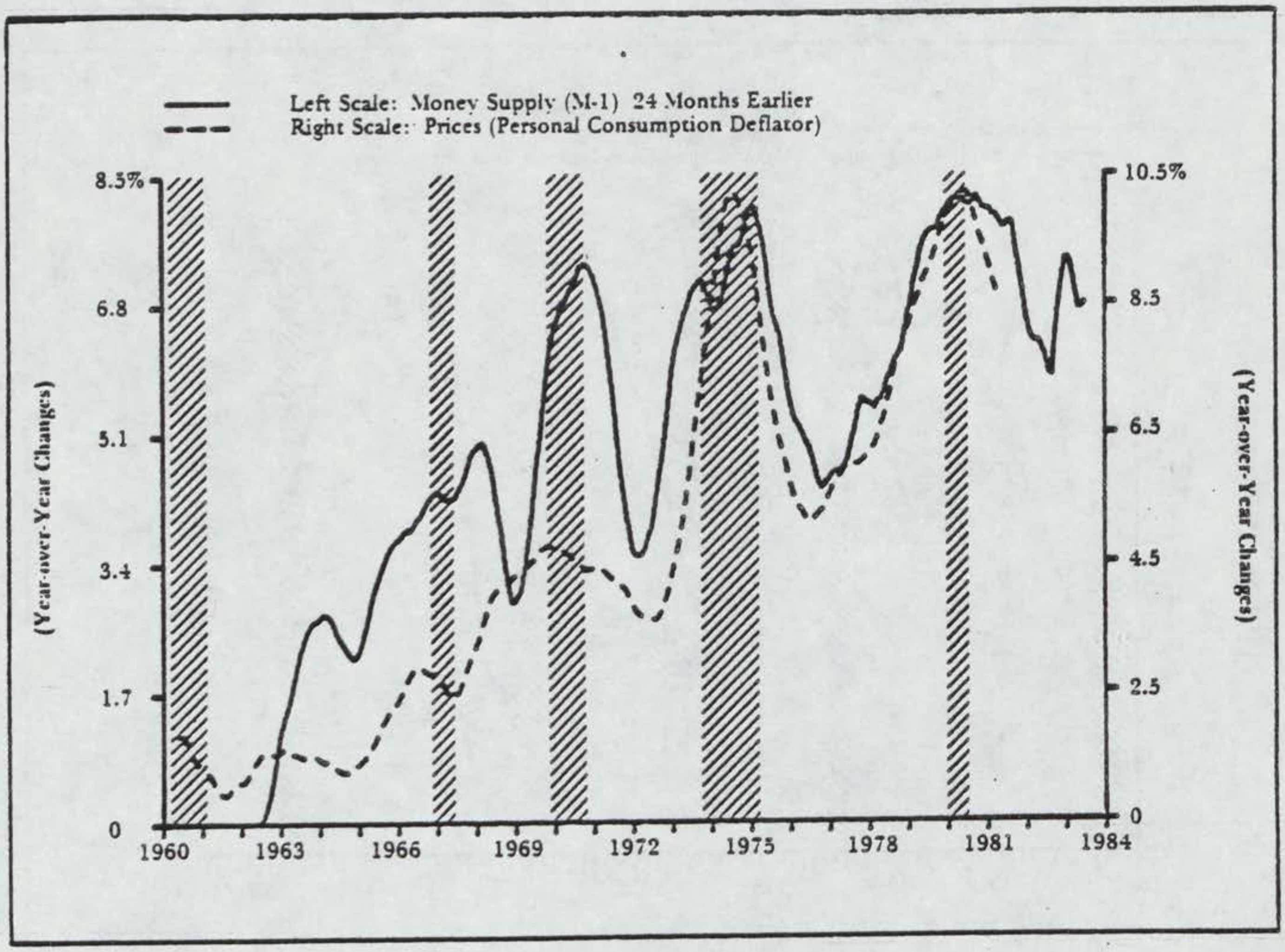
Data are trailing four-quarter moving averages. Money supply has been lagged two quarters.

Shaded areas, except for the mini-recession of 1966-1967, represent periods of recession as designated by the National Bureau of Economic Research.

Sources: Econalyst Data Base; Morgan Stanley Research

Figure 4

Disinflation is on Schedule



Data are 12-month moving averages centered on the sixth month.

Shaded areas, except for the mini-recession of 1966-1967, represent periods of recession as designated by the National Bureau of Economic Research.

Sources: Econalyst Data Base; Morgan Stanley Research

between money, spending, and prices, one would have expected an acceleration of this sort to be reflected in the economy (the year-over-year increase in expanded money was almost 17 percent in January 1982, up from 9.4 percent a year earlier). The fact that it has not been so reflected could be an indication that (1) money fund shares lack some of the critical properties of money, or (2) as is more likely, their creation does not result in a net expansion of the effective stock of transaction blances. (Data on the expanded money stock are reported regularly in Morgan Stanley's weekly publication, Money and the Economy.)

In summary, it seems to me unlikely that the rapid spread of devices to avoid Federal limitations on the payment of interest on deposits has impaired in any material way the conduct of monetary policy. Aggregate economic activity continues to be most closely related to prior changes in traditional measures of transaction balances. In any event, to the extent that financial innovations of the sort being focused on in these hearings represent a "problem" — which I doubt — the way to deal with it is to reduce inflation and eliminate regulations. New rules, which would have as their primary purpose a reduction in the yield to investors, would serve no useful end and would be inequitable to some of the nation's most productive citizens, who too long have been penalized by the unlegislated inflation tax.

TARGETS FOR MONETARY POLICY

One of the central themes in these hearings, as I understand the questions raised by the Chairman, concerns the proper definition of the "money supply" that the Federal Reserve System should be seeking to control in its day-to-day implementation of policy. This is, of course, one of the oldest questions in economics, and one which has never been answered satisfactorily. To be sure, there is fairly general agreement that currency and accounts available for third party payments inlcude most of the criteria of "money." The Federal Reserve's official definition of a "transaction account" picks up most of these characteristics:

> "All deposits on which the account holder is permitted to make withdrawals by negotiable or transferable instruments, payment orders of withdrawal, and telephone and preauthorized transfers (in excess of three per month) for the purpose of making payments to third persons or others."

In practice, however, it is obvious that there are many gray areas that greatly complicate the problem of defining and measuring "money" for the purposes of monetary control. Just to cite one very simple example — how would you classify a bank account which is generally inactive but is occasionally used aggressively (say, once every two or three years) when its holder decides to make a series of major expenditures? There are no easy answers to questions of this sort. In the meantime, the Federal Reserve is left with the totally practical need to decide what it should be controlling, and how. I have already argued that the monetary base and conventionally defined M-1 have provided adequate gauges of monetary changes during a period of major structural upheaval in the financial system. Sustained accelerations or decelerations in these aggregates have generally provided reliable clues to subsequent developments in total spending, and, eventually, in inflation. But adequate performance is not optimal performance. Therefore, it seems to me that consideration should be given to reforms that could further stabilize the relationships between Federal Reserve actions in controlling the monetary base, growth in the money supply, and the overall performance of the economy.

The Monetary Control Act of 1980 was designed, as you know, to simplify and rationalize bank reserve requirements. To some extent, it succeeded in doing so. When the Act is fully implemented in 1987, bank reserve requirements will indeed be less complicated than they were prior to its passage. But to my way of thinking, reserve requirements will still be too complicated and will still represent a thinly disguised, unlegislated tax on the banking system. There will still be three categories of bank reserves (12 percent, 3 percent, and zero, depending on the type of account and its maturity), and the actual level of reserves will still be well in excess of the cash balances prudent bankers would hold in the absence of any regulation. In rough outline, the approach I would prefer is as follows:

* Remove all constraints on the payment of interest on deposits, including the remaining prohibition on the payment of interest on demand deposits. Action of this sort would represent an essential first step to eliminating the incentive to develop subterfuges to avoid rate ceilings and differential reserve requirements. For example, the automatic transfer service offered by many banks had the effect — prior to the passage of the Monetary Control Act — of reclassifying

what in reality were demand deposits into savings accounts. This lowered the effective reserve requirement for the bank and allowed the depositor to earn interest on a checking balance, which at that time was illegal.

* Impose a single, uniform reserve requirement at an absolutely low level (say, one or two percent) on all liabilities of all financial institutions that offer deposit services to the public. The only possible exemption from this reserve requirement might be capital notes of perhaps seven years' or more maturity. There would be no need for banks to try to avoid such a reserve requirement, since prudent banking demands that some cash be kept on hand at all times.
* Allow the marketplace to determine the yield on all liabilities of financial institutions. For purposes of social accounting, the public and the institutions would be asked to distinguish between sight accounts (from which third-party payments could be made) and time accounts (from which such payments could not be made). There would be no incentive for banks to allow their depositors to blur the distinction between the two types of accounts because both would carry market rates of interest.
* Require the Federal Reserve to manage its own balance sheet explicitly by setting targets for the monetary base. The base is the only aggregate that the central bank can control directly and in any event (with or without additional reforms) ought to be the primary focus of Federal Reserve actions. The present system of multiple monetary targets has its bureaucratic uses, since emphasis can always be placed on the aggregate that is closest to the mark, but it does not provide optimal policy performance.

The advantage which in my judgment would emerge from an approach of this sort would be a substantial stabilization of the relationship between direct actions by the monetary authorities and the subsequent response in monetary growth, in the financial markets, and in the overall economy. On the assumption that growth in the monetary base was then maintained along a stable and non-inflationary path (a critical assumption, to be sure), the likelihood of attaining a sustainable acceleration in real economic growth would be greatly enhanced.

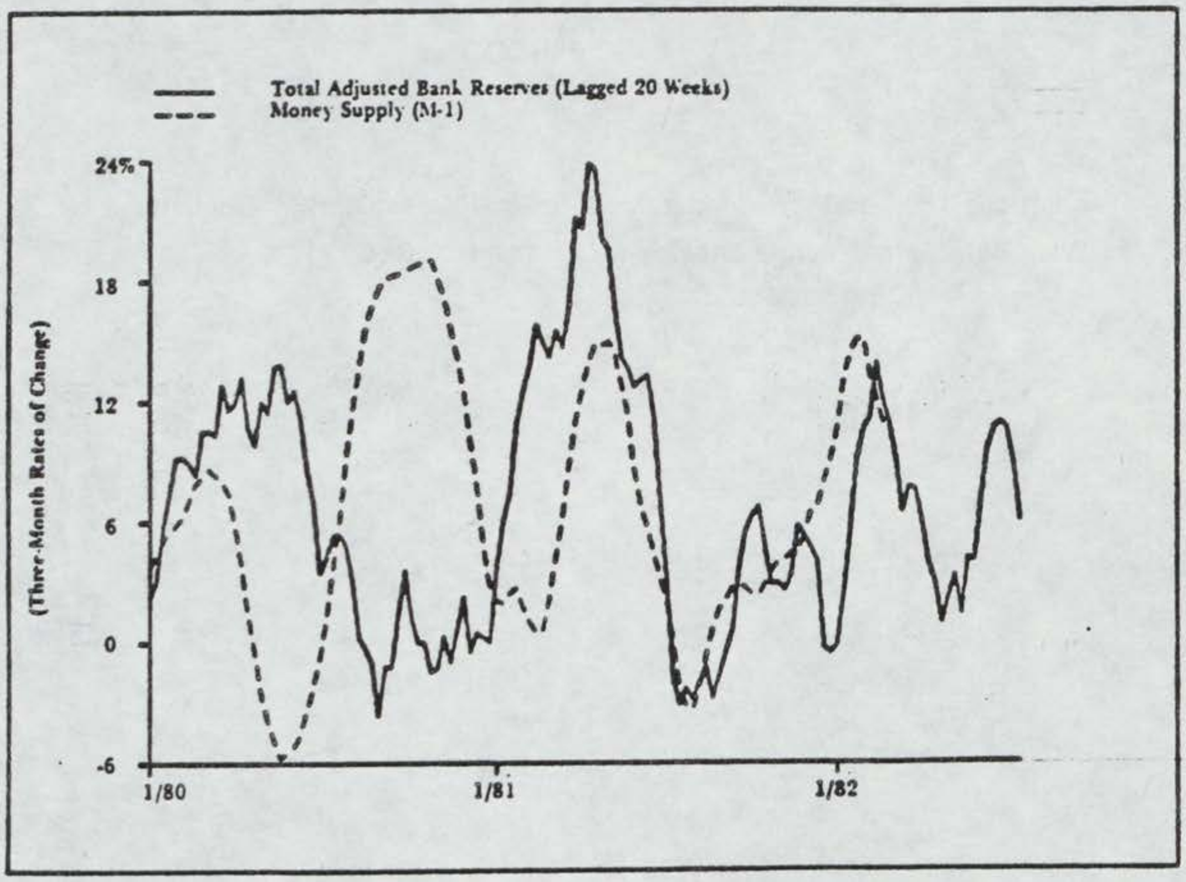
Thank you for the opportunity to present my views here this morning.

APPENDIX

Additional material provided to the Shadow Open Market Committee by H. Erich Heinemann, Morgan Stanley & Co., Incorporated.

Figure 1

The Lagged Relationship Between Bank Reserves and Monetary Expansion

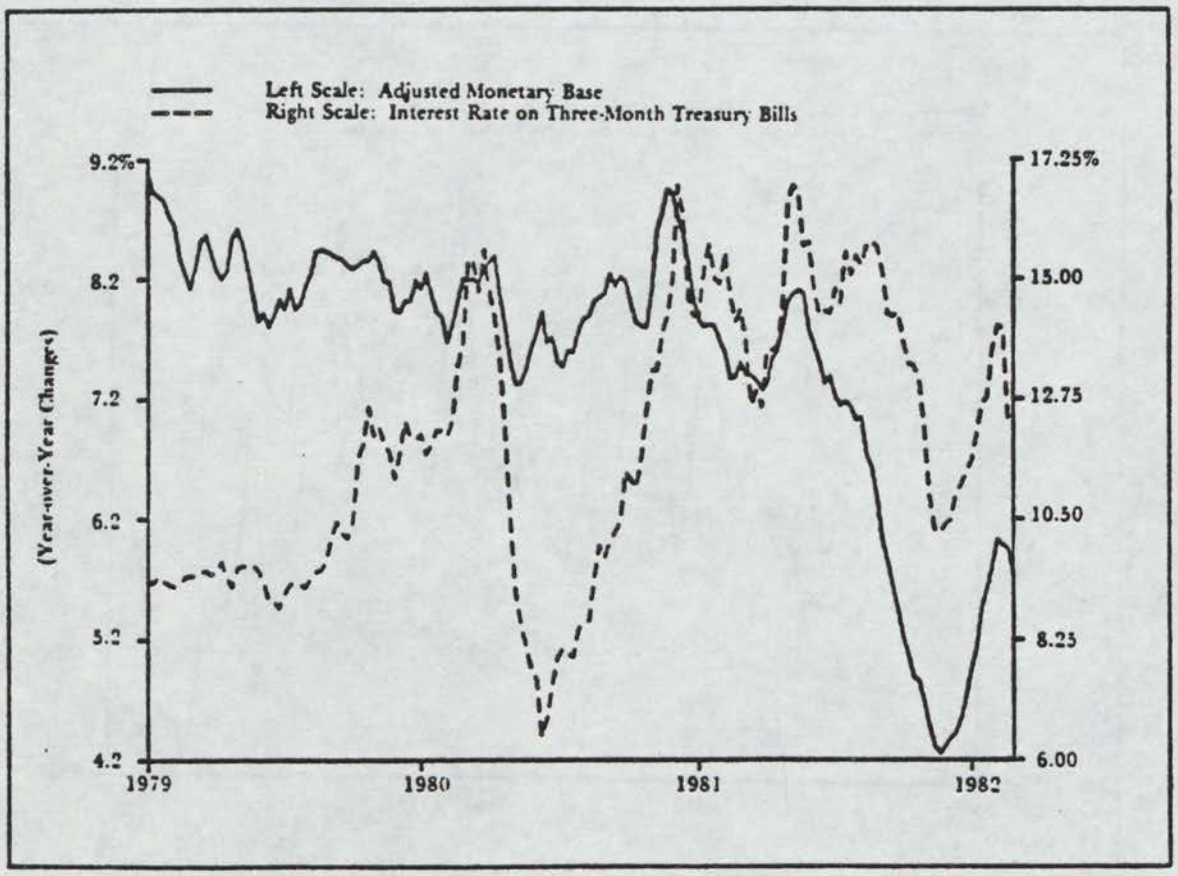


Data are four-week moving averages.

Sources: Econalyst Data Base; Morgan Stanley Research

Figure # 2

Monetary Base and Short-Term Interest Rates

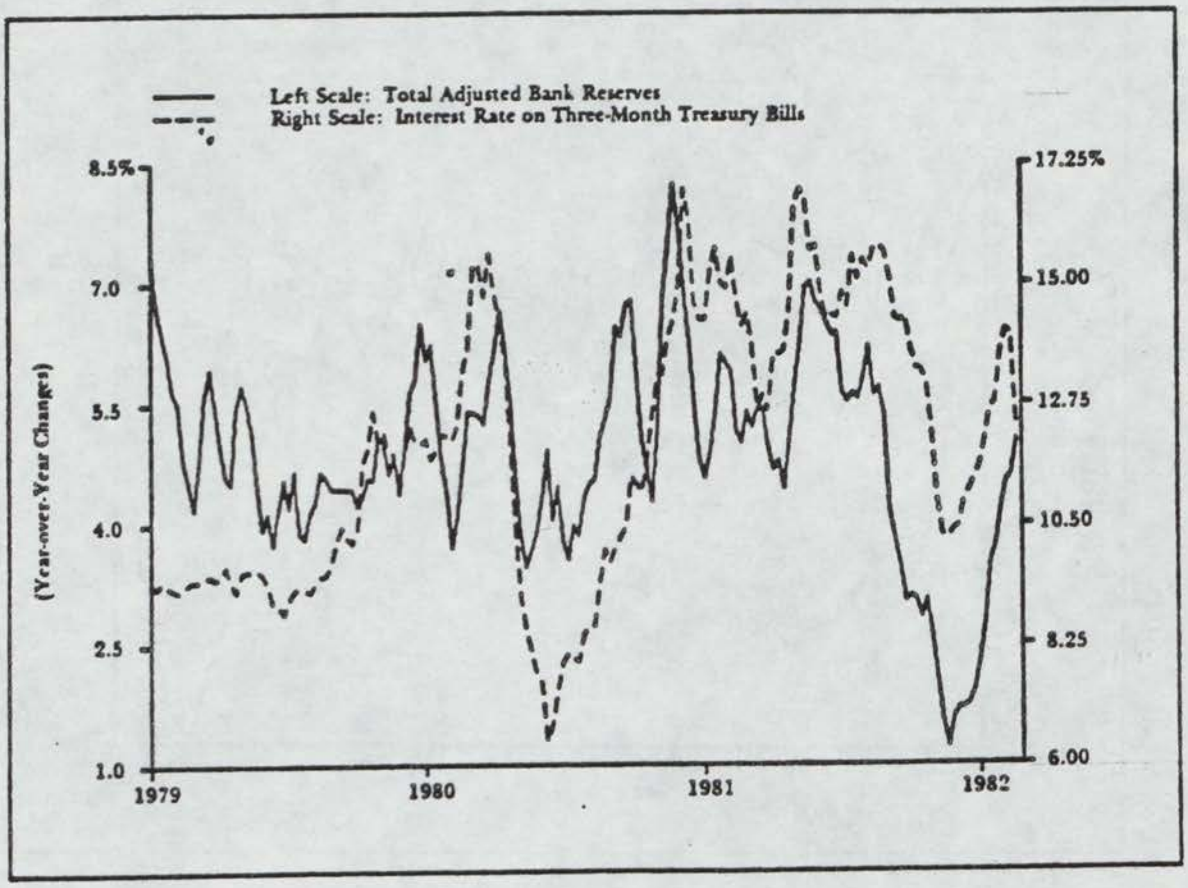


Data are four-week moving averages.

Sources: Econalyst Data Base; Morgan Stanley Research

Figure 5

Bank Reserves and Short-Term Interest Rates



Data are four-week moving averages.

Sources: Econalyst Data Base; Morgan Stanley Research

THE BEHAVIOR OF THE MONETARY AGGREGATES: THE PREDICTABILITY OF THE PAST AND SOME PROGNOSTICATIONS FOR THE FUTURE

James M. Johannes and Robert H. Rasche
Michigan State University

I. A RETROSPECTIVE ANALYSIS OF 1981

Judging by the hand wringing and gnashing of teeth on the part of Federal Reserve officials in the course of recent speeches, 1981 represents a year of historically unprecedented difficulties for monetary management. A representative sampling of the anguish can be culled from the recent sayings of President Solomon of the Federal Reserve Bank of New York:[1)]

> The ongoing process of financial innovation seems to have produced a sharp and largely unexpected divergence this year in the performance of the narrow money measures (such as M-1B) and the broader measures (such as M-2 and M-3). In the eleven months through November, M1-B, adjusted for the effects of the introduction of nationwide NOW accounts at the beginning of the year, rose at a 2.8 percent annual rate. The comparable rates for the broader measures M-2 and M-3, however, were 10.1 percent and 11.3 percent, respectively. ... Perhaps just as important, we did not anticipate, and almost certainly could not have anticipated, the extent of these divergencies. In terms of the midpoints of our 1981 targets for M-1B and the broader measures, the divergencies allowed for were far smaller than the divergencies that have actually materialized. ... Thus the very large gap between M-2 and M-1B in 1981 represents an extremely unusual, if not actually unique situation that has complicated the task of setting policy as the year has proceeded.

The basic message of this report to the Shadow Open Market Committee is that we find no substantive basis for these contentions. There was nothing particularly unusual about the differential behavior of the various monetary aggregates during 1981 (adjusted for the regulatory change allowing for nationwide NOW accounts; the behavior was certainly not unique; and while the behavior obviously was unexpected by the Federal Reserve System, there is no reason why it should have been unexpected. The current bewilderment within the Federal Reserve System about the events of 1981 is yet another demonstration of the old proverbs that "you can lead a horse to water, but you can't make him drink" or even more appropriately "you can't teach an old dog new tricks."

In spite of all the talk about the behavior of the different monetary aggregates in 1981, there has been pitiful little analysis of what actually happened. This problem is easily analyzed within the Brunner-Meltzer non-linear money multiplier framework, and thus the empirical question raised by President Solomon in the quotations above can be addressed using our money multiplier component forecasting models.

First consider the money multipliers for two monetary aggregates (indexed by i) with respect to any of the various reserve or monetary base aggregates (indexed by j). We can express this relationship as:

$$\ln M_i = \ln m_{ij} + \ln R_j \qquad \begin{array}{l} i = 1, I. \\ j = 1, J. \end{array} \tag{1}$$

The relative behavior of two monetary aggregates, i_1 and i_2, is completely determined by the behavior of the two money multipliers, since, given an R_j,

$$\ln M_{i_1} - \ln M_{i_2} = \ln m_{i_1 j} - \ln m_{i_2 j}. \tag{2}$$

In addition, the multipliers for the various monetary aggregates can be written as the ratio of a numerator which depends only on the monetary aggregate (i.e is indexed only by i) and a denominator that depends only on the reserve aggregate selected (i.e. indexed only by j). Thus we can write

$$\ln m_{ij} = \ln Num_i - \ln Den_j \tag{3}$$

and regardless of the reserve aggregate we can rewrite (2) as:

$$\ln M_{i_1} - \ln M_{i_2} = \ln Num_{i_1} - \ln Num_{i_2}. \tag{4}$$

In the case of M1 and M2, the numerators of the respective multipliers are $[1 + k(1+tc)]$ and $[1 + k(1+tc) + t_1]$ using the notation of our previous reports to this committee. The convenient part of this analysis is that the result, (4), is invarient to our choice of reserve aggregate on which to base the multiplier.

Our predictions of the relative behavior of M1 and M2 and M1 to M3, based on our multiplier component forecasts over a one month horizon for the 12 months of 1981 are presented in table 1. The forecasts for January through June are those that are prepared on an export basis for the September, 1981 Shadow committee meeting, and reflect the data available as of August, 1981. The forecasts for July through December are new and reflect the data that is available as of January 1982. It is important to note that these forecasts of the component ratios include intervention terms to allow for the extension of NOW accounts nationwide in January, 1981. These intervention terms are those described in our last report to this committee and reflect a simple log linear adjustment for the months of January through April, 1981.[2)] The models used to generate the forecasts are estimated over sample periods ending in December, 1979.[3)] It should also be noted that no adjustments have been made to the models or forecasts for the introduction of All Savers Certificates in October, 1981.

The forecast errors in table 1 fail to indicate that anything unique, or indeed even highly unusual, is going on with respect to the relative behavior of the various monetary aggregates in 1981, after allowance is made for the extension of NOW accounts nationwide. The average (one month ahead) forecast error for the M-3, M-1B differential is essentially zero. There is a small positive error on average for the M-2, M-1B differential, but it is this differential that would be most sensitive to the NOW account shift, and the largest positive errors are in the first four months of the year. Since our NOW account adjustment was not designed to be exact, but rather to replicate on average, with a very simple functional form, the type of shift that the Board of Governors found from its sampling information, we feel that it is safe to interpret the data in table 1 as suggesting that the impact of financial innovation, as contrasted with the impact of changes in the regulatory environment, on the differential behavior of the various monetary aggregates was highly predictable during 1981.

It is one thing to claim that the behavior of the various monetary aggregates during 1981 is explainable with perfect hindsight as in table 1. It is quite another thing to claim that they should have been foreseen. In this case, we feel that there is substantial evidence for even this stronger claim. Last March we presented a set of forecasts to the Shadow Open Market Committee

TABLE 1

Differential Behavior of Various Monetary Aggregates: 1981

	$\ln(M_2)-\ln(M_{1B})$			$\ln(M_3)-\ln(M_{1B})$		
	Actual	Predicted	Difference	Actual	Predicted	Difference
Jan.	1.38677	1.38145	.00532	1.55625	1.54930	.00695
Feb.	1.41667	1.40869	.00808	1.58827	1.58384	-.00443
March	1.41810	1.41722	.00088	1.58493	1.58939	-.00446
Apr.	1.39223	1.38090	.01133	1.55384	1.56341	-.00957
May	1.41611	1.41599	.00012	1.58298	1.57651	.00647
June	1.41521	1.41009	.00512	1.58346	1.57556	.00790
July	1.40540	1.40406	.00134	1.57661	1.58201	-.00540
Aug.	1.41391	1.41470	-.00079	1.58802	1.58994	-.00192
Sept.	1.41721	1.41235	.00486	1.59387	1.58621	.00766
Oct.	1.42018	1.41369	.00649	1.59528	1.59594	-.00066
Nov.	1.42000	1.41847	.00153	1.59434	1.59139	.00294
Dec.	1.40701	1.41603	-.00902	1.58052	1.58864	-.00812
Mean error			.00294			-.00022
Standard deviation of errors			.00498			.00612

meeting that indicated our predictions of the behavior of the M-1B, M-2 and M-3 adjusted unborrowed reserves multipliers for the remainder of 1981, based on information available at the end of February, 1981. This included the data on the monetary aggregates for January, 1981, and the initial results of the Board of Governors survey data on shifts into NOW accounts from non-demand deposit sources as reported in Chairman Volcker's testimony of February 25, 1981. These forecasts are a matter of public record.[4)] Using those forecasts, which incorporate only the NOW account shifts that occurred in January, 1981, and assume no subsequent shifts into NOW's from non-demand deposit sources, we find an average forecast error of 2.4 percent for the fourth quarter of 1981 in the ratio of M-1B to M-2, and an average forecast error of 2.3 percent for the fourth quarter of 1981 in the ratio of M-1B to M-3. Such errors are very small when it is realized that the average forecasting horizon is 10 months! Furthermore, the 2+ percent error is divided into an underestimate of fourth quarter M-1B of approximately 1.6 percent and an overestimate of fourth quarter M-2 and M-3 of .8 and .7 percent, respectively. This is just the type of forecasting errors that are to be expected given our incomplete information on the extent of the NOW account shifts. Given that by all estimates the NOW account shift was completed by the end of April, 1981, there is no reason why anyone should remain bewildered about the differential behavior of the monetary aggregates after the middle of 1981.

II. PROGNOSTICATIONS FOR 1982

At present, we are somewhat handicapped in making forecasts for 1982. The Board of Governors has just released (February 5, 1982) revisions to the monetary aggregates. Many of the revisions (changes in seasonal adjustment techniques, new call report benchmarks, renaming M_{1B} as M_1) do not cause us any difficulty. The consolidation adjustment for vault cash of thrift institutions in M-1 and the netings of CIPC of thrifts against transactions deposits also should not cause us severe problems, since they have negligible impact on growth rates of M-1. Unfortunately, the compositional changes involving the allocation of retail RP's and money market mutual funds between M-2 and M-3 have a substantial impact on our t_1 and t_2 component ratios. At the present (March 1, 1982) historical data for the revised series are not available. Thus we have not been able to reestimate our models with the new data, nor can we forecast with the existing models and the revised data.

We have chosen to use the old (1981) data and construct M-1 forecasts for 1982 based on a December, 1981 origin. While our forecasts for t_1 and t_2 obviously will be in error compared with the new data, the errors should be essentially offsetting since only the sum of t_1 and t_2 is involved in forecasting the various M-1 multipliers. Our M-1 multiplier forecasts should not be affected systematically by the recent revisions. Our current forecasts on the M-1 adjusted unborrowed reserves multiplier are:

	1981	1982	
Jan.		9.6489	
Feb.		9.7931	
Mar.		9.8717	
Apr.		9.9980	
May		9.7494	
June		9.9360	
July	10.2693	9.8506	
Aug.	10.1550	9.8320	
Sept.	10.0738	9.8041	
Oct.	9.9806	9.7761	
Nov.	9.9497	9.7434	-2.2%
Dec.	9.9757	9.7409	

FOOTNOTES

1) Anthony M. Solomon, "Financial Innovation and Monetary Policy," Sixty-Seventh Annual Report of the Federal Reserve Bank of New York, 1981, pp. 4-5. (Emphasis added.)

2) The NOW account adjustment is that described in the "Shadow Open Market Committee Policy Statement and Position Papers, September 13-14, 1981," Center for Research in Government Policy and Business, Graduate School of Management, University of Rochester, PPS-81-8, p. 42-46.

3) For what follows it is interesting to note parenthetically that the models are nearly identical to models estimated through 1978. See ibid., p. 40.

4) Shadow Open Market Committee Policy Statement and Position Papers, op. cit., pp. 61-64.

SOURCES OF FINANCING FOR THE GOVERNMENT DEFICIT

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This analysis updates materials that I supplied to the Shadow meeting on a regular basis several years ago. The analysis is derived from the combination of the Treasury identity for the government financing requirement, including both the unified budget deficit and the deficit of off-budget agencies, and the Federal Reserve identity for the sources and uses of member bank reserves. In table 1 the three major categories of financing for the government deficit are identified: 1) borrowing from private capital markets, 2) increases in the net source base by the Federal Reserve (monetization of the deficit if you like) and 3) borrowings from Foreign Official Institutions. The latter represents that portion of the government deficit that is financed by Foreign Official Institutions and does not have to be sold on the private capital markets. All other of the detailed sources of financing of the government deficit have been lumped into the fourth category, "other" in table 1. Most of the detailed items in this category are either Federal Reserve or Treasury "float" accounts that may be a substantial source of financing in the short run, but are not available in any large amount as a permanent source of financing. I have the detailed data available on a monthly and quarterly basis, but none of it is seasonally adjusted, and the strong seasonal components in the series tend to obliterate the longer run movements of the series. Therefore, the information in table 1 has been aggregated to an annual basis.[1)]

The first striking feature of table 1 is the dramatic decline since 1977-78 in the percentage of the deficit that has been financed by foreign official institutions. Unfortunately, the component data of this series are not available

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1) A full explanation of the derivation of the numbers in table 1 appears in my earlier article "Financing the Government Defict," Policy Studies Journal, Autumn 1980.

TABLE 1

Sources of Financing of U.S. Government Deficit
(Billions of Dollars)

A. Calendar Years	76	77	78	79	80	81 (11 mo.)
Total Financing Required	62.1	61.4	52.8	41.4	83.3	74.5
(1) Borrowing on Private Capital Market	49.6	19.4	22.3	51.6	65.1	64.5
(2) Change in Net Source Base	6.4	11.4	14.3	9.3	9.0	2.6
(3) Borrowings from Foreign Official Institutions	7.0	29.4	29.0	-22.6	2.8	5.0
(4) Other	-1.0	1.3	-12.8	3.1	6.5	2.4

B. Fiscal Years	77	78	79	80	81
Total Financing Required	53.7	59.0	39.7	73.2	78.9
(1) Borrowing on Private Capital Market	23.5	24.3	35.2	68.6	68.7
(2) Change in Net Source Base	5.3	12.3	13.6	10.4	5.6
(3) Borrowings from Foreign Official Institutions	20.3	23.3	1.2	-4.5	4.6
(4) Other	4.7	-.9	-10.3	-1.3	--

on a geographic basis, but some insight into what is happening can be obtained from table 3.14, "Selected U.S. Liabilities to Foreign Official Institutions" in the Federal Reserve Bulletin. These data include more items than U.S. Government Securities, but among the various types of liabilities included, the major changes in volume outstanding since the end of 1978 has been in the Treasury Security subset. In the geographic area distribution, Official Institutions in Western Europe have reduced their holdings from 93.1 billion at the end of 1978 to 63.0 billion at the end of November, 1981. The decrease in 1981 alone was 18.6 billion; probably in large part the losses suffered by Europeans in the attempt to defend their currencies against a rising dollar in the absence of Federal Reserve intervention in foreign exchange markets.

The other large, and offsetting movement has been the increase in U.S. dollar liabilities to Asian Official Institutions from 70.8 billion at the end of 1979 to 91.3 at the end of November, 1981. Presumably this represents significant accumulations by OPEC members.

What financing is likely to be provided by foreign official sources in the coming months? Given recent trends in the spot price of oil and the outbreak of price cutting within OPEC, it seems unlikely that "petro dollars" will continue to accumulate at rapid rates in the near future. Indeed if we are to take seriously the recent reports of the balance of payments situations in a number of OPEC countries, it is conceivable that a "runoff" of petro dollars could occur in the near future if the price of oil continues to decline. Also, given the current price of the U.S. dollar in terms of Western European currencies, it does not seem likely that European central banks would intervene to buy large quantities of dollars, even if the dollar were to start declining. Therefore, my conclusion is that it is unlikely that these institutions, around the world, will be a major factor in the financing of the U.S. deficit. I think 1982 in this respect, will more closely resemble 1979-81 than 1977-78.

That brings us to the Federal Reserve. If we assume a maximum of 3-5 percent growth in the net source based over 1982, allowing for the Fed to be somewhere near or above its M_1 targets and some upward drift in the M_1 — gives something in the range of 4.5 to 7.5 billion of financing to be provided by the Federal Reserve. Thus it is likely that the bulk of the 1982 deficit will have to be financed in the private market as it was in 1980-81.

Prepared for Shadow Open Market Committee, March, 1981.

ECONOMIC PROSPECTS THROUGH 1983

and

BUSINESS OUTLOOK-MONTHLY UPDATE

Robert J. Genetski

Harris Trust and Savings Bank

Background paper prepared for the March 14-15, 1982 meeting of the Shadow Open Market Committee and distributed earlier by Harris Trust and Savings Bank.

HARRIS BANK
Chicago Illinois

Harris Economics

February 26, 1982

BUSINESS OUTLOOK—MONTHLY UPDATE

The decline in business activity appears to be moderating and soon will give way to the beginning of an economic recovery. Signs of recovery could appear anytime from now to July. However, the recent conduct of monetary policy poses a significant threat to attaining economic prosperity with low inflation. Although signs of an economic recovery are likely to appear soon, there is a growing probability that any such recovery will be characterized by a surge in spending that ushers in higher inflation and another roller coaster pattern of business activity.

The Recession Continues

Business activity dropped sharply in January as bad weather aggravated an already serious decline. Tentative data for early February indicate that some of the extreme weakness of the previous month is being offset. In early February, initial claims for unemployment insurance dipped to 520,000 per week on average, (down from the 550,000 range of the previous two months). Autos also staged a modest comeback, with sales of domestic cars in the first 20 days of February averaging 6.5 million units at an annual rate, up from 6.0 million units in January.

In spite of these coincident indicators, leading indicators such as sensitive commodity prices, housing starts and stock prices continue to point to a weak economy in the period immediately ahead. At this point the decline in business activity appears to have moderated, but evidence on the precise timing of the recovery is not conclusive.

The Surge in Money Continues

The Fed does not appear to have made any headway in solving its monetary problems. In the four months since October the M1 measure of money (currency plus checkable deposits) has grown at a double digit pace. As shown in the following table, the main factor in the recent spurt in the money supply was aggressive purchases of securities by the Fed. Between October and February the Fed purchased $4 billion of securities. During the entire year ending in October, 1981 when policy was highly restrictive, the Fed added only $1.4 billion to its holdings of securities.

MONETARY AGGREGATES
(Annual Rates of Change)

	October 1980-October 1981	October 1981-February 1982[E]
M1	4.2%	10.8%
St. Louis Monetary Base	4.7%	9.0%
Fed Holdings of Securities and Acceptances	1.1%	9.3%

[E]Estimate for M1 is an average of the two weeks ending February 10; estimates for the Monetary Base and Holdings of Securities are for the three weeks ending February 17.
Source: Federal Reserve Board; Harris Bank

Inflation—Another Cycle?

After several years of gradually lower monetary growth the inflation cycle appears to be broken. Sensitive commodity prices have dropped 40% over the past two years, producer price increases have averaged 4%-5% at an annual rate since last spring, and consumer prices and wages during the past four months slowed to the 5% and 7% vicinity, respectively. However, this relief may not last. The sharp boost in the monetary base in recent months has lifted the 2-year average growth of M1 (our key indicator of future inflation) from the 5%-6% range to 7%. While this change should not affect the inflation numbers in the immediate future, it does suggest that by year-end inflation may be moving back toward the 8% vicinity.

Interest Rates - More Erratic Moves Ahead

The recent drop in short-term rates reflects the continued instability inherent in recent swings in the money supply. A forthcoming Harris Economics paper on interest rates will show that the volatility of month-to-month moves in the money supply during the past two years has added as much as 4 to 6 percentage points to the real rate for short-term commercial paper. The impact of monetary volatility and the resultant funding risk has been so strong as to overwhelm the impact of liquidity and cyclical factors in determining interest rates. Recognizing the role of monetary volatility in determining interest rates suggests that there is a wide band of interest rate possibilities associated with the same average yearly increase in the money supply.

After allowing for inflationary expectations of 8%-9%, 4-month commercial paper rates of 13%-14% incorporate a real premium of approximately 5 percentage points. If, as we expect, the inflationary premium drops to 7% by year-end, while monetary volatility remains high, commercial paper rates of 12% and a prime of 14% could be expected by December. However, if the Fed were to stabilize monetary growth, interest rates could be as much as 3-4 percentage points lower, while even greater monetary volatility would imply a prime rate in the 17%-18% vicinity. A year-end prime rate range of 10%-18% is obviously too wide a range to be helpful for planning purposes. However, this is indicative of the extreme risk that most businesses face and will continue to face as long as the degree of monetary volatility remains uncertain.

Summary

Although the near-term economic forecast dated February 11, 1982 has not changed, more recent monetary developments imply substantial volatility, the probability of a more vigorous rebound in the second half of 1982, and higher inflation rates for 1983. These indications are still preliminary and could be altered if the Fed quickly returns monetary growth to its targeted range.

Robert J. Genetski
Vice President and Economist

CURRENT ECONOMIC STATISTICS

	JUNE 1981	JULY 1981	AUGUST 1981	SEPTEMBER 1981	OCTOBER 1981	NOVEMBER 1981	DECEMBER 1981	JANUARY 1982	FEBRUARY 1982
MONEY AND PRICES									
MONETARY BASE (BILLIONS OF $)	167.2	167.7	168.5	168.5	168.1	169.2	170.7	171.9	173.0[E]
% CHANGE*	5.2	3.6	5.9	0.0	-2.8	8.1	11.2	8.8	8.0
M-1 (BILLIONS OF $)	428.4	429.4	431.1	431.2	432.9	436.4	440.9	448.6	447.9[E]
% CHANGE*	-2.2	2.8	4.9	0.3	4.8	10.1	13.1	23.1	-1.9
WPI-FINISHED GOODS (1967=100)	270.3	271.3	272.1	272.6	273.9	275.3	276.1	277.3	NA
% CHANGE	0.6	0.4	0.3	0.2	0.5	0.5	0.3	0.4	NA
CPI-ALL URBAN (1967=100)	270.6	273.7	275.9	278.9	280.1	281.5	282.6	283.4	NA
% CHANGE	0.7	1.1	0.8	1.1	0.4	0.5	0.4	0.3	NA
PRODUCTION AND ORDERS									
INDUSTRIAL PRODUCTION (1967=100)	152.9	153.9	153.6	151.6	149.1	146.4	143.4	139.1	NA
% CHANGE	0.1	0.7	-0.2	-1.3	-1.6	-1.8	-2.0	-3.0	NA
DURABLE GOODS NEW ORDERS (BILLIONS OF $)	88.303	89.696	87.350	86.278	77.804	79.956	79.764	78.543	NA
% CHANGE	0.2	1.6	-2.6	-1.2	-9.8	2.8	-0.2	-1.5	NA
NONDEFENSE CAPITAL GOODS NEW ORDERS (BILLIONS OF $)	23.230	24.226	24.700	23.026	20.996	23.813	22.518	22.227	NA
% CHANGE	-2.7	4.3	2.0	-6.8	-8.8	13.4	-5.4	-1.3	NA
HOUSING STARTS**	1.046	1.040	0.946	0.899	0.854	0.860	0.899	0.894	NA
INCOME, SALES AND EMPLOYMENT									
PERSONAL INCOME (BILLIONS OF $-SAAR)	2,384.3	2,419.2	2,443.4	2,462.6	2,474.7	2,492.0	2,490.9	2,494.7	NA
% CHANGE	0.7	1.5	1.0	0.8	0.5	0.7	0.0	0.2	NA
RETAIL SALES (BILLIONS OF $)	87.385	87.356	88.593	88.699	86.660	87.222	87.060	86.119	NA
% CHANGE	2.2	0.0	1.4	0.1	-2.3	0.6	-0.2	-1.1	NA
AUTO SALES-TOTAL**	7.5	8.2	10.4	8.8	7.2	7.7	7.2	8.2	8.9[E]
DOMESTIC**	5.2	5.9	8.2	6.7	5.2	5.4	5.0	5.7	6.5[E]
IMPORTS**	2.2	2.3	2.2	2.1	2.1	2.3	2.3	2.5	2.4[E]
EMPLOYMENT (MILLIONS OF PERSONS)	100.430	100.864	100.840	100.258	100.343	100.172	99.613	99.581	NA
% CHANGE	-0.6	0.4	0.0	-0.6	0.1	-0.2	-0.6	0.0	NA
UNEMPLOYMENT RATE	7.4%	7.2%	7.3%	7.6%	8.0%	8.3%	8.8%	8.5%	NA
LEADING INDICATORS (1967=100)	134.1	134.3	133.3	131.1	128.8	128.6	129.4	126.4[E]	NA
% CHANGE	-0.9	0.1	-0.7	-1.7	-1.8	-0.2	0.6	-2.3	NA

ALL DATA ARE SEASONALLY ADJUSTED
% CHANGE GIVES MONTH-TO-MONTH PERCENT CHANGES
* PERCENT CHANGES ARE MONTH-TO-MONTH CHANGES AT AN ANNUAL RATE
** MILLIONS OF UNITS AT A SEASONALLY ADJ ANNUAL RATE
E HARRIS BANK ESTIMATE

HARRIS BANK
Chicago, Illinois

Harris Economics

February 12, 1982

ECONOMIC PROSPECTS THROUGH 1983

A volatile monetary policy is leading to erratic and conflicting signals throughout the economy. These signals are likely to continue through the first half of 1982 before giving way to clear signs of recovery in business activity. At the present time prospects for 1983 are for a moderate recovery. This forecast is based on the assumption that the small change in government tax and spending policies will have a moderately positive impact on productivity, while monetary policy limits the expansion in spending. As more information becomes available on policy changes and the magnitude of the economy's response to supply-side economics, a more definitive view of 1983 will be possible.

Conflicting Economic Signals

The increase in money creation between October and December began to pave the way for a typical cyclical recovery. Lower interest rates, a boost in housing activity and an increase in the leading indicators in December were clear signals that a cyclical recovery was nearing. However, when a 13% annual rate increase in money in December was followed by a 24% annual rate rise in January, the magnitude of these numbers increased uncertainty, lifted interest rates and dimished the likelihood of a sustainable recovery.

The lack of a clear direction in the economy is likely to continue in the months ahead. Once the Fed has reattained its money targets, the process of recovery can start anew. At the present time the recovery is expected to begin in earnest by this summer.

Interest Rate Problems

Interest rates moved sharply higher in December and January. While many observers attribute the move to concern over future federal deficits, the higher rates developed as it became apparent that the Fed was rapidly increasing the growth in money. A recent study by the Economic Research Office shows that month-to-month volatility in the money supply can add a significant risk premium to interest rates (over and above inflation). The reduction in this risk premium during the fourth quarter, which followed six months of more stable money growth, as well as recent increases in this premium are consistent with the results of our study.

Unfortunately, our volatility measure suggests that the recent erratic moves in money will add to the risk premium and keep interest rates higher than previously expected during the first half of this year. Continued extreme volatility in money in the months ahead will drive rates even higher than our present forecast sugests, while more stable month-to-month moves in money will cause interest rates to fall short of our forecast. The outlook for interest rates presented in the following tables assumes that month-to-month volatility in money continues to be as erratic as it has been in the past two years.

Federal Deficits and Supply-Side Economics

Of all recent statements concerning future federal deficits, the most perceptive came from President Reagan when he indicated that no one really has any idea of the true magnitude of those deficits. Most forecasts of receipts fail to capture the feedback effects from lower taxes. It is reasonable to assume that lower tax rates will mean increases in taxable relative to nontaxable activities. There is no reliable estimate of how large an increase in revenues can be expected from this shift, so most forecasts assume no feedback at all. In an upcoming report on the federal budget we will show that tax receipts in the fourth quarter of 1981 were higher than might have been expected. If the fourth quarter figures are reflecting the feedback effects of supply-side tax cuts instead of a possible random erratic movement, then they suggest that future government revenues could be substantially higher than conventional forecasts have assumed.

Strong Profit Gain Seen for 1983

Since 1979, a weak economy and high interest rates have taken their toll on corporate profits. After-tax profits (adjusted to exclude inventory profits and to allow for depreciation at replacement cost) are expected to show year-over-year declines of almost 10% in the first half of 1982. For 1982 as a whole, this measure of profits is forecast to be the same as it was in 1979. For 1983, the combination of an economic recovery, lower interest rates, and corporate tax breaks is expected to produce an increase in after-tax adjusted profits of close to 20%.

Summary

The sharp rise in money in January has increased uncertainty and added a further premium to interest rates. If monetary growth remains rapid in the months ahead, then the odds for a sustained and lasting recovery will decline. Further volatile money growth threatens to keep interest rates extremely high, thereby threatening the Administration's future objectives. At present, the forecast assumes that the Fed will quickly reduce the money supply and put the recovery back on schedule.

Robert J. Genetski
Vice President and Economist

2/11/82

ECONOMIC OUTLOOK
(BILLIONS OF DOLLARS--SEASONALLY ADJUSTED ANNUAL RATES)

	ACTUAL	FORECAST								YEARS			
	1981:4	1982:1	1982:2	1982:3	1982:4	1983:1	1983:2	1983:3	1983:4	1980	1981	1982	1983
GROSS NATL PRODUCT	2984.9	3019.7	3084.5	3172.7	3253.6	3329.1	3397.3	3465.7	3535.5	2626.1	2922.2	3132.6	3431.9
%CH	2.7	4.7	8.9	11.9	10.6	9.6	8.4	8.3	8.3	8.8	11.3	7.2	9.6
CONSTANT DOLLAR GNP	1495.6	1487.6	1493.8	1513.6	1528.7	1542.7	1553.5	1563.7	1574.7	1480.7	1509.5	1505.9	1558.7
%CH	-5.2	-2.1	1.7	5.4	4.1	3.7	2.8	2.6	2.8	-0.2	2.0	-0.2	3.5
PRICE DEFLATOR	1.9958	2.0299	2.0649	2.0962	2.1284	2.1580	2.1868	2.2163	2.2452	1.7738	1.9360	2.0799	2.2016
%CH	8.4	7.0	7.1	6.2	6.3	5.7	5.4	5.5	5.3	9.0	9.1	7.4	5.9
CONSUMPTION EXPENDITURES	1909.5	1944.1	1986.7	2047.1	2098.4	2144.3	2188.7	2234.1	2278.6	1672.7	1858.1	2019.1	2211.4
%CH	5.6	7.4	9.1	12.7	10.4	9.0	8.5	8.6	8.2	10.7	11.1	8.7	9.5
DURABLES	226.4	229.2	237.5	254.6	265.4	274.4	283.0	292.4	302.7	211.9	232.0	246.7	288.1
%CH	-15.6	5.1	15.3	32.1	18.1	14.3	13.1	14.0	14.9	-0.2	9.5	6.3	16.8
NONDURABLES	760.9	771.0	784.3	801.9	819.2	834.5	848.5	862.2	874.2	675.7	743.4	794.1	854.9
%CH	5.2	5.4	7.1	9.3	8.9	7.7	6.9	6.6	5.7	12.2	10.0	6.8	7.7
SERVICES	922.2	943.9	964.9	990.6	1013.8	1035.4	1057.2	1079.5	1101.7	785.2	882.7	978.3	1068.5
%CH	12.0	9.7	9.2	11.1	9.7	8.8	8.7	8.7	8.5	12.8	12.4	10.8	9.2
INVESTMENT EXPENDITURES	443.6	433.3	440.8	458.5	475.0	495.2	510.6	525.7	540.8	395.3	450.6	451.9	518.1
%CH	-15.7	-9.0	7.1	17.1	15.2	18.1	13.0	12.4	12.0	-4.9	14.0	0.3	14.6
NONRES FIXED EXPEND	332.6	333.1	331.9	335.7	340.5	347.2	353.9	360.2	366.9	295.9	327.1	335.3	357.1
%CH	-3.0	0.6	-1.4	4.7	5.8	8.1	7.9	7.3	7.7	5.8	10.5	2.5	6.5
PRODUCERS DUR EQUIP	201.2	201.8	202.1	206.1	210.5	215.9	220.8	225.0	229.3	187.1	202.0	205.1	222.8
%CH	-10.5	1.3	0.6	8.2	8.8	10.7	9.4	7.8	7.9	2.0	8.0	1.5	8.6
BUSINESS STRUCTURES	131.4	131.3	129.8	129.6	130.0	131.3	133.1	135.2	137.6	108.8	125.0	130.2	134.3
%CH	10.2	-0.4	-4.5	-0.6	1.2	4.1	5.6	6.5	7.3	13.0	14.9	4.1	3.2
RES FIXED EXPEND	93.4	89.3	93.6	104.4	117.1	132.5	144.1	155.4	167.7	105.3	105.3	101.1	149.9
%CH	-25.4	-16.4	20.7	54.8	58.3	63.9	39.9	35.3	35.6	-11.2	0.1	-4.0	48.3
INVENTORY CHANGE	17.6	10.9	15.3	18.4	17.4	15.5	12.6	10.1	6.2	-5.9	18.2	15.5	11.1
NET EXPORTS	16.0	17.6	19.5	19.0	14.5	11.7	8.4	4.0	-4.0	23.3	23.8	17.7	5.0
GOVT PURCHASES	615.7	624.7	637.5	648.1	665.7	677.9	689.6	701.9	720.1	534.7	589.6	644.0	697.4
%CH	19.5	6.0	8.5	6.8	11.3	7.5	7.1	7.3	10.8	12.9	10.3	9.2	8.3
FEDERAL	246.7	249.2	256.0	260.3	272.2	278.6	284.4	291.4	304.6	198.9	228.6	259.4	289.8
%CH	41.0	4.1	11.4	6.9	19.6	9.7	8.6	10.2	19.7	18.5	14.9	13.5	11.7
MILITARY	165.8	175.7	182.7	187.0	197.1	203.5	210.4	217.2	229.1	131.7	153.3	185.6	215.1
OTHER	81.0	73.5	73.3	73.3	75.1	75.1	74.0	74.2	75.7	67.2	75.2	73.8	74.8
STATE & LOCAL	369.0	375.5	381.5	387.8	393.5	399.3	405.2	410.5	415.3	335.8	361.1	384.6	407.6
%CH	7.4	7.2	6.5	6.8	6.0	6.0	6.0	5.3	4.8	9.8	7.5	6.5	6.0

NOTE: PERCENTAGE CHANGES AT ANNUAL RATES

2/11/82

ECONOMIC OUTLOOK
(BILLIONS OF DOLLARS--SEASONALLY ADJUSTED ANNUAL RATES)

	ACTUAL	FORECAST								YEARS			
	1981:4	1982:1	1982:2	1982:3	1982:4	1983:1	1983:2	1983:3	1983:4	1980	1981	1982	1983
PRETAX PROFITS*	207.3	200.3	201.4	209.0	212.9	217.7	219.3	220.7	222.3	245.5	231.9	205.9	220.0
%CH	-38.8	-12.9	2.3	15.8	7.7	9.4	3.0	2.4	3.0	-3.8	-5.5	-11.2	6.8
PRETAX PROFITS ADJ 1)	176.0	168.5	169.7	180.5	188.1	194.8	198.7	202.4	206.5	182.7	191.3	176.7	200.6
%CH	-34.6	-16.0	2.8	28.2	17.8	15.0	8.5	7.6	8.3	-7.2	4.7	-7.6	13.5
TAX LIABILITY	66.9	64.2	64.2	66.1	66.3	67.6	67.9	67.8	67.7	82.4	77.3	65.2	67.8
%CH	-46.3	-15.0	-0.3	13.0	1.1	8.0	1.7	-0.2	-0.9	-6.0	-6.2	-15.6	3.9
AFTER TAX PROFITS	140.5	136.1	137.3	142.8	146.6	150.1	151.5	152.8	154.6	163.2	154.7	140.7	152.3
%CH	-34.7	-11.9	3.5	17.2	10.9	10.0	3.6	3.6	4.8	-2.7	-5.2	-9.0	8.2
AFT TAX PROF ADJ 1)	109.1	104.3	105.5	114.4	121.7	127.1	130.9	134.6	138.8	100.3	114.0	111.5	132.8
%CH	-25.8	-16.6	4.6	38.2	28.3	19.0	12.2	11.8	13.2	-8.1	13.6	-2.2	19.2
PERSONAL INCOME	2484.4	2513.7	2561.9	2623.1	2677.8	2739.8	2796.3	2852.6	2910.0	2160.3	2403.6	2594.1	2824.7
%CH	7.2	4.8	7.9	9.9	8.6	9.6	8.5	8.3	8.3	11.1	11.3	7.9	8.9
TAX & NONTAX PAYMENT	398.0	399.8	409.9	388.8	394.4	406.4	417.2	389.9	399.8	338.5	388.2	398.2	403.3
%CH	-1.8	1.8	10.5	-19.1	5.9	12.7	11.1	-23.7	10.5	12.1	14.7	2.6	1.3
DISPOSABLE INCOME	2086.4	2113.9	2152.0	2234.3	2283.4	2333.4	2379.1	2462.7	2510.2	1821.7	2015.5	2195.9	2421.4
%CH	9.0	5.4	7.4	16.2	9.1	9.1	8.1	14.8	7.9	11.0	10.6	9.0	10.3
PERSONAL OUTLAYS	1962.3	1997.9	2041.9	2103.7	2156.6	2203.9	2249.9	2296.8	2342.9	1720.3	1908.8	2075.0	2273.4
%CH	5.7	7.5	9.1	12.7	10.4	9.1	8.6	8.6	8.3	10.6	11.0	8.7	9.6
PERSONAL SAVINGS	124.1	116.0	110.1	130.6	126.8	129.5	129.2	165.9	167.3	101.4	106.6	120.9	148.0
%CH	81.6	-23.7	-18.8	98.0	-11.1	8.8	-0.9	171.9	3.4	17.6	5.2	13.4	22.4
SAVING RATE(%)	6.0	5.5	5.1	5.8	5.6	5.5	5.4	6.7	6.7	5.6	5.3	5.5	6.1
EMPLOYMENT	100.0	99.9	100.0	100.5	101.2	102.0	102.7	103.3	103.7	97.3	100.4	100.4	102.9
%CH	-2.4	-0.6	0.4	2.0	2.8	3.2	2.8	2.4	1.6	0.3	3.2	0.0	2.5
LABOR FORCE	109.2	109.5	109.8	110.1	110.5	111.0	111.5	112.0	112.5	104.8	108.7	110.0	111.8
%CH	1.8	1.3	1.1	1.1	1.5	1.8	1.8	1.8	1.8	1.8	3.7	1.2	1.6
UNEMPLOYMENT RATE(%)	8.4	8.8	8.9	8.7	8.4	8.1	7.9	7.8	7.8	7.2	7.6	8.7	7.9
PRODUCTIVITY-NONFARM	0.980	0.975	0.975	0.982	0.986	0.991	0.994	0.998	1.001	0.988	0.996	0.980	0.996
%CH	-7.4	-2.0	0.1	2.6	1.9	1.9	1.4	1.4	1.5	-0.3	0.8	-1.6	1.7
INDUSTRIAL PRODUCTION	1.463	1.438	1.441	1.471	1.492	1.510	1.523	1.533	1.546	1.470	1.509	1.460	1.528
%CH	-16.5	-6.8	0.8	8.7	5.8	5.1	3.3	2.9	3.2	-3.6	2.6	-3.2	4.6

*NOTE: PROFITS FOR 81:4 ARE ESTIMATES.
1) PROFITS ARE ADJUSTED TO EXCLUDE INVENTORY PROFITS AND ALLOW FOR DEPRECIATION AT REPLACEMENT COST.

ECONOMIC OUTLOOK

	ACTUAL	FORECAST								YEARS			
	1981:4	1982:1	1982:2	1982:3	1982:4	1983:1	1983:2	1983:3	1983:4	1980	1981	1982	1983
INTEREST RATES													
NEW ISSUE AA INDUS BONDS	15.7	15.9	14.8	14.5	13.6	13.0	12.8	11.6	11.3	12.3	15.1	14.7	12.2
NEW ISSUE AA UTIL BONDS	16.9	17.0	15.9	15.5	14.6	14.0	13.8	12.6	12.3	13.3	16.2	15.7	13.2
PRIME RATE	17.0	16.0	15.5	13.8	13.1	12.3	11.6	11.4	11.2	15.3	18.9	14.6	11.6
COMMERCIAL PAPER 4 MOS 1)	13.0	13.7	13.2	11.5	10.8	10.3	9.9	9.7	9.5	12.6	15.2	12.3	9.8
3 MONTH T-BILLS	11.8	13.0	12.2	10.6	9.9	9.5	9.1	8.9	8.7	11.4	14.0	11.4	9.0
PRIMARY 90 DAY CDS	13.1	14.6	13.5	11.8	11.1	10.6	10.2	10.0	9.8	12.9	15.7	12.8	10.1
MONEY AND VELOCITY													
MONETARY BASE-(MB)	169.3	172.3	174.3	176.6	179.1	181.7	184.4	187.1	189.8	156.6	166.9	175.6	185.8
%CH	2.6	7.1	4.7	5.4	5.8	5.9	6.1	6.0	5.9	8.1	6.5	5.2	5.8
VELOCITY OF MB*	17.927	17.950	18.219	18.414	18.667	18.851	18.969	19.074	19.173	17.442	17.985	18.311	19.016
%CH	-4.8	0.5	6.1	4.5	5.6	4.0	2.5	2.2	2.1	0.7	3.1	1.8	3.9
MONEY SUPPLY-(M1)**	436.7	446.1	451.9	457.8	463.7	469.4	475.2	481.0	486.9	402.4	429.5	454.9	478.1
%CH	5.9	8.9	5.3	5.3	5.3	5.0	5.0	5.0	5.0	6.2	6.7	5.9	5.1
VELOCITY OF M1*	6.937	7.015	7.063	7.112	7.200	7.272	7.326	7.383	7.440	6.729	6.988	7.098	7.355
%CH	-6.3	4.6	2.8	2.8	5.0	4.1	3.0	3.1	3.1	1.7	3.9	1.6	3.6
MONEY SUPPLY-(M2)**	1806.9	1850.5	1885.6	1921.3	1960.0	1998.1	2036.9	2076.5	2116.8	NA	1746.4	1904.3	2057.1
%CH	9.8	10.0	7.8	7.8	8.3	8.0	8.0	8.0	8.0	NA	NA	9.0	8.0
VELOCITY OF M2*	1.723	1.711	1.707	1.715	1.726	1.733	1.733	1.734	1.736	NA	NA	1.714	1.734
%CH	-8.7	-2.9	-0.9	1.8	2.6	1.7	0.1	0.3	0.3	NA	NA	NA	1.1
CPI-ALL URBAN	2.813	2.864	2.909	2.953	2.998	3.039	3.079	3.120	3.160	2.470	2.724	2.931	3.100
%CH	7.8	7.4	6.4	6.2	6.2	5.6	5.4	5.4	5.2	13.5	10.3	7.6	5.7
AUTO SALES 2)	7.375	7.900	8.600	9.400	10.000	10.400	10.600	10.700	10.800	8.977	8.602	8.975	10.625
DOMESTIC	5.184	5.600	6.100	6.800	7.200	7.600	7.700	7.800	7.900	6.596	6.271	6.425	7.750
IMPORTS	2.224	2.300	2.500	2.600	2.800	2.800	2.900	2.900	2.900	2.405	2.331	2.550	2.875
HOUSING STARTS 2)	0.903	0.864	1.032	1.120	1.341	1.523	1.616	1.750	1.800	1.303	1.109	1.089	1.672

*NOTE: VELOCITY IS MEASURED AS GNP DIVIDED BY MONEY SERIES LAGGED TWO QUARTERS
**NOTE: DUE TO REVISIONS, M1 DATA ARE TEMPORARILY INCONSISTENT, AND M2 DATA ARE NOT YET AVAILABLE PRIOR TO OCTOBER 1980
1) PRIOR TO NOVEMBER 1979, COMMERCIAL PAPER 4-6 MOS
2) IN MILLIONS OF UNITS-SEASONALLY ADJUSTED ANNUAL RATES

ECONOMIC PROJECTIONS

Burton Zwick
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Since the election of President Reagan in November 1980, the inflation rate has declined from the 10-11 percent area to about 8 percent in response to monetary restraint and slack in the economy. Despite many forecasts that inflation will continue to decline to the 6-7 percent area over the next 12 to 18 months, government bond rates remain near 14 percent, compared with a 12 percent rate in November 1980 and single digit rates as recently as October 1979. Following a decline in late 1981, short-term rates have recently risen above November 1980 levels, suggesting that double digit rates will persist throughout 1982.

Whether the rise in nominal rates reflects a rise in real rates _or_ expectations that inflation will reaccelerate, economists both outside and inside the Administration perceive the rise in rates as a "no confidence" vote on Reaganomics from the financial markets. Unless confidence is restored, a major Reagan Administration objective — to promote capital formation and productivity growth — cannot be achieved.

A number of financial economists have pointed to changes in the financial structure and the determination of investors to earn after tax real returns to explain the rise in rates. While these factors undoubtably account for some of the increase in rates, I believe that most of the rise can be explained by two of the more traditional determinants of income and interest rates, namely, monetary policy and fiscal policy.

In October 1979, in response to a second dollar crisis within a year, the Federal Reserve reaffirmed its determination to control inflation by controlling money and announced a change in operating procedures, namely that policy

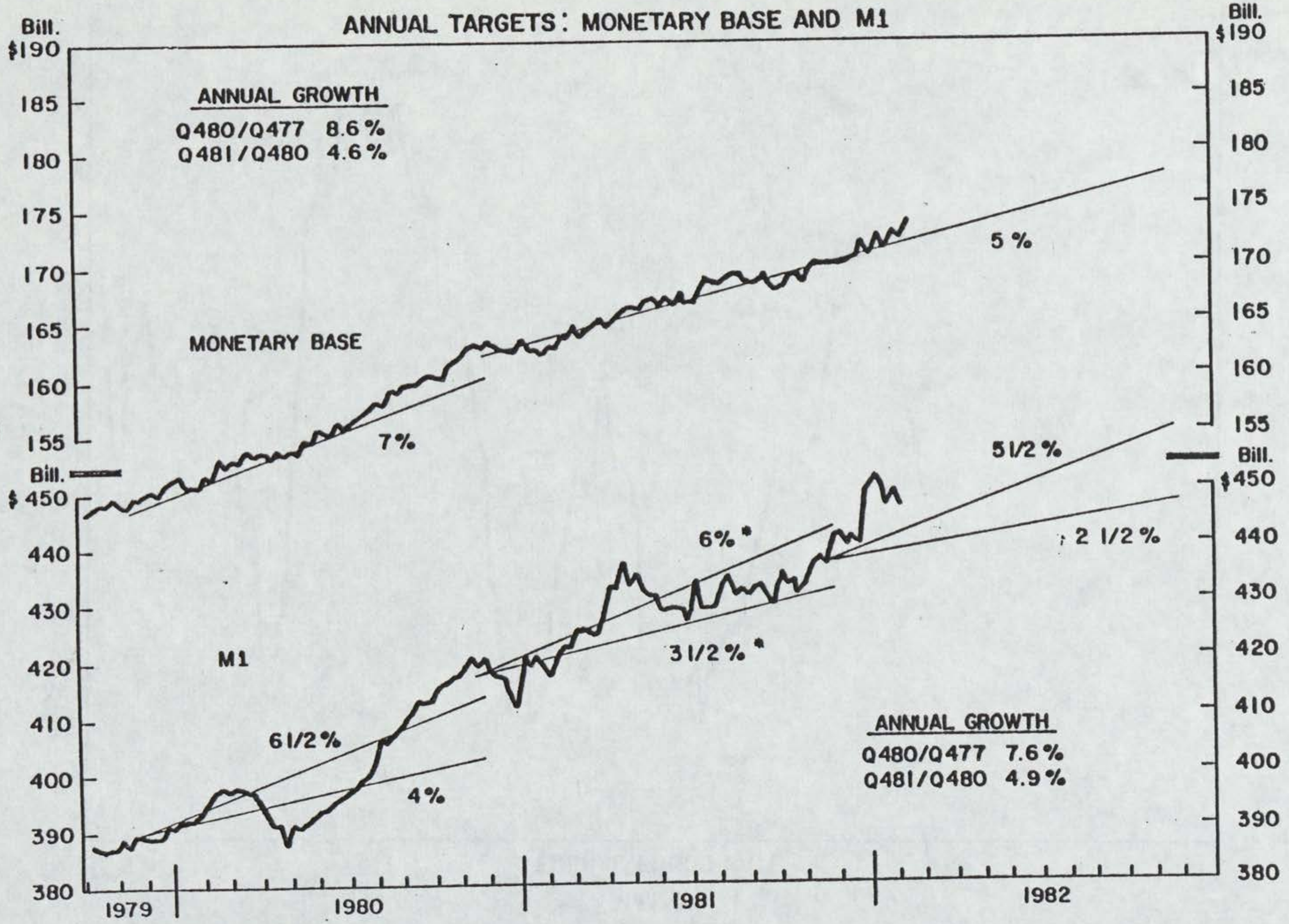
* The projections presented here reflect my own personal views and should not be interpreted as the official view of the Prudential. I appreciate the comments of Michael J. Hamburger.

operations would henceforth be directed at controlling money rather than interest rates. Despite the change in policy, the money supply experienced unprecedented fluctuations in 1980 and sizable fluctuations in 1981 as well. These fluctuations took money substantially below its target in the spring of 1980 and substantially above its target in late 1980 and again in the first few weeks of 1982. (See the lower panel of table 1.)

Since interest rates also fluctuated by large amounts in 1980 and 1981, some analysts have argued that the fluctuations in money growth reflect other factors — such as credit controls in 1980 and the introduction of NOW accounts in 1981 — rather than Federal Reserve attempts to control rates. However, amidst the general interest rate volatility of the 1980-81 period, there have been several intervals of up to 16 weeks when the Federal funds rate traded within a narrow range (see table 2). During each of these intervals, money growth accelerated or decelerated sharply and moved outside or near the extreme end of the target range. The Federal Reserve was then forced to adjust the funds rate by large amounts in an attempt to restablish control over the money supply. This pattern of volatile money supply growth — insofar as it contributed to unprecedented swings in long rates as well as short rates — probably raised real rates at the long end of the yield curve by introducing a "volatility" component to the risk of holding long-term fixed income securities. Volatile money growth probably raised nominal rates further by undermining confidence in the Federal Reserve's ability to control money and inflation over the longer term. Stated somewhat differently, during the year of 1981 when money growth declined by several percentage points from its average in the 1977-80 period, the pattern of monetary deceleration was so erratic that investors saw little reason to expect lower money growth to persist.

Probably an even more important cause of high rates are the federal budget deficits projected not only for the recessionary period running through 1982 but for the recovery period of 1983 and 1984 as well. The Reagan Administration's 1983 budget message calls for budget deficits of $92 billion in 1983 and $83 billion in 1984. If the continued monetary restraint assumed in the Reagan Administration's projections leads to slower growth in 1983 and 1984, the 1983-84 deficits could easily rise to the $100-$150 billion range. Deficits of $100-$150 billion in 1983-84 would be equivalent to about 3 percent to 4 1/2 percent of GNP.

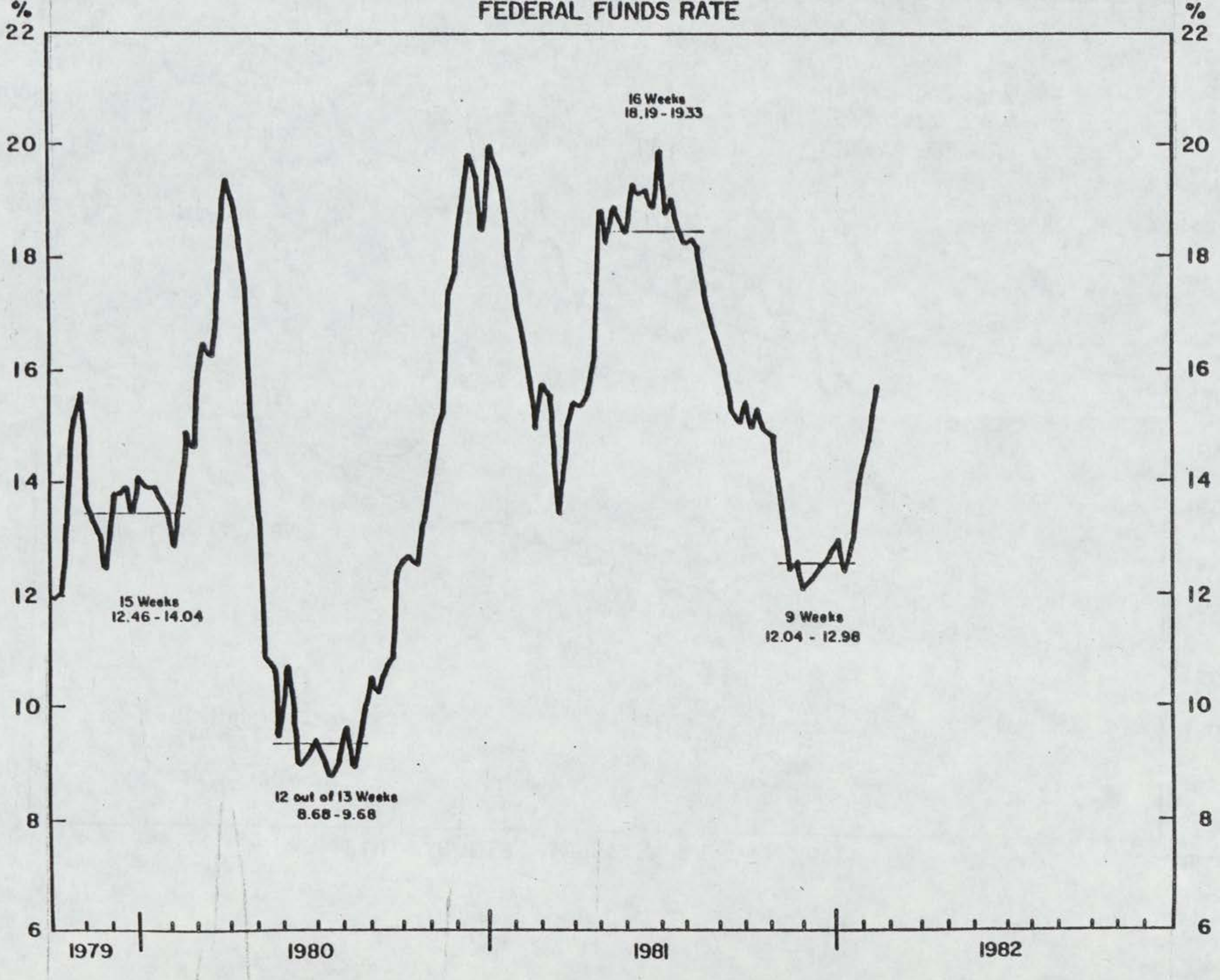
TABLE 1



* 1981 Target for adjusted M1B

TABLE 2

FEDERAL FUNDS RATE



Though U.S. government financing (including the off-budget financing through the Federal Financing Bank) reached about 4 percent of GNP during the 1975 recession, such financing was a much smaller percentage during most of the 1970's. As shown in table 3, U.S. government financing was 0.6 percent and 1.5 percent of GNP in 1973 and 1979, cyclical peak years preceding the 1974-75 and 1980 recessions. With total funds raised by the non-financial sector running between 15 percent and 16 percent of GNP in these cyclical peak years, funds equal to about 14.5 percent of GNP were available for non-financial sector borrowers other than the U.S. government.

The two right columns of table 3 show a prospective flow of funds distribution in 1983-84, on the assumption that total funds raised remain closely related to GNP and run 16.5 percent of GNP in 1983-84, slightly higher than in 1973 and 1979. The first column for 1983-84 assumes annual budget deficits of $100 billion (plus $25 billion of off-budget financings) for total U.S. government financing equal to 3.5 percent of GNP; the far right column assumes deficits of $150 billion (plus $25 billion of off-budget financings) for a total equal to 4.9 percent of GNP. With 16.5 percent of funds available for all non-financial sectors, U.S. government borrowings equal to 3 1/2 percent to 5 percent of GNP leave 11 1/2 percent to 13 percent for non-U.S. government sectors, down from about 14.5 percent in the earlier peak years. Such a reduction in funds available — particularly down to 11 1/2 percent — implies increased pressure on the Federal Reserve to purchase securities, in which case the deficits promote inflation and higher nominal rates. Since the Federal Reserve is unlikely to buy more than $10 or $15 billion of the $100-$150 billion of treasury issues, the large federal deficit will crowd out some private borrowings and contribute to higher real rates. In the proposed figures, I have assumed that state and local government, foreign, and non-financial corporations will hold on to the bulk of their earlier shares, in which case most of the crowding out will occur in home mortgage and consumer credit financing. A large part of the deficits will be financed through higher household saving, but presumably at higher real rates.

Whatever the reasons for high bond rates, I believe that the state of the bond market — and realization that monetary expansion will further destabilize the markets — almost precludes a sustained move toward monetary expansion in 1982 by the Federal Reserve. I am assuming that the recent bulge in the money supply will be offset over the year, and the Federal Reserve will keep M1

TABLE 3

FUNDS RAISED IN CREDIT MARKETS BY NON-FINANCIAL SECTOR
AS PERCENT OF GNP

	1973	1979	1983-4	1983-4
Total Funds	15.3	16.0	16.5	16.5
U.S. Government*	0.6	1.5	3.5**	4.9***
Other	14.7	14.5	12.9	11.5
State & Local Govt.	1.0	0.8	0.8	0.8
Households	5.9	7.1	5.8	4.8
Mortgages	3.5	4.7	3.7	3.3
Consumer Credit	1.8	1.9	1.7	1.1
Other	0.6	0.4	0.4	0.4
Non-financial Business	7.3	5.8	5.7	5.3
Foreign	0.5	0.9	0.7	0.7

*Direct Federal Borrowings, including off-budget financing of Federal Financing Bank.

**Federal Government Budget Deficit of $100 billion per year, plus $25 billion off-budget financing.

***Federal Government Budget Deficit of $150 billion per year, plus $25 billion off-budget financing.

growth near or only slightly above the upper end of the target range of 2 1/2 percent to 5 1/2 percent. I am also assuming limited fiscal policy initiatives until after the election, leaving prospective budget deficits for 1983 and 1984 at $100 billion or higher.

The current recession should end within the next few months. However, continued monetary restraint is likely to produce much slower output growth during the recovery than in earlier post World War II recoveries. M1 growth of 5.5 percent — and monetary base (MB) growth of 6.5 percent — are consistent with 1982 nominal income growth of about 9.7 percent. Assuming inflation of about 6.7 percent, output will grow about 2.8 percent over the four quarters of 1982 (see table 4).

Though rates may remain high in the next few weeks as the Federal Reserve moves aggressively to bring the money supply under control, I believe that declining inflation and a slow recovery will promote a modest easing in rates over the year. By year end, government bond yields should be around 12 percent to 12 1/2 percent, down 150 to 200 basis points from current levels, but still quite high by historical standards. Short-term rates should be in the 10 percent to 12 percent area. The failure of rates to decline further will keep interest sensitive sectors, such as the housing and automobile sectors, extremely weak by historical standards. Reflecting low utilization rates as well as high interest rates, capital spending will also recover slowly despite the recent tax incentives to promote business investment.

One risk to this forecast is that current financial pressure — or concern about fiscal and monetary policies over the longer term — will cause rates to remain at current levels or, as suggested by some Wall Street economists, move to new highs before the end of 1982. In this event, I believe that the recovery will be even slower and the economy could reenter recession by early 1983. I reject this as a most probably forecast even though I have continuously underestimated the level of rates for the past year and a half. A second risk is that the Federal Reserve will move sharply toward expansion, either because of unacceptably high unemployment or large deficits. As mentioned above, I believe this is unlikely because the financial markets will simply not permit monetary reacceleration.

As at the time of the Shadow Open Market Meeting last September, the Committee emphasized that the Reagan Administration faced a severe credibility problem because of its failure to come to grips with the imbalance in

TABLE 4

ECONOMIC PROJECTIONS

(Percent Changes)

Projections for 1982 as of March 1982 Meeting

	GNP	Output	Deflator	M1	Velocity of M1	MB	Velocity of MB
Q4/81-Q4-82	9.7	2.8	6.7	5.5	4.0	6.5	3.0

Projections for 1982 as of September 1981 Meeting

	GNP	Output	Deflator	M1	Velocity of M1	MB	Velocity of MB
Q4/81-Q4/82	9.0	1.9	7.0	5.0	3.8	6.0	2.8

(Annual growth in velocity of M1 was 3.7% for 1971-81, 3.6% for 1971-76, and 3.7% for 1976-81. For velocity of monetary base, annual growth was 2.4% for 1971-81, 1.9% for 1971-76 and 2.9% for 1976-81.)

its fiscal policy program. While its support of non-inflationary monetary policy, particularly with unemployment rising in an election year, is impressive, historical evidence strongly suggests that the Federal Reserve will not be able to maintain a restrictive policy in the face of deficits as large as those projected for 1983 and beyond. Recent Reagan Administration criticism of the Federal Reserve, though directed at the erratic pattern of money growth and the recent monetary expansion, only serves to raise further questions about the one institution of government that — for the year of 1981 taken as a whole — promoted a return to lower inflation rates.

Econ Pol

file no TEB/CA/01

PPS/CHANCELLOR

copied to:

Mr Salveson (for transmission to No.10)
PS/CST
PS/FST
PS/EST
PS/MST(C)
PS/MST(L)
PS/Home Secretary
PS/Lord Chancellor
PS/Foreign Secretary
PS/Secretary of State for Education and Science
PS/Lord President of the Council
PS/Secretary of State for Northern Ireland
PS/Secretary of State for Defence
PS/Minister of Agriculture, Fisheries and Food
PS/Secretary of State for the Environment
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PS/Secretary of State for Wales
PS/Lord Privy Seal
PS/Secretary of State for Industry
PS/Secretary of State for Social Services
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 ECONOMIC BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 1 March, are sidelined. Briefing for the Budget Statement and White Paper on Public Expenditure will be circulated separately.

M M Deyes

M M DEYES

RIGA

R I G ALLEN

7 March 1982

EB Division
HM 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. Relative importance given to inflation and unemployment?

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

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

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

4. Budget objectives

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

5. PM's remarks about Chancellor's 'limited room for manoeuvre'?

[Speech for Engineering Employers' Federation 23 February.]

PM stressed in remarks to EEF that not seeking to pre-empt rhF's Budget speech. But was trying to inject a note of realism.

6. Implications of falling oil prices?

See R2.

7. Scope for tax cuts? Stimulation of economy?

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

8. Armstrong report - TCSC comment

[Report from TCSC expected in the Spring]

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

9. Government has failed to accommodate recession?

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

10. Failure to control monetary growth?

Despite likely overshoot of £M3 target this year, monetary conditions have been moderately restrictive ,as intended. Total money spending has grown at an annual rate of 10 per cent during 1980 and 1981, broadly consistent with original MTFS guidelines.

11. Lower interest rates ?

Must proceed cautiously if not to jeopardise progress on inflation through either a weakening exchange rate or excessive monetary growth. But despite difficult conditions abroad, bank base rates have come down by 2½ per cent since September ,and market rates have fallen generally.

12. Expectations for UK economy in 1982 disappointing?

[New forecasts recently published by NIESR, LBS, P&D, Liverpool Group.]

Published forecasts show usual wide range of views. Government will publish new forecast with Budget on 9 March.

BULL POINTS As at 5.3.82 (Tape 455)

(i) Signs of recovery

- Total output (GDP) rose in both 3Q and 4Q 1981. Level in 4Q some 1 per cent above 2Q.
- Short time working in manufacturing fell in 1981 to below 1/4 its January peak;
- 1981 figures show volume of engineering and construction orders up about 17 and 9 per cent respectively on 2H 1980.
- Private sector housing starts in 1981 up by 37 per cent on 2H 1980.
- Most recent major independent forecasts assess low point in activity reached in 1H 1981; prospect of some recovery in 1982.

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

(iii) Productivity. Output per head in manufacturing rose 10 per cent during 1981. Investment in plant and machinery holding up well.

(iv) Unit labour costs: Pay moderation and higher productivity has meant dramatically low increase in manufacturers unit wage costs over last year - just 2½ per cent in year to 4Q 1981.

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

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

(vii) Exports holding up well; non-oil export volumes in 4 months to December up 3½ per cent on 1980. 1981 figures (incomplete) show engineering export orders up 20 per cent on 2H 1980.

(viii) Unemployment. Rate of increase in unemployment since mid 1981 about half that in 1H and 1/3 that in 4Q 1980. Vacancies improving since mid 1981. Short-time working in manufacturing reduced by over ¾ during 1981 and overtime working has increased.

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

(x) Training. Over next 3 years £4 billion to be provided to bring training schemes up to date. New Youth Training Scheme for school leavers to be introduced September 1983 represents major step towards comprehensive provision for young people.

(xi) Industrial relations. Number of strikes in 1980 and 1981 less than in any year since 1941 and number of working days lost only a third of average of last ten years.

(xii) Retail prices. Inflation almost halved since peak in spring 1980 (21.9 per cent). 12 monthly increase in January of 12.0 per cent. [NB Progress affected by lower exchange rate.]

(xiii) Share Ownership Schemes: Number of schemes has increased from 30 in May 1979 to over 350. Number of employees covered roughly doubled between first and second years in office. Profit sharing schemes alone now cover about 250,000 employees.

(xiv) Loan Guarantee Scheme. Over 2300 guarantees issued so far on loans totalling over £80 million. Over half of loans going to new businesses.

(xv) Enterprise Zones. 10 out of 11 zones already in operation. Last one (Isle of Dogs) expected to start in April.

(xvi) Examples of export successes reported in the Press include: £160 million contract for construction of two new colleges in the largest ever such contract between Britain and Nigeria (Mitchell Cotts Group); approved tender for veterinary vaccines to Kampuchea (Hoechst UK); supply of 1000 special gearboxes to Istanbul within five weeks of order (Turner-Spicer Transmissions); travelling hoists with exceptionally low headroom (550mm) for use in Danish oil and gas exploration platform in North Sea (Tonnes Force); a profiled metal cladding system for a power station in The Gambia (Ash and Lacy Steel); and glazing for the new Financial Complex in Port of Spain - the biggest ever such gained by a UK glass processor (Clark and Eaton with Pilkingtons). New British-designed, managed and partly funded, domestic water supply project in Jordan was opened by King Hussein on 18 February.

(xvii) UK preferred location: US electronics industry survey reports UK most preferred location for establishing new plants.

(xviii) Overseas debt repayments. Official external debt reduced from over $22 billion, when Government took office, to $13.3 billion at end-1981.

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

B ECONOMIC ACTIVITY AND PROSPECTS

1. Current position and prospects?

[Preliminary GDP (output) estimate for Q4 1981 up ½ per cent on Q3 reflecting higher North Sea output and higher gas and electricity demand partially offset by fall in manufacturing and construction output. Little change elsewhere.]

Recovery confirmed by second successive quarterly rise in total output. Output in Q4 1 per cent up on Q2 - the earlier low point.

IF ASKED about relationship to Government forecasts - improvement in H2 consistent with December IAF - NB new assessment in FSBR.

IF PRESSED on apparent weakening of recovery (based on November/December industrial output) - see 2 below.

2. Recent manufacturing production figures show resumed decline?

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

November and December figures affected by car disputes and exceptionally severe weather. Even so, index for Q4 as a whole much the same as in Q3, and about 2-3 per cent higher than in H1 (cyclical low point).

3. Other evidence of improvement in economy?

Engineering and construction orders and private sector housing starts all well up during 1981 on H2 1980. Productivity (output per head) in manufacturing rising strongly - up 10 per cent in Q3 1981 from Q4 1980. January cyclical indicators continue to confirm recovery under way. (Coincident indicator has been rising consistently since May; earlier weakening in longer leading indicator partly reversed, with improvements during November to January. (Labour market indicators - see C1.)

4. Latest CBI Enquiry?

February's enquiry shows a further improvement in order books and a rise in the net balance of firms (from 1 to 3 per cent) expecting to increase output over the next four months.

5. Government assessment of prospects

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

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

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

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

6. Outside forecasts

[GDP profile in recently released major forecasts:

	NIESR (Feb)	LBS (Feb)	CBI (Nov)	Phillips & Drew (Mar)	OECD (Dec)	IAF (Dec)
Per cent change 1982 on 1981	+1½	+1½	+1	+1¼	+¼	+1]

Most recent major independent forecasts assess that low point in activity was reached in first half of 1981, with prospect of some recovery in 1982. As always, a range, with Cambridge forecasts being the more pessimistic.

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

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

C LABOUR

1. Unemployment continues to rise?

[February total count was 3,045,000 (12.6 per cent) down by 26,000 on January. Seasonally adjusted excluding school leavers figure was 2,836,000 (11.7 per cent), a rise of just 7,000 on January.]

Figures so far this year distorted by severe weather. Average monthly increase in January and February together about 30,000 (after allowance for over 60's transferring to long term Supplementary Benefit). Compared with 40,000 a month in H2 1981 this suggests a further slowing down in rate of increase (but figures have been affected for almost half a year by series of distortions - bad weather, civil service strike).

2. Vacancies?

Whilst down very marginally in February, both stock and flow figures show definite improvement since mid 1981.

3. Employment continues to fall?

[Total employment declined 1.9 million or 8 per cent in 2 years to Sept 1981. Q3 figures indicate decline of 150,000 compared with 300,000 per quarter in H1 1981. Manufacturing employment declined by 34,000 a month in Q4, a little more than Q3.]

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

4. Government forecasts for unemployment

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

Like previous administrations Government does not publish forecasts of unemployment, though some Government publications, eg Government Actuary's Report, contain working assumptions. Government is concerned about unemployment. Scale of special employment measures (SEMs) adequate evidence of this. Prospects depend on further progress on productivity and competitiveness. [See 5 below for independent forecasts.]

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

5. Independent forecasts?

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

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

6. Unemployment higher than in other countries?

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

Yes, but unemployment now rising more rapidly in most other OECD countries. German unemployment has risen ½ million since mid-1981, reaching its highest level (7½ per cent) since early post-war period, and compares with about 1 per cent in early 1970's. Serioüsness of UK position reflects poor productivity and competitiveness in the past and inflationary excesses in the 1978-79 and 1979-80 pay rounds.

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

[Subject of oral PQs 11 February and of CST speech at Guisborough 5 February]

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

8. Cost of unemployment - Revised estimate?

[Intended article for EPR 'suppressed' - The Times 18 February.]

Work has been done to update the figures on the cost of unemployment which appeared in February 1981 edition of Economic Progress Report. But there are considerable problems and doubts about such calculations and it is not possible to consider publication until these doubts have been resolved.

9. Total cost of unemployment £13 billion?

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

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

We continue to examine the options. But schemes to provide jobs in the public sector tend to have a net Exchequer cost, unless the amount paid is relatively low.

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

As announced last July and in 2 December statement, Government has increased spending on special employment and training measures. Plan to spend £1.5 million cash in 1982-83 - nearly 40 per cent more than in 1981-82. Much of this specifically on young people.

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

Agreed. White Paper on New Training Initiative set out action required in industry and education, as well as lead from Government.

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

Have taken action on a number of points:

Training: extra spending on 16-17 year olds, plans to reform apprenticeship system (see C11 above).

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

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

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

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

D TAXATION

1. Burden of taxation

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

This has inevitably increased during a time when national production has not been growing. But real personal disposable income is still higher than at any time in the period when the Labour Party was in Government.

2. Not worse than in other countries?

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

3. What will be in this year's Budget?

The Hon. Member will have to contain himself for a few more minutes.

N.B. Briefing on the Budget will be circulated on 9 March.

E PUBLIC EXPENDITURE AND FINANCE

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

1. Further announcements?/Outturn in 1981-82? / Questions on later years?

Full details will be new in White Paper to be published Tuesday pm 9 March.

[Briefing on Public Expenditure White Paper Cmnd 8494 being circulated separately.]

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

The Government last year concluded that provision for 1982-83 should be made on the basis of a 4 per cent pay factor overall. This remains its view. Some public servants may get more than 4 per cent, some may get less. But there is no automatic entitlement. Every settlement will have to be justified on a rigorous assessment of its merits. That position is unchanged. (See also J7-8)

3. Preferential treatment for Civil Service?

Mechanisms for dealing with expenditure on public service pay apply to the Civil Service as they do to others. We did give an undertaking to the Civil Service unions last year that if agreement could not be reached in this year's negotiations we would be prepared to go arbitration. The award would be subject if necessary, to override-with the approval of this House. We stand by that assurance in the terms it was made. An offer has now been made to the non-industrial civil servants (grades up to Principal) which averages 4.05 per cent. (See also J9-10)

4. Contingency reserve and pay

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

5. Cut staff numbers in public services?

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

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

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

LOCAL GOVERNMENT

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

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

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

Not at all. If local authorities budget to spend in line with Government's plans, rate increases should be very low. Where they are high, it is because local authorities have chosen to overspend. [NB. FSBR published 9 March to quote 12 per cent rise in rate income-taking account of information on actual rate increases.]

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

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

10. Control of local authority spending?

We will maintain pressure to reduce spending through rate support grant system and otherwise. Provision in Local Government Finance (No.2) Bill to ban supplementary rates will oblige local authorities to budget responsibly at start of year and prevent a repetition of the irresponsible increases in spending planned by some authorities this year. In Scotland, we are seeking power to oblige excessive spenders to reduce their rate demands.

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

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

F SOCIAL SECURITY

1. November 1982 uprating?

The forecast movement in prices to be used for this uprating and the rates for certain benefits will be given by the Chancellor of the Exchequer in his Budget statement. Further information will be given by the Secretary of State for Social Services on Wednesday 10 March.

2. Restoration of shortfall?

We have already made clear that the 2% shortfall will be made good for the State retirement pension and other long-term benefits. The Chancellor of the Exchequer will make clear our decision on the restoration of the shortfall for unemployment and other short-term benefits in his Budget statement.

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

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

Await Budget statement.

4. People no longer better off when unemployed

[Report by Institute of Fiscal Studies looked at position of short-term unemployed after abolition of earnings related supplement and 5 per cent abatement of UB made in November 1980. Reported that gap between in and out of work incomes had widened, concluded that UB and supplementary benefit should be increased in real terms.]

We have taken measures such as the abolition of earnings-related supplement and the taxation of short term benefits which serve to improve financial incentives to work. In a minority of cases, however, the gap between incomes in and out of work is still narrow. We shall continue to promote measures to encourage effort and improve the balance in incomes in and out of work.

5. Death grant - increase to realistic level?

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

6. Supplementary Benefit - uprate by RPI less housing cost component?

It is our intention to uprate the scale rates of Supplementary Benefits by the forecast movement in the RPI with a broadly based adjustment for the likely relative movement of housing costs [Note: we do not wish to make public a forecast of the housing index.]

Housing costs are not met from the scale rates of supplementary benefit, recipients of this benefit receive separate provision for housing, normally representing 100% of their costs. It is quite reasonable, therefore, to exclude housing costs from the scale rates.

7. National Insurance - contracting out?

[DHSS announced on Wednesday 3 March that the rebate on national insurance contributions for "contracting out" employment was to be reduced from 7% to 6¼% from April 1983 and that changes were to be made to the terms for "buying back" into the State scheme.]

The rebate recognises that occupational pension schemes provide benefits which the Government would otherwise have to provide. The Government Actuary now considers that pension funds should find it easier to finance those obligations - hence the reduction in the rebate. The change will narrow the margin between contracted in and contracted out contribution rates, but not necessarily increase the actual contracted out rates of payment, this will depend on the decisions taken on contribution rates for 1983-84.

We do not think the changes will cause many private sector schemes to move back into the State scheme. The "buy back" terms are to be changed gradually - so there should be no sudden rush to "buy back".

G PUBLIC SECTOR BORROWING

1. PSBR in 1981-82

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

Await Financial Statement and Budget Report for latest estimate.

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

[CGBR April-January published 9 February, was £8 billion.]

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

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

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

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

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

5. PSBR in 1982-83 ?

Await Budget Speech and FSBR.

H MONETARY AND FINANCIAL POLICY

1. Lower interest rates?

[Bank base rates were reduced by ½ per cent to 13½ per cent with effect from 25 February. Have come down 2½ per cent from peak of 16 per cent in the autumn. Market rates generally fell back during last week of February and early March]

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

2. Will high US rates push up our rates?

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

3. What is the Government doing about it?

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

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

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

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

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

6. Interest rates levels choking the recovery?

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

7. Two tier system of interest rates?

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

8. Will there be an overshoot of money supply target?

[£M3 increased by 1.7 per cent in banking January, bringing annualised rate of growth over target period to 15.7 per cent. M1 grew by 1.8 per cent in January and at a rate of 10.0 per cent over target period. PSL2 grew by 1.1 per cent in January and at a rate of 12.4 per cent over target period. Position remains seriously distorted by effect of Civil Service strike.]

Growth in £M3 over target period will be above top end of target range, even allowing for effects of Civil Service strike. Too early to say by how much. Interpretation of figures very difficult because of Civil Service strike distortions. Some good features in monetary picture: 1981-82 PSBR should be close to forecast; funding programme is on track. But bank lending disturbingly high, despite level of interest rates.

9. When will the strike distortions be eliminated?

Distortion will continue for some months yet. The distortion to the CGBR was reduced by about £½ billion in (calendar) January. In ten months ending January the effect of the strike was to add around £2¼-2½ billion to the CGBR.

J PRICES AND EARNINGS

1. Inflation has increased under this Government?

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

2. When will single figure inflation be achieved?

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

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

3. Nationalised industry prices

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

4. TPI

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

5. Current level of pay settlements ?

In economy generally ,settlements in last pay round averaged 8-9 per cent . Negotiators seem to be settling up to about a third lower in this round than they did in previous. And almost all settlements seem to be in single figures.

6. Private sector pay - the CBI's 7 per cent?

[CBI figures published 17 February suggest that manufacturing settlements monitored since 1 August are averaging around 7 per cent.]

Settlements have been lower in recent months, reflecting an increasing sense of realism about pay. But the need is for continuing low settlements which are consistent with maintaining economic recovery and improving employment prospects.

7. Public sector pay

Government's approach to pay in the public services must take account of what the taxpayer can afford. Pay negotiations in the nationalised industries and local authorities are a matter for the parties concerned, as are the financial consequences of any settlements reached.

8. 4 per cent cash factor unrealistic/unfair?

Real incomes had risen to unsustainable level and public service pay increased relative to private sector since 1979. 4 per cent is broad measure of what Government thinks reasonable and can be afforded as general allowance in fixing programmes from which public service pay bill has to be met.

9. Application to the Civil Service?

There have been two negotiating meetings with the non-industrial civil service trade unions. Government has reaffirmed its undertakings to negotiate without a predetermined cash limit and its willingness to go to arbitration in the event of disagreement. This is subject to reserving the right to ask the House of Commons to set aside the arbitration award if necessary on grounds of overriding national policy. The unions have said that the offer is unacceptable and have asked to proceed immediately to arbitration.

10. Difference between Government's offer and the union claim?

In framing its offer the Government has placed much more emphasis on market considerations and management objectives than on comparability and the cost of living. The unions' emphasis is on the latter two aspects.

11. Average earnings index

[Fall in year on year growth from 11.3 per cent in November to 9.9 per cent in December may attract attention, though (unpublished) underlying increase, broadly unchanged at, just over 11 per cent]

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

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

Yes. But follows growth of 17½ per cent in personal living standards in three years 1977-80.

13. Government aiming to cut living standards?

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

Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

14. Incomes Policy

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

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

15. Index-linked pensions and the Scott Report?

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

K BALANCE OF PAYMENTS

1. Balance of payments December 1981

[December trade figures published 25 January]

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

2. Trends in exports

Non-oil exports were 3½ per cent higher in volume terms than in 1980. Exports of intermediate and capital finished manufactured goods are now higher in both value and volume terms than in 1979 and 1980 despite loss of competitiveness. DoI survey of engineering industry suggests export deliveries will continue to rise in 1982, as does CBI Industrial Trends Survey.

3. Oil exports and erratics

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

4. Trends in imports

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

5. Trends in invisibles

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

6. TUC proposal for an import deposit scheme?

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

L EXCHANGE RATE AND THE RESERVES

1. Sterling still too high?

[Since last September, sterling has remained broadly stable and is currently over 12 per cent below its effective rate peak early last year. Recent lows have been $1.77 on 14 September, DM4.07 on 20 October. Highs were $1.97 on 30 November, DM4.407 on 9 February. Rates at noon on 4 March were $1.8255; DM4.32 and an effective rate of 90.96. Reserves at end February stood at $23.4 billion, compared with $23.2 billion at end January.]

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

2. Has the Bank intervened to support the rate?

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

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

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

4. Does the Government have an exchange rate target?

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

5. Sterling should join the EMS?

[See M8-9]

6. Exchange rate and competitiveness?

I welcome the improvement in UK cost competitiveness of over 10 per cent in 1981. This has been partly due to a decline in the exchange rate; more importantly because there are signs that our domestic unit labour costs are now growing more slowly than those of our major competitors.

7. Debt repayments

We have made substantial progress with our plans to reduce the burden of external debt substantially during this Parliament. We aimed to reduce official external debt to \$14 billion by the end of 1981. This has been more than achieved - external debt is now around \$13½ billion, compared with over \$22 billion when the Government took office.

M EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. 'Mandate negotiations'

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

2. Net UK contribution to community too high?

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

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

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

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

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

5. Do supplementary measures grants lead to additionality?

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

6. Policy for CAP reform

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

7. Costs of CAP to UK consumers

My rhF, the Minister of Agriculture, has dealt with a number of questions on this. Costs to consumers of the CAP as such depend on nature of alternative support system that is envisaged. Arrangements leading to a reduction in the cost of food to the consumer could well involve increased costs to taxpayers.

EUROPEAN MONETARY SYSTEM

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

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

9. When will the conditions be right?

Sterling is an international financial currency and is also particularly affected by oil market factors. These mark sterling out from other Community currencies, and add to the difficulty of the decision on the timing of sterling's participation. The balance of advantages, risks and disadvantages is constantly changing, so that the question of participation remains complex.

N INDUSTRY

1. Prospects for industry - recovery?

Fall in output has now come to an end. Industrial production in Q4 1981 ½ per cent upon Q3 and some 2 per cent up on H1. New forecast will be published with Budget on 9 March.

2. Company sector finances improved?

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

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

3. High interest rates damaging for industry and investment?

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

Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking. 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 H).

4. Mr Chandler's call for a new industrial policy

[In speech Thursday 25 February, DG of NEDO called on both sides of industry to bury their differences and formulate a new long-term industrial policy]

I agree with Mr Chandler's remarks about the complex set of causes underlying Britain's problems, and about the need for action to improve the country's long term lack of competitiveness. But not within the power of Government to bring about all the changes required. Improvements in work practices, for example, and restraint in wage and price increases depend above all on the approach of the two sides of industry.

SMALL FIRMS

5. Government help for small firms

Over 75 measures taken which help important small firms sector: in particular the Business Start-Up Scheme, the pilot Loan Guarantee Scheme, the Venture Capital Scheme, and reduction in the burden of small firms' corporation tax.

6. Response to Loan Guarantee Scheme?

Scheme operating successfully. We have already issued more than 2700 guarantees - well over half to new businesses. Total lending under scheme is just under £100 million. Ten new banks were admitted to the Scheme in November 1981: a total of twenty-seven financial institutions are now participating.

ENTERPRISE ZONES

7. Progress with setting up Enterprise Zones?

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

8. Response from private sector?

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

P NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83?

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

2. Pay assumptions?

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

3. Government simply forcing financing burden onto consumer, ie through higher prices?

Some further price rises assumed in reaching decision on EFLs as in previous years. Should be possible to avoid large real increases experienced in 1980-81; but requires continuing effort to keep down current costs, particularly pay.

4. Government still cutting back the industries savagely?

Not so. The industries made very large original bids for additional external finance in 1982-83, totalling about £2.5 billion, in their medium-term financial plans presented to Government in summer 1981. This would have brought their total external finance to around £4 billion. Agreed increase of £1.3 billion was roughly halfway between the industries' original bids and the White Paper figure.

INVESTMENT

5. Current year?

Last Public Expenditure White Paper showed nationalised industry planned investment 15 per cent higher in real terms this year than a year ago. Although now expect final figure to be lower than this the industries will still be investing well over £6 billion. Quantity of investment frustrated by tight EFLs is less than often implied. TSSC report last August estimated in range of £250-500 million this financial year.

6. Future years?

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

7. Take nationalised industry investment out of PSBR?

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

8. Private finance for NI investment?

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

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

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

NATIONALISED INDUSTRY PAY AND PRICES

10. Nationalised industries' prices

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

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

[IF PRESSED on domestic gas price increases: These prices will still be below economic levels.]

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

The review by the Electricity Council of the CEGB's Bulk Supply Tariff has now been produced and considered by Ministers. Await my rhF's Budget Statement.

12. Will HMG take action over industrial gas prices?

HMG is well aware of industry's concern about further increases in gas contract prices. Await my rhF's Budget Statement.

PRIVATISATION

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

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

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

Legislation already passed to enable public to hold equity stake in British Airways, British Transport Dock Board, subsidiaries of British Rail; and to dispose of some of British Telecom's peripheral activities. Oil and Gas (Enterprise) Bill published 17 December will permit public to invest in BNOC's upstream business and certain parts of BGC's activities, in particular oil production. The Government have now sold its entire shareholding in the National Freight Company and Amersham International. We shall be announcing further measures in due course.

15. Special disposals programme just a subsidy for speculators?

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

Not in Government's interest to see shares underpriced, but also risks in pitching price too high. Getting balance right not easy - especially where company's shares have not previously been traded. [IF PRESSED: Government concerned to learn from experience: well aware of the criticisms that have been made.]

16. How will Government handle sale of Britoil in light of Amersham experience and falling world oil prices?

No detailed decisions have yet been made as to the manner of the sale.

17. Will HMG postpone sale of Britoil after recent oil price falls?

HMG hopes that the sale of shares will take place before the end of this year. HMG is determined to ensure that taxpayer benefits to the fullest extent from the sale. We would not go ahead unless satisfied that the price obtainable for the shares represents fair value to the taxpayer.

R NORTH SEA AND UK ECONOMY

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

[BNOC have agreed $4 a barrel reduction - equivalent to 11 per cent reduction in $ price of Forties oil - now at $31. Effect on sterling price - and hence Government revenues -could be smaller if the exchange rate falls as a direct result of the fall in $ oil prices.]

Prices of UK oil are set by commercial negotiation. BNOC is largely a third party trader, and must find prices which satisfy both suppliers and customers.

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

[PM warned in 23 February speech that limited room for manoeuvre in Budget.]

Other things being equal, lower oil prices will reduce Government revenues from the North Sea. Economic Secretary to Treasury has estimated that each $1 off the price reduces revenue, other things being equal, £300 million in full year. (New forecasts of Government revenues will be published at Budget time). But note that falling world oil prices are good for the world economy. We will benefit from that - not only from impact on activity, but also lower oil prices will help in reducing inflation.

3. What will HMG do about oil taxation revenues?

Await my rhF's Budget.

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

I commend the oil industry's representatives and others who have made suggestions for the hard work they have put in. We have looked at the suggestions with an open mind. Await my rhF's Budget statement.

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

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

6. North Sea oil depletion policy?

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

7. <u>Benefits of North Sea should be used to strengthen the economy?</u>

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. Only one-twentieth of total general government receipts in 1981-82.

8. <u>Government revenues from the North Sea should be used to finance cheap energy for industry?</u>

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

9. <u>North Sea revenues should be channelled into a special fund to finance new investment, particularly in energy?</u>

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.

S WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Governments will have no choice but to reverse policies now unemployment has risen to post-war record levels in many Western countries?

[Unadjusted unemployment exceeded 10 million in USA and 1 million in Canada in January. It exceeded 2 million in Italy in September, 2 million in France in October, and probably exceeded 2 million in Germany in February. Highest ever unemployment levels in Canada, France, Italy and UK and highest in USA and Germany since 1935.]

No indication of a widespread departure from consensus achieved last year (eg Ottawa Summit, IMF Interim Committee) about need for prudent fiscal and monetary policies to bring down inflation.

2. Anti-inflation policies not working?

[Year on year consumer price inflation in major countries fell to 9.4 per cent in December. Underlying rates falling in US. OECD and IMF expect some decline in 1982.]

Takes time to squeeze inflation out of system. Year-on-year consumer price inflation in major economies down from peak of 13 per cent in April 1980 to around 9.4 per cent in December 1981. Further decline expected 1982.

3. Governments' policies have failed or worsened situation?

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

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

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

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

[Most major countries (US, Japan, Germany, Italy, Netherlands, Belgium, Australia, Sweden) have recently announced measures to cut planned public spending. France has announced the deferral of FF15 billion (£1½ billion) of capital investment. Belgian government has used its special powers to freeze prices temporarily and severely curtail wage increases for rest of 1982.]

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

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

UK far from alone. Almost all European governments working to curb public spending, budget deficits and monetary growth. German government plans to reduce its borrowing in 1982 Budget even in nominal terms by almost 30 per cent. Unlikely investment/employment scheme will entail any significant increase in borrowing - increase in VAT (by 1 per cent to 14 per cent) part of the package from 1 July next year. Impact on employment remains to be seen.

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

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

8. Even US using fiscal deficit to stimulate economy?

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

9. Recent international interest rate developments?

True that US interest rates rose earlier this year. But prime rates are well below their peak of 21½ per cent last summer and have fallen in the last few weeks.

10. 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.

AIDE MEMOIRE ON THE UK ECONOMY 5 March 1982

PRESENT SITUATION

Most recent major outside forecasts (NIESR, P&D, CBI, LBS, St James) assess fall in output ended in H1 1981, with some recovery thereafter (in range 1-1½ per cent for 1982). ITEM and OECD are more pessimistic; seeing further falls of output into 1982. Year-on-year inflation is forecast by most groups to fall further to a range of 9-10½ per cent in 1982 Q4. Most groups see little possibility of further substantial reductions in 1983; inflation forecast to remain around 10 per cent in 1983. The industry Act forecast, of a 1 per cent rise in output in 1982, and 10 per cent inflation in Q4 1982 is broadly in line with this consensus. Unemployment (UK adult seasonally adjusted) forecast to reach around 3 million by end 1982, with some groups (P&D, LBS, Simon & Coates) expecting stabilisation in 1982, other expecting some further rise.

GDP output estimate rose in both Q3 and Q4 1981. Level in Q4 some 1 per cent above Q2. In Q4 1981 industrial output rose ½ per cent while manufacturing output was little different from the previous quarter.

Consumers' expenditure rose 1½ per cent in Q4 1981: the overall level in 1981 was only very slightly higher than 1980. Retail sales rose sharply in January 1982 but the average level in the 3 months to January fell by ½ per cent. The volume of visible exports in Q4 1981 was 5½ per cent higher than in Q4 1980. The volume of visible imports rose 14 per cent on the same comparison. DI investment intentions survey conducted in October/November suggests volume of investment, by manufacturing, distributive and service industries (excluding shipping) will rise by about 2 per cent in 1982 following a fall of about 5 per cent in 1981. A large rise is tentatively expected in 1983. Investment by manufacturing (including leasing) is expected to rise during 1982, but for the year as a whole it is likely to be 1 per cent lower than 1981. An appreciable rise is expected in 1983. Manufacturers', wholesalers' and retail stocks dropped by £20 million (at 1975 prices) in Q4 1981 the smallest quarterly fall in the last two years of continuous destocking.

Unemployment (UK, seasonally adjusted excl, school-leavers) was 2,836,000 (11.7 per cent) at February count, up 7,000 on January. Vacancies were 113,500 in February.

Wholesale input prices (fuel and materials) rose ½ per cent in February; however the year-on-year increase fell to 12 per cent. Wholesale output prices rose ¾ per cent in February and are 10½ per cent above a year ago. Year-on-year RPI increase remained at 12.0 per cent in January. Year-on-year increase in average earnings was 9.9 per cent in December. RPDI was flat in Q3 1981 following falls in the previous two quarters and a 17.5 per cent rise over the 3 years 1977 to 1980. The savings ratio rose 1 per cent to 14½ per cent in Q3 1981.

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

Sterling M3 increased by 1.7 per cent in banking January.

Visible trade showed average monthly surplus of £190 million in the 4 months to December 1981 compared with an average monthly surplus of £525 million in the first two months of 1981. Invisibles surplus in 1981 estimated at £2.8 billion. Reserves at end-February $23.4 billion. At the close 4 March - the sterling exchange rate weakened to $1.828 : the effective rate was 91.0.

Econ Pol

PPS/CHANCELLOR

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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 ECONOMIC BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 22 February, are sidelined.

M M Deyes

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RGA

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EB Division
HM Treasury
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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. Relative importance given to inflation and unemployment?

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

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

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

4. Budget objectives

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

5. PM's remarks about Chancellor's 'limited room for manoeuvre'?

[Speech for Engineering Employers' Federation 23 February.]

I stressed in my remarks last week that I was not seeking to pre-empt my rhF's Budget speech. But I was trying to inject a note of realism.

6. Implications of falling oil prices?

See R2.

7. Scope for tax cuts? Stimulation of economy?

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

8. Armstrong report - TCSC comment

[Report from TCSC expected in the Spring]

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

9. Government has failed to accommodate recession?

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

10. Failure to control monetary growth?

Despite likely overshoot in £M3 target this year, monetary conditions have not been lax. Total money spending has grown at annual rate of 10 per cent during 1980 and 1981, broadly consistent with original MTFS guidelines.

11. Why are high interest rates needed?

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

12. Expectations for UK economy in 1982 disappointing?

[New forecasts recently published by NIESR, LBS, P&D, Liverpool Group.]

Published forecasts show usual wide range of views. Government will publish new forecast with Budget on 9 March.

BULL POINTS As at 1.3.82 (Tape 455)

(i) Signs of recovery

- Total output (GDP) rose in both 3Q and 4Q 1981. Level in 4Q some 1 per cent above 2Q.
- Short time working in manufacturing fell in 1981 to below 1/4 its January peak;
- 1981 figures show volume of engineering and construction orders up about 17 and 9 per cent respectively on 2H 1980.
- Private sector housing starts in 1981 up by 37 per cent on 2H 1980.
- Most recent major independent forecasts assess low point in activity reached in 1H 1981; prospect of some recovery in 1982.

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

(iii) Productivity. Output per head in manufacturing rose 10 per cent during 1981. Investment in plant and machinery holding up well.

(iv) Unit labour costs: Pay moderation and higher productivity has meant dramatically low increase in manufacturers unit wage costs in latest 12 months - under 4 per cent in year to November.

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

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

(vii) Exports holding up well; non-oil export volumes in 4 months to December up 3½ per cent on 1980. 1981 figures (incomplete) show engineering export orders up 20 per cent on 2H 1980.

(viii) Unemployment. Rate of increase in unemployment since mid 1981 about half that in 1H and 1/3 that in 4Q 1980. Vacancies improving over recent months. Short-time working in manufacturing reduced by over ¾ during 1981 and overtime working has increased.

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

(x) Training. Over next 3 years £4 billion to be provided to bring training schemes up to date. New Youth Training Scheme for school leavers to be introduced September 1983 represents major step towards comprehensive provision for young people.

(xi) Industrial relations. Number of strikes in 1980 and 1981 less than in any year since 1941 and number of working days lost only a third of average of last ten years.

(xii) Retail prices. Inflation almost halved since peak in spring 1980 (21.9 per cent). 12 monthly increase in January of 12.0 per cent. [NB Progress affected by lower exchange rate.]

(xiii) Share Ownership Schemes: Number of schemes has increased from 30 in May 1979 to over 350. Number of employees covered roughly doubled between first and second years in office. Profit sharing schemes alone now cover about 250,000 employees.

(xiv) Loan Guarantee Scheme. Over 2300 guarantees issued so far on loans totalling over £80 million. Over half of loans going to new businesses.

(xv) Enterprise Zones. 10 out of 11 zones already in operation. Last one (Isle of Dogs) expected to start in April.

(xvi) Examples of export successes reported in the Press include: £160 million contract for/ construction of two new colleges in the largest ever such contract between Britain and Nigeria (Mitchell Cotts Group); approved tender for veterinary vaccines to Kampuchea (Hoechst UK); supply of 1000 special gearboxes to Istanbul within five weeks of order (Turner-Spicer Transmissions); travelling hoists with exceptionally low headroom (550mm) for use in Danish oil and gas exploration platform in North Sea (Tonnes Force); a profiled metal cladding system for a power station in The Gambia (Ash and Lacy Steel); and glazing for the new Financial Complex in Port of Spain - the biggest ever such gained by a UK glass processor (Clark and Eaton with Pilkingtons). New British-designed, managed and partly funded, domestic water supply project in Jordan was opened by King Hussein on 18 February.

(xvii) UK preferred location: US electronics industry survey reports UK most preferred location for establishing new plants.

(xviii) Overseas debt repayments. Official external debt reduced from over $22 billion, when Government took office, to $13.3 billion at end-1981.

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

B ECONOMIC ACTIVITY AND PROSPECTS

1. Current position and prospects?

[Preliminary GDP (output) estimate for Q4 1981 up ½ per cent on Q3 reflecting higher North Sea output and higher gas and electricity demand partially offset by fall in manufacturing and construction output. Little change elsewhere.]

Recovery confirmed by second successive quarterly rise in total output. Output in Q4 1 per cent up on Q2 - the earlier low point.

IF ASKED about relationship to Government forecasts - improvement in H2 consistent with December IAF - NB new assessment in FSBR.

IF PRESSED on apparent weakening of recovery (based on November/December industrial output) - see 2 below.

2. Recent manufacturing production figures show resumed decline?

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

November and December figures affected by car disputes and exceptionally severe weather. Even so, index for Q4 as a whole much the same as in Q3, and about 2-3 per cent higher than in H1 (cyclical low point).

3. Other evidence of improvement in economy?

Engineering and construction orders and private sector housing starts all well up during 1981 on H2 1980. Productivity (output per head) in manufacturing rising strongly - up 10 per cent in Q3 1981 from Q4 1980. January cyclical indicators continue to confirm recovery under way. (Coincident indicator has been rising consistently since May; earlier weakening in longer leading indicator partly reversed, with improvements during November to January. (Labour market indicators - see C1.)

4. Latest CBI Enquiry?

February's enquiry shows a further improvement in order books and a rise in the net balance of firms (from 1 to 3 per cent) expecting to increase output over the next four months.

5. Government assessment of prospects

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

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

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

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

6. Outside forecasts

[GDP profile in recently released major forecasts:

	NIESR (Feb)	LBS (Feb)	CBI (Nov)	Phillips & Drew (Mar)	OECD (Dec)	IAF (Dec)
Per cent change 1982 on 1981	+1½	+1½	+1	+1¼	+¼	+1]

Most recent major independent forecasts assess that low point in activity was reached in first half of 1981, with prospect of some recovery in 1982. As always, a range, with Cambridge forecasts being the more pessimistic.

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

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

C LABOUR

1. Unemployment continues to rise?

[February total count was 3,045,000 (12.6 per cent) down by 26,000 on January. Seasonally adjusted excluding school leavers figure was 2,836,000 (11.7 per cent), a rise of just 7,000 on January.]

Figures so far this year distorted by severe weather. Average monthly increase in January and February together about 30,000 (after allowance for over 60's transferring to long term Supplementary Benefit). Compared with 40,000 a month in H2 1981 this suggests a further slowing down in rate of increase (but figures have been affected for almost half a year by series of distortions - bad weather, civil service strike).

2. Vacancies?

Whilst down very marginally in February, both stock and flow figures show definite improvement since mid 1981.

3. Employment continues to fall?

[Total employment declined 1.9 million or 8 per cent in 2 years to Sept 1981. Q3 figures indicate decline of 150,000 compared with 300,000 per quarter in H1 1981. Manufacturing employment declined by 34,000 a month in Q4, a little more than Q3.]

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

4. Government forecasts for unemployment

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

Like previous administrations Government does not publish forecasts of unemployment, though some Government publications, eg Government Actuary's Report, contain working assumptions. Government is concerned about unemployment. Scale of special employment measures (SEMs) adequate evidence of this. Prospects depend on further progress on productivity and competitiveness. [See 5 below for independent forecasts.]

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

5. Independent forecasts?

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

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

6. Unemployment higher than in other countries?

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

Yes, but unemployment now rising more rapidly in most other OECD countries. German unemployment has risen ½ million since mid-1981, reaching its highest level (7½ per cent) since early post-war period, and compares with about 1 per cent in early 1970's. Seriousness of UK position reflects poor productivity and competitiveness in the past and inflationary excesses in the 1978-79 and 1979-80 pay rounds.

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

[Subject of oral PQs 11 February and of CST speech at Guisborough 5 February]

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

8. Cost of unemployment - Revised estimate?

[Intended article for EPR 'suppressed' - The Times 18 February.]

Work has been done to update the figures on the cost of unemployment which appeared in February 1981 edition of Economic Progress Report. But there are considerable problems and doubts about such calculations and it is not possible to consider publication until these doubts have been resolved.

9. Total cost of unemployment £13 billion?

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

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

We continue to examine the options. But schemes to provide jobs in the public sector tend to have a net Exchequer cost, unless the amount paid is relatively low.

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

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

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

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

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

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

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

Have taken action on a number of points:

Training: extra spending on 16-17 year olds, plans to reform apprenticeship system (see C11 above).

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

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

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

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

D TAXATION

1. Burden of taxation

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

This has inevitably increased during a time when national production has not been growing. But real personal disposable income is still higher than at any time in the period when the Labour Party was in Government.

2. Not worse than in other countries?

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

3. Prospects for 1982 Budget?

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

4. Government policy has harmed incentives?

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

5. Reduce National Insurance Surcharge?

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

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

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

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

Green Paper showed that burden of corporation tax has more or less matched changes in company profitability. Question of appropriate burden of corporation tax was not covered in Green Paper but will be considered by my rhF in reaching his Budget decisions.

8. Progress so far on tax reform/simplification?

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

9. North Sea fiscal regime?

See R2-3.

E PUBLIC EXPENDITURE AND FINANCE

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

1. Further announcements?/Questions on later years?

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

2. 1981-82: Overspending?

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

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

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

4. Failure to cut spending?

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

5. Further reductions possible in 1982-83?

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

Further savings in manpower not feasible. Plans take account of savings in administrative costs and reduction of manpower. 4 per cent provided for increases in public sector pay next year (see E12 and 13 and J7-10). Government considering question of index-linking of and contributions to public service pensions (see J15). Figures for contingency reserve, asset sales and interest payments must be realistic.

6. Increase spending during recession?

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

7. Fall in real terms?

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

8. Increase spending on worthwhile infrastructure projects?

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

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

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

10. Government overspending by £1,250 million?

[D Blake in The Times 27 January.]

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

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

The Government last year concluded that provision for 1982-83 should be made on the basis of a 4 per cent pay factor overall. This remains its view. Some public servants may get more than 4 per cent, some may get less. But there is no automatic entitlement. Every settlement will have to be justified on a rigorous assessment of its merits. That position is unchanged. (See also J7-8)

12. Preferential treatment for Civil Service?

Mechanisms for dealing with expenditure on public service pay apply to the Civil Service as they do to others. We did give an undertaking to the Civil Service unions last year that if agreement could not be reached in this year's negotiations we would be prepared to go arbitration. The award would be subject if necessary, to override-with the approval of this House. We stand by that assurance in the terms it was made. An offer has now been made to the non-industrial civil servants (grades up to Principal) which averages 4.05 per cent. (See also J9-10)

13. Contingency reserve and pay

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

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

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

15. Cut staff numbers in public services?

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

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

Ratios in 1980-81 (43½ per cent) and 1981-82 (45 per cent forecast) remain below the level of 1974-75 and 1975-76 (46 per cent in both years). The large rise from 41 per cent in 1979-

80 is partly because of the "relative price effect" and partly because the volume of expenditure rose at a time when real GDP has fallen. Good chance that ratio will fall in 1982-83.

LOCAL GOVERNMENT

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

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

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

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

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

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

20. Control of local authority spending?

We will maintain pressure to reduce spending through rate support grant system and otherwise. Provision in Local Government Finance (No.2) Bill to ban supplementary rates will oblige local authorities to budget responsibly at start of year and prevent a repetition of the irresponsible increases in spending planned by some authorities this year. In Scotland, we are seeking power to oblige excessive spenders to reduce their rate demands.

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

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

F SOCIAL SECURITY

1. November 1982 uprating?

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

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

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

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

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

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

4. DHSS leaflet on 'suitable jobs'?

I have asked my rhF the Social Services Secretary to examine the leaflet's definition of a 'suitable job' to see whether it encourages people to refuse work for which they might be suitable.

5. People no longer better off when unemployed

[Report by Institute of Fiscal Studies looked at position of short-term unemployed after abolition of earnings related supplement and 5 per cent abatement of UB made in November 1980. Reported that gap between in a and out of work incomes had widened, concluded that UB and supplementary benefit should be increased in real terms.]

We have taken measures such as the abolition of earnings-related supplement and the taxation of short term benefits which serve to improve financial incentives to work. In a minority of cases, however, the gap between incomes in and out of work is still narrow. We shall continue to promote measures to encourage effort and improve the balance in incomes in and out of work.

6. Death grant - increase to realistic level?

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

G PUBLIC SECTOR BORROWING

1. PSBR in 1981-82

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

The Civil Service dispute has greatly affected the PSBR so far this year, but the underlying PSBR looks to be in line with the Budget forecast of £10½ billion. Despite the strike, the PSBR for April-December was only £10¾ billion, compared with £13½ billion for the same period last year. PSBR for 1980-81 as a whole was £13¼ billion.

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

[CGBR April-January published 9 February, was £8 billion.]

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

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

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

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

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

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

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

H MONETARY AND FINANCIAL POLICY

1. Lower interest rates?

[Bank base rates were reduced by ½ per cent to 13½ per cent with effect from 25 February. Have come down 2½ per cent from peak of 16 per cent in the autumn. Market rates generally fell back during last week of February.]

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

2. Will high US rates push up our rates?

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

3. What is the Government doing about it?

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

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

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

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

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

6. Interest rates levels choking the recovery?

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

7. Two tier system of interest rates?

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

8. Will there be an overshoot of money supply target?

[£M3 increased by 1.7 per cent in banking January, bringing annualised rate of growth over target period to 15.7 per cent. M1 grew by 1.8 per cent in January and at a rate of 10.0 per cent over target period. PSL2 grew by 1.1 per cent in January and at a rate of 12.4 per cent over target period. Position remains seriously distorted by effect of Civil Service strike.]

Growth in £M3 over target period will be above top end of target range, even allowing for effects of Civil Service strike. Too early to say by how much. Interpretation of figures very difficult because of Civil Service strike distortions. Some good features in monetary picture: 1981-82 PSBR should be close to forecast; funding programme is on track. But bank lending disturbingly high, despite level of interest rates.

9. When will the strike distortions be eliminated?

Distortion will continue for some months yet. The distortion to the CGBR was reduced by about £½ billion in (calendar) January. In ten months ending January the effect of the strike was to add around £2¼-2½ billion to the CGBR.

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

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

11. Plans for modifying MTFS?

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

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

Are concerned that competition with building societies in mortgage market may be leading to the monetisation of housing equity through additional lending unrelated to housing finance. Guidance designed to hold off such a development and its adverse monetary consequences. Not seeking to obstruct competition. Should reduce any scope for abuse of tax relief for lending on housing.

13. Ceilings on non-priority bank lending?

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

J PRICES AND EARNINGS

1. Inflation has increased under this Government?

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

2. When will single figure inflation be achieved?

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

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

3. Nationalised industry prices

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

4. TPI

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

5. Current level of pay settlements

Settlements in the last pay round averaged 8-9 per cent, and there has been some further moderation in the current pay round, with almost all settlements in single figures.

6. Private sector pay - the CBI's 7 per cent?

[CBI figures published 17 February suggest that manufacturing settlements monitored since 1 August are averaging around 7 per cent.]

Settlements have been lower in recent months, reflecting an increasing sense of realism about pay. But the need is for continuing low settlements which are consistent with maintaining economic recovery and improving employment prospects.

7. Public sector pay

Government's approach to pay in the public services must take account of what the taxpayer can afford. Pay negotiations in the nationalised industries and local authorities are a matter for the parties concerned, as are the financial consequences of any settlements reached.

8. The 4 per cent pay factor

The 4 per cent factor announced on 15 September [for calculations in Public Expenditure Survey] is not a pay norm. It is a broad measure of what the Government thinks reasonable and can be afforded as a general allowance for increases in pay, at this stage of fixing the programme from which the public service wage bill has to be met.

9. Application to the Civil Service?

There have been two negotiating meetings with the non-industrial civil service trade unions. Government has reaffirmed its undertakings to negotiate without a predetermined cash limit and its willingness to go to arbitration in the event of disagreement. This is subject to reserving the right to ask the House of Commons to set aside the arbitration award if necessary on grounds of overriding national policy. The unions have said that the offer is unacceptable and have asked to proceed immediately to arbitration.

10. Difference between Government's offer and the union claim?

In framing its offer the Government has placed much more emphasis on market considerations and management objectives than on comparability and the cost of living. The unions' emphasis is on the latter two aspects.

11. Average earnings index

[Fall in year on year growth from 11.3 per cent in November to 9.9 per cent in December may attract attention, though (unpublished) underlying increase, broadly unchanged at, just over 11 per cent]

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

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

Yes. But follows growth of 17½ per cent in personal living standards in three years 1977-80.

13. Government aiming to cut living standards?

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

Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

14. Incomes Policy

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

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

15. Index-linked pensions and the Scott Report?

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

K BALANCE OF PAYMENTS

1. Balance of payments December 1981

[December trade figures published 25 January]

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

2. Trends in exports

Non-oil exports were 3½ per cent higher in volume terms than in 1980. Exports of intermediate and capital finished manufactured goods are now higher in both value and volume terms than in 1979 and 1980 despite loss of competitiveness. DoI survey of engineering industry suggests export deliveries will continue to rise in 1982, as does CBI Industrial Trends Survey.

3. Oil exports and erratics

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

4. Trends in imports

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

5. Trends in invisibles

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

6. TUC proposal for an import deposit scheme?

[TUC Economic Review published 2 February]

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

L EXCHANGE RATE AND THE RESERVES

1. Sterling still too high?

[Since last September, sterling has remained broadly stable and is currently over 12 per cent below its effective rate peak early last year. Recent lows have been $1.77 on 14 September, DM4.07 on 20 October. Highs were $1.97 on 30 November, DM4.407 on 9 February. Rates at close on 26 February were $1.8225; DM4.43 and an effective rate of 91.06. Reserves at end January stood at $23.2 billion, compared with $23.3 billion at end December]

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

2. Has the Bank intervened to support the rate?

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

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

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

4. Does the Government have an exchange rate target?

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

5. Sterling should join the EMS?

[See M8-9]

6. Exchange rate and competitiveness?

I welcome the improvement in UK cost competitiveness of over 10 per cent in 1981. This has been partly due to a decline in the exchange rate; more importantly because there are signs that our domestic unit labour costs are now growing more slowly than those of our major competitors.

7. Debt repayments

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

M EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. 'Mandate negotiations'

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

2. Net UK contribution to community too high?

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

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

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

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

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

5. Do supplementary measures grants lead to additionality?

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

6. Policy for CAP reform

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

7. Costs of CAP to UK consumers

My rhF, the Minister of Agriculture, has dealt with a number of questions on this. Costs to consumers of the CAP as such depend on nature of alternative support system that is envisaged. Arrangements leading to a reduction in the cost of food to the consumer could well involve increased costs to taxpayers.

EUROPEAN MONETARY SYSTEM

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

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

9. When will the conditions be right?

Sterling is an international financial currency and is also particularly affected by oil market factors. These mark sterling out from other Community currencies, and add to the difficulty of the decision on the timing of sterling's participation. The balance of advantages, risks and disadvantages is constantly changing, so that the question of participation remains complex.

N INDUSTRY

1. Prospects for industry - recovery?

[NB. NEDC meeting Wednesday 3 March]

Fall in output has now come to an end. Industrial production in Q4 1981 ½ per cent upon Q3 and some 2 per cent up on H1. New forecast will be published with Budget on 9 March.

2. Company sector finances improved?

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

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

3. High interest rates damaging for industry and investment?

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

Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking. 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 H).

4. Mr Chandler's call for a new industrial policy

[In speech Thursday 25 February, DG of NEDO called on both sides of industry to bury their differences and formulate a new long-term industrial policy]

I agree with Mr Chandler's remarks about the complex set of causes underlying Britain's problems, and about the need for action to improve the country's long term lack of competitiveness. But not within the power of Government to bring about all the changes required. Improvements in work practices, for example, and restraint in wage and price increases depend above all on the approach of the two sides of industry.

SMALL FIRMS

5. Government help for small firms

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

6. Response to Loan Guarantee Scheme?

Scheme operating successfully. We have already issued more than 2300 guarantees - well over half to new businesses. Total lending under scheme is already over £80 million. Ten new banks were admitted to the Scheme in November 1981: a total of twenty-seven financial institutions are now participating.

ENTERPRISE ZONES

7. Progress with setting up Enterprise Zones?

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

8. Response from private sector?

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

P NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83?

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

2. Pay assumptions?

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

3. Government simply forcing financing burden onto consumer, ie through higher prices?

Some further price rises assumed in reaching decision on EFLs as in previous years. Should be possible to avoid large real increases experienced in 1980-81; but requires continuing effort to keep down current costs, particularly pay.

4. Government still cutting back the industries savagely?

Not so. The industries made very large original bids for additional external finance in 1982-83, totalling about £2.5 billion, in their medium-term financial plans presented to Government in summer 1981. This would have brought their total external finance to around £4 billion. Agreed increase of £1.3 billion was roughly halfway between the industries' original bids and the White Paper figure.

INVESTMENT

5. Current year?

Last Public Expenditure White Paper showed nationalised industry planned investment 15 per cent higher in real terms this year than a year ago. Although now expect final figure to be lower than this the industries will still be investing well over £6 billion. Quantity of investment frustrated by tight EFLs is less than often implied. TSSC report last August estimated in range of £250-500 million this financial year.

6. Future years?

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

7. Take nationalised industry investment out of PSBR?

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

8. Private finance for NI investment?

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

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

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

NATIONALISED INDUSTRY PAY AND PRICES

10. Nationalised industries' prices

[Percentage increase over 12 months to:

	Oct 1981	Nov 1981	Dec 1981
Nationalised industries (domestic) prices	15	13	11
RPI (all items)	12	12	12

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

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

[IF PRESSED on domestic gas price increases: These prices will still be below economic levels.]

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

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

12. Will HMG take action over industrial gas prices?

HMG is well aware of industry's concern that further increase in gas contrast prices may worsen its competitive position, and is looking at whether there is scope for the British Gas Corporation to relax its pricing policy for industrial consumers.

PRIVATISATION

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

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

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

Legislation already passed to enable public to hold equity stake in British Airways, British Transport Dock Board, subsidiaries of British Rail; and to dispose of some of British Telecom's peripheral activities. Oil and Gas (Enterprise) Bill published 17 December will permit public to invest in BNOC's upstream business and certain parts of BGC's activities, in particular oil production. The Government have now sold its entire shareholding in the National Freight Company and Amersham International. We shall be announcing further measures in due course.

15. Special disposals programme just a subsidy for speculators?

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

Not in Government's interest to see shares underpriced, but also risks in pitching price too high. Getting balance right not easy - especially where company's shares have not previously been traded. [IF PRESSED: Government concerned to learn from experience: well aware of the criticisms that have been made.]

16. How will Government handle sale of Britoil in light of Amersham experience and falling world oil prices?

No detailed decisions have yet been made as to the manner of the sale.

R NORTH SEA AND UK ECONOMY

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

[BNOC have agreed with larger oil companies $1.50 a barrel reduction - equivalent to a 4 per cent reduction in $ price of Forties oil. Effect on sterling price - and hence Government revenues - could be smaller if the exchange rate falls as a direct result of the fall in $ oil prices. Negotiations continuing with other smaller companies].

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

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

[PM warned in 23 February speech that limited room for manoeuvre in Budget.]

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

3. What will HMG do about oil taxation revenues?

Await my rhF's Budget.

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

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

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

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

6. North Sea oil depletion policy?

[CAUTION: statement might be made in week beginning 1 March]

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

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

[Direct contribution of North Sea oil and gas to GNP is estimated to rise from 3 per cent in 1980 to about 5 per cent in 1984; expected contribution to Government revenues estimated at £3¾ billion in 1980-81 and £6 billion in 1981-82 (at current prices). Less susceptible of measurement is boost given by North Sea to local employment and to industry in offshore equipment].

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve a lower level of interest rates to the benefit of industry and the economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Only one-twentieth of total general government receipts in 1981-82.

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

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

9. 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.

S WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Governments will have no choice but to reverse policies now unemployment has risen to post-war record levels in many Western countries?

[Unadjusted unemployment exceeded 10 million in USA and probably exceeded 1 million in Canada in January. It exceeded 2 million in Italy in September, 2 million in France in October, and probably exceeded 2 million in Germany in February. Highest ever unemployment levels in Canada, France, Italy and UK and highest in USA and Germany since 1935.]

No indication of a widespread departure from consensus achieved last year (eg Ottawa Summit, IMF Interim Committee) about need for prudent fiscal and monetary policies to bring down inflation.

2. Anti-inflation policies not working?

[Year on year consumer price inflation in major countries fell to 9.4 per cent in December. Underlying rates falling in US. OECD and IMF expect some decline in 1982.]

Takes time to squeeze inflation out of system. Year-on-year consumer price inflation in major economies down from peak of 13 per cent in April 1980 to around 9.4 per cent in December 1981. Further decline expected 1982.

3. Governments' policies have failed or worsened situation?

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

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

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

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

[Most major countries (US, Japan, Germany, Italy, Netherlands, Belgium, Australia, Sweden) have recently announced measures to cut planned public spending. France has announced the deferral of FF15 billion (£1½ billion) of capital investment. Belgian government has used its special powers to freeze prices temporarily and severely curtail wage increases for rest of 1982.]

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

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

UK far from alone. Almost all European governments working to curb public spending, budget deficits and monetary growth. German government plans to reduce its borrowing in 1982 Budget even in nominal terms by almost 30 per cent. Unlikely investment/employment scheme will entail any significant increase in borrowing - increase in VAT (by 1 per cent to 14 per cent) part of the package from 1 July next year. Impact on employment remains to be seen.

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

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

8. Even US using fiscal deficit to stimulate economy?

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

9. Recent international interest rate developments?

True that US interest rates rose earlier this year. But prime rates are well below their peak of 21½ per cent last summer and have fallen in the last two weeks.

10. 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.

AIDE MEMOIRE ON THE UK ECONOMY 1 March 1982

PRESENT SITUATION

Most recent major outside forecasts (NIESR, P&D, CBI, LBS, St James) assess fall in output ended in H1 1981, with some recovery thereafter (in range 1-1½ per cent for 1982). ITEM and OECD are more pessimistic; seeing further falls of output into 1982. Year-on-year inflation is forecast by most groups to fall further to a range of 9-10½ per cent in 1982 Q4. Most groups see little possibility of further substantial reductions in 1983; inflation forecast to remain around 10 per cent in 1983. The industry Act forecast, of a 1 per cent rise in output in 1982, and 10 per cent inflation in Q4 1982 is broadly in line with this consensus. Unemployment (UK adult seasonally adjusted) forecast to reach around 3 million by end 1982, with some groups (P&D, LBS, Simon & Coates) expecting stabilisation in 1982, other expecting some further rise.

GDP output estimate rose in both Q3 and Q4 1981. Level in Q4 some 1 per cent above Q2. In Q4 1981 industrial output rose ½ per cent while manufacturing output was little different from the previous quarter.

Consumers' expenditure rose 1½ per cent in Q4 1981: the overall level in 1981 was only very slightly higher than 1980. Retail sales rose sharply in January 1982 but the average level in the 3 months to January fell by ½ per cent. The volume of visible exports in Q4 1981 was 5½ per cent higher than in Q4 1980. The volume of visible imports rose 14 per cent on the same comparison. DI investment intentions survey conducted in October/November suggests volume of investment, by manufacturing, distributive and service industries (excluding shipping) will rise by about 2 per cent in 1982 following a fall of about 5 per cent in 1981. A large rise is tentatively expected in 1983. Investment by manufacturing (including leasing) is expected to rise during 1982, but for the year as a whole it is likely to be 1 per cent lower than 1981. An appreciable rise is expected in 1983. Manufacturers', wholesalers' and retail stocks dropped by £20 million (at 1975 prices) in Q4 1981 the smallest quarterly fall in the last two years of continuous destocking.

Unemployment (UK, seasonally adjusted excl, school-leavers) was 2,836,000 (11.7 per cent) at February count, up 7,000 on January. Vacancies were 113,500 in February.

Wholesale input prices (fuel and materials) rose ¾ per cent in January; however the year-on-year increase fell to 13¾ per cent. Wholesale output prices rose 1 per cent in January and are 11 per cent above a year ago. Year-on-year RPI increase remained at 12.0 per cent in January. Year-on-year increase in average earnings was 9.9 per cent in December. RPDI was flat in Q3 1981 following falls in the previous two quarters and a 17.5 per cent rise over the 3 years 1977 to 1980. The savings ratio rose 1 per cent to 14½ per cent in Q3 1981.

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

Sterling M3 increased by 1.7 per cent in banking January.

Visible trade showed average monthly surplus of £190 million in the 4 months to December 1981 compared with an average monthly surplus of £525 million in the first two months of 1981. Invisibles surplus in 1981 estimated at £2.8 billion. Reserves at end-January $23.2 billion. At the close 26 February the sterling exchange rate weakened to $1.8215: the effective rate was 91.1.

Covering

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PPS/CHANCELLOR

copied to:

Mr Salveson (for transmission to No.10)
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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 ECONOMIC BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 15 February, are sidelined.

M M Deyes

M M DEYES

RA.

R I G ALLEN

22 February 1982

EB Division
HM 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. Relative importance given to inflation and unemployment?

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

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

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

4. Budget objectives

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

5. Scope for tax cuts? Stimulation of economy?

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

6. Armstrong report - TCSC comment

[Report from TCSC expected in the Spring]

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

7. Government has failed to accommodate recession?

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

8. Failure to control monetary growth?

Despite likely overshoot in £M3 target this year, monetary conditions have not been lax. Total money spending has grown at annual rate of 10 per cent during 1980 and 1981, broadly consistent with original MTFS guidelines.

9. Why are high interest rates needed?

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

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

US policy of special concern to rest of world. Particularly important that US deficit should not be excessive if US interest rates are not to bear too much of burden of holding down monetary growth and inflation.

11. Chancellor Schmidt has introduced reflationary package?

Germans plan to reduce Government borrowing even in nominal terms. New investment/employment scheme unlikely to entail significant increase in borrowing this year. It will be at least partly offset by a 1 per cent increase in VAT (see also Section S).

12. Expectations for UK economy in 1982 disappointing?

[New forecast will be published with Budget on 9 March.]

13. Recovery faltering?

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

Possible that output may have temporarily levelled out at end of year, though position confused with strikes, holiday season and severe weather.

14. Unemployment in 1982?

[January figures to be published on 23 February.]

The rate of rise in unemployment has slowed. Increase in recent months one third that at end 1980. This trend should continue. But clearly any firm forecasts for unemployment very uncertain and depend on a number of factors (see also Section C).

BULL POINTS — As at 22.2.82 (Tape 455)

(i) Signs of recovery

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

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

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

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

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

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

(vii) Exports holding up well; non-oil export volumes in 4 months to December up 3½ per cent on 1980. 1981 figures (incomplete) show engineering export orders up 22 per cent on 2H 1980.

(viii) Unemployment. Rate of increase in unemployment since mid 1981 about half that in 1H and 1/3 that in 4Q 1980. Vacancies improving over recent months. Short-time working in manufacturing reduced by ¾ during 1981 and overtime working has increased. Total hours worked in manufacturing stable since Spring 1981.

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

(x) Training. Over next 3 years £4 billion to be provided to bring training schemes up to date. New Youth Training Scheme for school leavers to be introduced September 1983 represents major step towards comprehensive provision for young people.

(xi) Industrial relations. Number of strikes in 1980 and 1981 less than in any year since 1941 and number of working days lost only a third of average of last ten years.

(xii) Retail prices. Inflation almost halved since peak in spring 1980 (21.9 per cent). 12 monthly increase in January of 12.0 per cent. [NB Progress affected by lower exchange rate.]

(xiii) Share Ownership Schemes: Number of schemes has increased from 30 in May 1979 to over 350. Number of employees covered roughly doubled between first and second years in office. Profit sharing schemes alone now cover about 250,000 employees.

(xiv) Loan Guarantee Scheme. Over 2300 guarantees issued so far on loans totalling over £80 million. Over half of loans going to new businesses.

(xv) Enterprise Zones. 10 out of 11 zones already in operation. Last one (Isle of Dogs) expected to start in April.

(xvi) Examples of export successes reported in the Press include: £3 million worth of equipment for the King Abdullah Aziz Military Academy in Saudi Arabia (SGB); £4 million worth of outside broadcasting vehicles and transmitters for Nigerian Television (PYE TV Ltd); £23 million worth of defence communications equipment for Austria (Racal jointly with Austrian counterparts); £20 million worth of power station pipework for Australia (Whessoe); British designed £26 million Aqaba domestic water project (involved Laing International, Howard Humphreys and other British companies).

(xvii) UK preferred location: US electronics industry survey reports UK most preferred location for establishing new plants.

(xviii) Overseas debt repayments. Official external debt reduced from over $22 billion, when Government took office, to $13.3 billion at end-1981.

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

B ECONOMIC ACTIVITY AND PROSPECTS

1. Current position and prospects?

[Preliminary GDP (output) estimate for Q4 1981 up ½ per cent on Q3 reflecting higher North Sea output and higher gas and electricity demand partially offset by fall in manufacturing and construction output. Little change elsewhere.]

Recovery confirmed by second successive quarterly rise in total output. Output in Q4 1 per cent up on Q2 - the earlier low point.

IF ASKED about relationship to Government forecasts - improvement in H2 consistent with December IAF - NB new assessment in FSBR.

IF PRESSED on apparent weakening of recovery (based on November/December industrial output) - see 2 below.

2. Recent manufacturing production figures show resumed decline?

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

November and December figures affected by car disputes and exceptionally severe weather. Even so, index for Q4 as a whole much the same as in Q3, and about 2-3 per cent higher than in H1 (cyclical low point).

3. Other evidence of improvement in economy?

Engineering and construction orders and private sector housing starts all well up during 1981 on H2 1980. Productivity (output per head) in manufacturing rising strongly - up 10 per cent in Q3 1981 from Q4 1980. January cyclical indicators continue to confirm recovery under way. (Coincident indicator has been rising consistently since May; earlier weakening in longer leading indicator partly reversed, with improvements during November to January. (Labour market indicators - see C1.)

4. Q4 stocks and investment figures for manufactures; and distributors show little sign of recovery?

Confirm sharp deceleration in rate of destocking and flat profile for investment during 1981. DoI investment intentions survey projects rise [of 2 per cent] in 1982.

5. Latest CBI Industrial Trends Survey shows prospects gloomy?

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

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

6. Government assessment of prospects

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

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

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

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

7. Outside forecasts

[GDP profile in recently released major forecasts:

	NIESR (Nov)	LBS (Nov)	CBI (Nov)	Phillips & Drew (Feb)	OECD (Dec)	IAF (Dec)
Per cent change 1982 on 1981	+½	+1¾	+1	+1	+¼	+1]

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

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

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

C LABOUR

1. Unemployment continues to rise?

[February count to be published Tuesday am 23 February - separate briefing will be supplied.]

2. Employment continues to fall?

[Total employment declined 1.7 million or 7½ per cent in 2 years to mid-1981. Preliminary Q3 figures indicate decline of 150,000 compared with 300,000 per quarter in H1 1981. Manufacturing employment fell back 32,000 a month in three months to November, compared with 50,000 a month earlier in 1981.).]

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

3. Government forecasts for unemployment

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

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

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

4. Independent forecasts?

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

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

5. Unemployment higher than in other countries?

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

Yes, but it has reached record levels in a number of other industrial countries. Most OECD countries have seen steeper rises than Britain in the last few months; in France, despite

President Mitterand's expansionist policies, it has gone over 2 million; in Germany it has reached 1.7 million, the highest figure since the early post-war period. In our case we are suffering the cumulative effects of lost competitiveness and low productivity and implications of inflationary pay settlements in 1978-79 and 1979-80 pay rounds. This is why the rise in UK unemployment has been higher than in most other countries, and points to the need to improve productivity and competitiveness.

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

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

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

7. Cost of unemployment - Revised estimate?

[Intended article for EPR 'suppressed' - The Times 18 February.]

Work has been done to update the figures on the cost of unemployment which appeared in February 1981 edition of Economic Progress Report. In making such calculations the assumptions made about, for example, what the unemployed person would otherwise have earned, and whether they would have been in the public or private sector, are crucial. Some doubts about the assumptions used in the calculations which produced the figure of £5,000 as the total cost per person - mentioned the article in The Times. It is not possible to consider publication until these doubts have been resolved.

8. Total cost of unemployment £13 billion?

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

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

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

We continue to examine the options. But schemes to provide public jobs inevitably have a net public expenditure cost. Since schemes are not costless the need to finance them is likely to lead to some reduction in employment elsewhere. We are, of course, spending money where circumstances justify this (see 9-12 below). Balance of public finances complex and figures depend on particular measures. Other elements as well as benefit savings and tax receipts. If jobs are in public sector there are wages and perhaps other expenses (supervision, costs of materials). If jobs in private sector, any subsidy would be an expenditure.

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

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

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

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

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

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

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

Have taken action on a number of points:

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

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

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

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

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

D TAXATION

1. Burden of taxation

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

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

2. Not worse than in other countries?

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

3. Prospects for 1982 Budget?

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

4. Government policy has harmed incentives?

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

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

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

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

...NIS burden in fact increased?

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

7. Reduce National Insurance Surcharge?

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

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

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

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

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

10. Progress so far on tax reform/simplification?

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

11. North Sea fiscal regime?

See R2-3.

E PUBLIC EXPENDITURE AND FINANCE

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

1. Further announcements?/Questions on later years?

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

2. 1981-82: Overspending?

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

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

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

4. Failure to cut spending?

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

5. Further reductions possible in 1982-83?

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

Further savings in manpower not feasible. Plans take account of savings in administrative costs and reduction of manpower. 4 per cent provided for increases in public sector pay next year (see E12 and 13 and J7-10). Government considering question of index-linking of and contributions to public service pensions (see J15). Figures for contingency reserve, asset sales and interest payments must be realistic.

6. Increase spending during recession?

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

7. Fall in real terms?

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

8. Increase spending on worthwhile infrastructure projects?

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

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

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

10. Government overspending by £1,250 million?

[D Blake in The Times 27 January.]

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

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

The Government last year concluded that provision for 1982-83 should be made on the basis of a 4 per cent pay factor overall. This remains its view. Some public servants may get more than 4 per cent, some may get less. But there is no automatic entitlement. Every settlement will have to be justified on a rigorous assessment of its merits. That position is unchanged. (See also J7-8)

12. Preferential treatment for Civil Service?

Mechanisms for dealing with expenditure on public service pay apply to the Civil Service as they do to others. We did give an undertaking to the Civil Service unions last year that if agreement could not be reached in this year's negotiations we would be prepared to go arbitration. The award would be subject if necessary, to override-with the approval of this House. We stand by that assurance in the terms it was made. An offer has now been made to the non-industrial civil servants (grades up to Principal) which averages 4.05 per cent. (See also J9-10)

13. Contingency reserve and pay

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

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

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

15. Cut staff numbers in public services?

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

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

Ratios in 1980-81 (43½ per cent) and 1981-82 (45 per cent forecast) remain below the level of 1974-75 and 1975-76 (46 per cent in both years). The large rise from 41 per cent in 1979-

80 is partly because of the "relative price effect" and partly because the volume of expenditure rose at a time when real GDP has fallen. Good chance that ratio will fall in 1982-83.

LOCAL GOVERNMENT

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

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

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

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

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

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

20. Control of local authority spending?

We will maintain pressure to reduce spending through rate support grant system and otherwise. Provision in Local Government Finance (No.2) Bill to ban supplementary rates will oblige local authorities to budget responsibly at start of year and prevent a repetition of the irresponsible increases in spending planned by some authorities this year. In Scotland, we are seeking power to oblige excessive spenders to reduce their rate demands.

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

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

F SOCIAL SECURITY

1. November 1982 uprating?

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

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

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

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

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

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

4. DHSS leaflet on 'suitable jobs'?

I have asked my rhF the Social Services Secretary to examine the leaflet's definition of a 'suitable job' to see whether it encourages people to refuse work for which they might be suitable.

5. People no longer better off when unemployed

[Report by Institute of Fiscal Studies looked at position of short-term unemployed after abolition of earnings related supplement and 5 per cent abatement of UB made in November 1980. Reported that gap between in a and out of work incomes had widened, concluded that UB and supplementary benefit should be increased in real terms.]

We have taken measures such as the abolition of earnings-related supplement and the taxation of short term benefits which serve to improve financial incentives to work. In a minority of cases, however, the gap between incomes in and out of work is still narrow. We shall continue to promote measures to encourage effort and improve the balance in incomes in and out of work.

6. Death grant - increase to realistic level?

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

G PUBLIC SECTOR BORROWING

1. PSBR in 1981-82

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

The Civil Service dispute has greatly affected the PSBR so far this year, but the underlying PSBR looks to be in line with the Budget forecast of £10½ billion. Despite the strike, the PSBR for April-December was only £10¾ billion, compared with £13½ billion for the same period last year. PSBR for 1980-81 as a whole was £13¼ billion.

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

[CGBR April-January published 9 February, was £8 billion.]

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

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

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

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

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

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

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

H MONETARY AND FINANCIAL POLICY

1. Lower interest rates?

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

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

2. Will high US rates push up our rates?

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

3. What is the Government doing about it?

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

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

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

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

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

6. Interest rates levels choking the recovery?

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

7. Two tier system of interest rates?

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

8. Will there be an overshoot of money supply target?

[£M3 increased by 1.7 per cent in banking January, bringing annualised rate of growth over target period to 15.7 per cent. M1 grew by 1.8 per cent in January and at a rate of 10.0 per cent over target period. PSL2 grew by 1.1 per cent in January and at a rate of 12.4 per cent over target period. Position remains seriously distorted by effect of Civil Service strike.]

Growth in £M3 over target period will be above top end of target range, even allowing for effects of Civil Service strike. Too early to say by how much. Interpretation of figures very difficult because of Civil Service strike distortions. Some good features in monetary picture: 1981-82 PSBR should be close to forecast; funding programme is on track. But bank lending disturbingly high, despite level of interest rates.

9. When will the strike distortions be eliminated?

Distortion will continue for some months yet. The distortion to the CGBR was reduced by about £½ billion in (calendar) January. In ten months ending January the effect of the strike was to add around £2¼-2½ billion to the CGBR.

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

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

11. Plans for modifying MTFS?

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

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

Are concerned that competition with building societies in mortgage market may be leading to the monetisation of housing equity through additional lending unrelated to housing finance. Guidance designed to hold off such a development and its adverse monetary consequences. Not seeking to obstruct competition. Should reduce any scope for abuse of tax relief for lending on housing.

13. Ceilings on non-priority bank lending?

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

J PRICES AND EARNINGS

1. Inflation has increased under this Government?

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

2. When will single figure inflation be achieved?

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

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

3. Nationalised industry prices

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

4. TPI

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

5. Current level of pay settlements

Settlements in the last pay round averaged 8-9 per cent. Negotiators seem to be settling up to about a third lower in this round than they did in the previous round. And almost all settlements seem to be in single figures.

6. Private sector pay - the CBI's 7 per cent?

[CBI figures published 17 February suggest that manufacturing settlements monitored since 1 August are averaging around 7 per cent.]

Settlements have been lower in recent months, reflecting an increasing sense of realism about pay. But the need is for continuing low settlements which are consistent with maintaining economic recovery and improving employment prospects.

7. Public sector pay

Government's approach to pay in the public services must take account of what the taxpayer can afford. Pay negotiations in the nationalised industries and local authorities are a matter for the parties concerned, as are the financial consequences of any settlements reached.

8. The 4 per cent pay factor

The 4 per cent factor announced on 15 September [for calculations in Public Expenditure Survey] is not a pay norm. It is a broad measure of what the Government thinks reasonable and can be afforded as a general allowance for increases in pay, at this stage of fixing the programme from which the public service wage bill has to be met.

9. Application to the Civil Service?

Negotiations have started with the non-industrial civil servants. Government has reaffirmed its undertaking to negotiate without a predetermined cash limit and its willingness to go to arbitration.

10. Difference between Government's offer and the union claim?

In framing its offer the Government has placed much more emphasis on market considerations and management objectives than on comparability and the cost of living. The unions' emphasis is on the latter two aspects.

11. Government aiming to cut living standards?

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

Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

12. Average earnings index

[Fall in year on year growth from 11.3 per cent in November to 9.9 per cent in December may attract attention, though (unpublished) underlying increase, broadly unchanged at, just over 11 per cent]

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

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

Yes. But follows growth of 17½ per cent in personal living standards in three years 1977-80.

14. Incomes Policy

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

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

15. Index-linked pensions and the Scott Report?

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

K BALANCE OF PAYMENTS

1. Balance of payments December 1981

[December trade figures published 25 January]

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

2. Trends in exports

Non-oil exports were 3½ per cent higher in volume terms than in 1980. Exports of intermediate and capital finished manufactured goods are now higher in both value and volume terms than in 1979 and 1980 despite loss of competitiveness. DoI survey of engineering industry suggests export deliveries will continue to rise in 1982, as does CBI Industrial Trends Survey.

3. Oil exports and erratics

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

4. Trends in imports

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

5. Trends in invisibles

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

6. TUC proposal for an import deposit scheme?

[TUC Economic Review published 2 February]

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

L EXCHANGE RATE AND THE RESERVES

1. Sterling still too high?

[Since last September, sterling has remained broadly stable and is currently over 12 per cent below its effective rate peak early last year. Recent "lows" have been $1.77 on 14 September, DM4.07 on 20 October. "Highs" were $1.97 on 30 November, DM4.407 on 9 February. Rates at noon on 19 February were $1.8583; DM4.38 and an effective rate of 91.68. Reserves at end January stood at $23.2 billion, compared with $23.3 billion at end December]

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

2. Has the Bank intervened to support the rate?

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

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

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

4. Does the Government have an exchange rate target?

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

5. Sterling should join the EMS?

[See M8-9]

6. Exchange rate and competitiveness?

I welcome the improvement in UK cost competitiveness of over 10 per cent in 1981. This has been partly due to a decline in the exchange rate; more importantly because there are signs that our domestic unit labour costs are now growing more slowly than those of our major competitors.

7. Debt repayments

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

M EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. 'Mandate negotiations'

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

2. Net UK contribution to community too high?

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

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

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

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

The UK is clear that the minimum net refunds payable under the 30 May agreement are [illegible]75 million ecus (European Currency Units) for 1980 and 1410 million ecus for 1981.

5. Do supplementary measures grants lead to additionality?

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

6. Policy for CAP reform

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

7. Costs of CAP to UK consumers

My rhF, the Minister of Agriculture, has dealt with a number of questions on this. Costs to consumers of the CAP as such depend on nature of alternative support system that is envisaged. Arrangements leading to a reduction in the cost of food to the consumer could well involve increased costs to taxpayers.

EUROPEAN MONETARY SYSTEM

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

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

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

9. When will the conditions be right?

Sterling is an international financial currency and is also particularly affected by oil market factors. These mark sterling out from other Community currencies, and add to the difficulty of the decision on the timing of sterling's participation. The balance of advantages, risks and disadvantages is constantly changing, so that the question of participation remains complex.

N INDUSTRY

1. Prospects for industry - recovery?

Fall in output has now come to an end. Industrial production in Q4 1981 ½ per cent upon Q3 and some 2 per cent up on H1. New forecast will be published with Budget on 9 March.

2. Company sector finances improved?

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

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

3. High interest rates damaging for industry and investment?

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

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

SMALL FIRMS

4. Government help for small firms

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

5. Response to Loan Guarantee Scheme?

Scheme operating successfully. We have already issued more than 2300 guarantees - well over half to new businesses. Total lending under scheme is already over £80 million. Ten new banks were admitted to the Scheme in November 1981: a total of twenty-seven financial institutions are now participating.

ENTERPRISE ZONES

6. Progress with setting up Enterprise Zones?

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

7. Response from private sector?

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

P NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83?

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

2. Pay assumptions?

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

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

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

4. Government still cutting back the industries savagely?

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

INVESTMENT

5. Current year?

Last Public Expenditure White Paper showed nationalised industry planned investment 15 per cent higher in real terms this year than a year ago. Although we now expect the final figure to be lower than this the industries will still be investing well over £6 billion. Quantity of investment frustrated by tight EFLs is less than often implied. TSSC report published last August estimated in range of £250-500 million this financial year.

6. Future years?

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

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

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

8. Take nationalised industry investment out of the PSBR?

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

9. Private finance for NI investment?

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

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

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

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

NATIONALISED INDUSTRY PAY AND PRICES

11. Nationalised industries' prices

[Percentage increase over 12 months to:

	Oct 1981	Nov 1981	Dec 1981
Nationalised industries (domestic) prices	15	13	11
RPI (all items)	12	12	12

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

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

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

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

PRIVATISATION

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

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

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

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

R NORTH SEA AND UK ECONOMY

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

[BNOC have agreed with larger oil companies $1.50 a barrel reduction - equivalent to a 4 per cent reduction in $ price of forties oil. Effect on sterling price - and hence Government revenues - could be smaller if the exchange rate falls as a direct result of the fall in $ oil prices. Negotiations continuing with other smaller companies].

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

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

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

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

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

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

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

5. North Sea oil depletion policy?

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

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

[Direct contribution of North Sea oil and gas to GNP is estimated to rise from 3 per cent in 1980 to about 5 per cent in 1984; expected contribution to Government revenues estimated at £3¾ billion in 1980-81 and £6 billion in 1981-82 (at current prices). Less susceptible of measurement is boost given by North Sea to local employment and to industry in offshore equipment].

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve a lower level of interest rates to the benefit of industry and the economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Only one-twentieth of total general government receipts in 1981-82.

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

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

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

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

S WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Governments' policies pushing world economy into recession?

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

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

2. Anti-inflation policies not working?

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

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

3. Governments' policies have failed or worsened situation?

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

4. Countries disagree over direction of policy?

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

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

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

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

[Most major countries (US, Japan, Germany, Italy, Netherlands, Belgium, Australia, Sweden) have recently announced measures to cut planned public spending. France has announced the deferral of FF15 billion (£1½ billion) of capital investment. Belgian government has been granted 'special powers' to carry through an austerity programme.]

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

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

UK far from alone. Almost all European governments working to curb public spending, budget deficits and monetary growth. German government plans to reduce its borrowing in 1982 Budget even in nominal terms by almost 30 per cent. Unlikely investment/employment scheme will entail any significant increase in borrowing - increase in VAT (by 1 per cent to 14 per cent) part of the package from 1 July next year. Impact on employment remains to be seen.

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

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

9. Even US using fiscal deficit to stimulate economy?

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

10. Recent international interest rate developments?

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

11. Prospects for international interest rates?

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

AIDE MEMOIRE ON THE UK ECONOMY 22 February 1982

PRESENT SITUATION

Most recent major outside forecasts (NIESR, P&D, CBI, LBS, St James) assess fall in output ended in H1 1981, with some recovery thereafter (in range ½-1¾ per cent for 1982). ITEM and OECD are more pessimistic; seeing further falls of output into 1982. Year-on-year inflation is forecast by most groups to fall further to a range of 9½-11½ per cent in 1982 Q4. Whilst some groups (ITEM and NIESR) see the possibility of further reductions (to 7-8 per cent), others see inflation remaining around 10 per cent in 1983. The industry Act forecast, of a 1 per cent rise in output in 1982, and 10 per cent inflation in Q4 1982 is broadly in line with this consensus. Unemployment (UK adult seasonally adjusted) forecast to reach around 3 million by end 1982.

GDP output estimate rose in both Q3 and Q4 1981. Level in Q4 some 1 per cent above Q2. In Q4 1981 industrial output rose ½ per cent while manufacturing output was little different from the previous quarter.

Consumers' expenditure rose 1½ per cent in Q4 1981: the overall level in 1981 was only very slightly higher than 1980. Retail sales rose sharply in January 1982 but the average level in the 3 months to January fell by ½ per cent. The volume of visible exports in Q4 1981 was [illegible] per cent higher than in Q4 1980. The volume of visible imports rose 14 per cent on the same comparison. DI investment intentions survey conducted in October/November suggests volume of investment, by manufacturing, distributive and service industries (excluding shipping) will rise by about 2 per cent in 1982 following an estimated fall of 4 per cent in 1981. A large rise is tentatively expected in 1983. Investment by manufacturing (including leasing) is expected to rise during 1982, but for the year as a whole it is likely to be 1 per cent lower than 1981. An appreciable rise is expected in 1983. Manufacturers', wholesalers' and retail stocks dropped by £20 mn (at 1975 prices) in Q4 1981 the smallest quarterly fall in the last two years of continuous destocking

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

Wholesale input prices (fuel and materials) rose ¾ per cent in January; however the year-on-year increase fell to 13¾ per cent. Wholesale output prices rose 1 per cent and are 11 per cent above a year ago. Year-on-year RPI increase remained at 12.0 per cent in January. Year-on-year increase in average earnings was 9.9 per cent in . ember. RPDI was flat in Q3 1981 following falls in the previous two quarters and a 17.5 per cent rise over the 3 years 1977 to 1980. The savings ratio rose 1 per cent to 14½ per cent in Q3 1981.

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

Sterling M3 increased by 1.7 per cent in banking January.

Visible trade showed average monthly surplus of £190 million in the 4 months to December 1981 compared with an average monthly surplus of £525 million in the first two months of 1981. Invisibles surplus in 1981 estimated at £2.8 billion. Reserves at end-January $23.2 billion. At the close 18 February the sterling exchange rate rose to $1.854: the effective rate was 91.6.

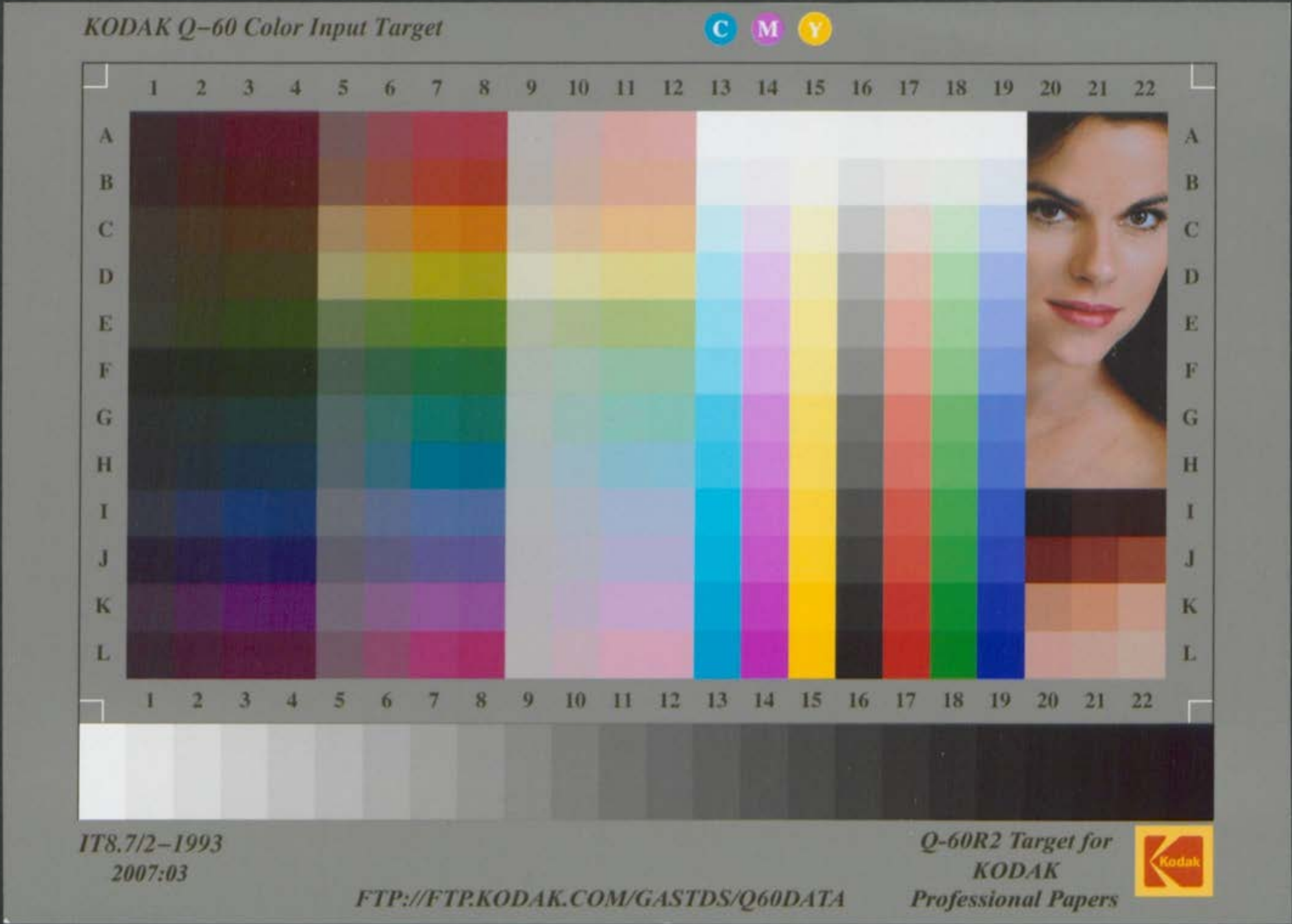
PART 13 ends:-

S/S Emp to PM + att

PART 14 begins:-

26.2.82

~~D. Wright~~ to HCS ~~22/2/82~~
~~A07578~~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