PREM 19/713

MT

PART 17

Confidential Filing

Economic Strategy
Pay + Prices Monthly Economic Report
The Economic Project
Treasury Weekly Brief

ECONOMIC POLICY

Part 1: May 1979

Part 17: June 1982

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~9.6.82~~							
~~14.6.82~~							
~~25.6.82~~							
~~28.6.82~~							
~~5.7.82~~							
~~8.7.82~~							
~~13.7.82~~							
14.7.82							

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PART 17 ends:-

AW to MCS 14/7

PART 18 begins:-

Treasury weekly brief 21/7/82

~~MISC 14 (82) 7 22/7~~

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
CC(82)32nd Conclusions, Minute 5	9.6.82
E(82)52	25.6.82
C(82)27	8.7.82

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 BHWayland Date 16 August 2012

PREM Records Team

CONFIDENTIAL

cc Mr. Mount
Mr. Vereker

MR. SCHOLAR

THE OUTLOOK FOR INDUSTRY: THE ~~JENKINS~~ JENKIN PACKAGE

1. The leading indicators are good. The leading indicators have an excellent record - they forecast the pause in recovery and now they forecast the continuation of the recovery. If the indicators were forecasting a decline, then there may well be a case for considering some sort of package. But they are not. And the most sensitive of the indicators, housing starts, is showing a dramatic 40% rise. on last year - but caution: there is some evidence that the upward trend is levelling out (see Flag A). MCS

2. This would be interpreted as a mini-Budget and would cause concern if not crisis in financial markets. It would be widely seen as a Government U-turn, a pre-election bonanza, just like all other previous governments have indulged in. Such increases in spending would be represented as the height of folly just after we have had all the expenses of the Falklands conflict. From January 1981 we have avoided interim budgets by introducing a consistency and stability in our budgetary and financial system - and this is much admired both by the City and by foreigners. Confidence has been hard to gain; it is, alas, easy to lose.

3. It would increase interest rates. Markets would rapidly revise their expectations of future inflation rates in the UK and interest rates would adjust upwards. Even quite modest increases in the borrowing requirement would be interpreted, as they are in America, as harbingers of larger deficits to come. Protestations that we were still sticking to our MTFS would be greeted with scepticism or derision. As we saw in March 1981, the only thing that will convince markets are actions. One might well fear that we would drift into a situation similar to the disastrous financial conditions that obtain at present in the United States; high budget deficits, high interest rates and no confidence in the Government's fiscal and financial policy. Recent experience in OECD countries shows that the budget deficit has an amplified effect on interest rates which would more than negate any supposed expansionary effect of an increased deficit. So we should do nothing to jeopardise the progressive fall in interest rates which is the best way to emerge from the slump.

/4. Hire Purchase Controls

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Hire Purchase Controls

Of all the recommendations which are made in the letter, the one we should accept immediately without reservation is to abolish hire purchase controls. This has been discussed between the Chancellor and the Governor and there is agreement on this issue. The Chancellor's letter to Lord Cockfield of 13 July refers.

attached
MCS

AW

14 July 1982

ALAN WALTERS

Econ Pol

Prime Minister

A firm rebuttal of Mr Jenkin's proposals. at Flag E

MCS 14/7

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

SECRETARY OF STATE FOR INDUSTRY

THE OUTLOOK FOR INDUSTRY

Thank you for your letter of 13 July. This minute sets out my initial reactions; I hope that we can meet soon to talk in more detail about the prospects for the company sector.

2. I agree, and my paper for Cabinet (C(82)27) indeed points out, that the recovery has shown some hesitation in recent months - though, as you say, the May figures are a little more encouraging. Certainly, as you suggest, there has been some worsening in the outlook for exports, but total order books have been holding up and in some areas (e.g. construction) strengthening. Productivity, and, recently competitiveness, have improved and there has been a strong investment performance by industry. Contrary to what you say the prospect for growth in 1983 has not changed materially since the forecast published at Budget time; and most forward indicators, and outside commentators, also look for a real though quite possibly uneven rise in output over the next year. I fully agree that we must do all we can to encourage this.

3. You suggest an autumn package of measures and announcements. There will in any case have to be autumn announcements, broadly on the same lines as last year or maybe slightly fuller, covering outline public expenditure plans for 1983-84 and our decisions, even if at that stage they are for "no change", in respect of National Insurance Surcharge and National Insurance Contribution rates to take effect from April 1983. In the autumn, too, we shall have, and shall be publishing, the half-yearly economic forecast required under the Industry Act. Measures of the kind

you propose - or something of the same kind - do indeed come up for consideration then: it would be premature to consider them in detail now.

4. Nevertheless perhaps I can make some general comments.

5. First, I think that we shall have some announcements to make before the Recess - for example, we are in touch about new Enterprise Zones, and you have seen my letter to Arthur Cockfield about Hire Purchase controls.

6. So far as measures which will involve public expenditure are concerned these must I think be considered in the context of the current PESC round. In my view, the international outlook - not least for interest rates - requires us to stick to the public expenditure plans published only four months ago. The reasons are set out in my paper and that of the Chief Secretary; they include the need to keep room for tax reductions which so many people would like to see - including yourself in the case of the NIS. If it were felt that the sort of spending measures you propose should be given priority - and I understand the case for them - I think it is reasonable that this should be in the context of an overall unchanged public expenditure total, and that room for them should be found be savings elsewhere, not necessarily from the provision for your Department.

7. On NIS, the way we, quite deliberately, set about this year's reduction does indeed mean that unless a decision to the contrary is taken in the autumn the current going rate of 2 per cent will revert to $2\frac{1}{2}$ per cent. I appreciate the desirability of not letting this happen, and I note what you say about the desirability of bringing the rate down further. The difficulty we shall face in the autumn, I fear, is that we shall then have to assess the risk that if we do announce a going rate of 2 per cent (or less) from next April, we might find, come the Budget, that we had over-relaxed and that tax increases in other areas were necessary. These other areas would inevitably involve, if not entirely

comprise, individuals. Our record on personal tax, and in the "Why Work" and poverty and unemployment trap areas, is not good and I would be reluctant further to worsen it - particularly in the next Budget. So we shall need to be cautious in the autumn. But I do see the problem involved in reverting to 2½ per cent NIS rate.

8. At the time of the last Budget, as you know, we envisaged for 1983-84 a positive "fiscal adjustment" of around £½ billion, and our current forecast does not alter this materially. The risk is that if we were to go for the sort of package you had in mind we would have to raise taxes or interest rates - and would certainly forego the prospect of making reductions. The difficulties with taxes are obvious. And interest rates, you point out, are one of industry's most important costs; we can only have a reasonable chance of making further reductions if we maintain external and domestic confidence in our financial management. I remain of the view that continued downward pressure on interest rates should be a top policy priority.

9. Final decisions in these matters cannot and need not be taken now. They will have to be reviewed in the autumn and finally settled at the time of the next Budget. Of course I shall bear in mind the merits of the sort of proposals which you put forward. But we all have to bear in mind the risks to recovery that could be involved in misjudged letting up. What we see happening in many overseas countries shows the dangers of succumbing to the temptation of excessive borrowing. The recovery is indeed slow and patchy, but action which prejudiced our general policy stance would be an inappropriate reaction to the slow pace, which is largely caused by events abroad.

10. To summarise, therefore, the points you make, both general and specific, can be taken into account in the autumn. The proposals which involve public expenditure do not necessarily conflict with the need to keep within the present planning totals:

I am sure they will be taken up in the further discussions which the Chief Secretary will be having before final decisions are made. I note what you say about the desirability of a reduction in the National Insurance Surcharge. I accept that there is a balance to be struck between sticking with our fiscal and monetary policies, on the one hand, and on the other the more visible, though not necessarily more real, benefits that might come from measures which require them to be modified. But in my present judgement - which takes full account of the Sam Brittan piece to which you refer - we have currently got the balance about right, in relation to our own circumstances and the world in which we live.

11. In the last Budget we managed to achieve a reconciliation of continued stability in our monetary and fiscal policies - which has led to pronounced progress recently on both inflation and interest rates - with some real and visible tax reductions and other measures which largely benefited industry. I would hope, though of course I cannot promise, that we could achieve the same again for the next Budget; though of course if this were possible it would be a nice question of political and economic judgement how any tax reductions which were available should be shared in the first place between industry and individuals. As I did before the last Budget, I would expect to discuss this with my colleagues before the next one.

G.H.

14 July 1982

I am copying this minute to the Prime Minister and other Members of the Cabinet, to the Chief Whip and to Sir Robert Armstrong.

0.10

for Cabinet folder

Prime Minister

Relevant to Public Expenditure Cabinet.

MES 14/7

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

PRIME MINISTER

THE INTERNATIONAL ECONOMIC SCENE AND OUR OWN POLICIES

In view of their implications for our own policies, it may be useful to bring to your attention some recent impressions of the international economic scene.

2. There were opportunities in Washington and Paris last week to hear the latest US views on interest rates. In Washington there were Versailles follow-up discussions, which Ken Couzens attended, on the proposed study of exchange rate intervention; and on the Group of Five consultations about convergence of policies in the interests of greater exchange rate stability, which Larosiere is to attend. (There will be meetings of Finance Ministers in Toronto on these subjects during the IMF Annual Meeting in September, but it would be wrong to expect rapid developments.) There were also OECD discussions last week on US interest rates, on international financing through the banking system and on prospects for recovery in the light of the recent OECD half-yearly forecast.

3. Perhaps the most authoritative view on US interest rates was that of Henry Wallich of the Federal Reserve. He told Ken Couzens that he expected rates to decline gently over the next year or so because of falling inflation but could not exclude "blips" around this trend. However US officials generally remained puzzled about the high level of real US interest rates and, because of the constitutional relationships and the aspects of the Budget which the Administration have excluded from change, gave an impression of

powerlessness and uncertainty. In addition to concern about financing the Budget deficit now forecast, US interest rates clearly contain a premium for uncertainty: about budget overruns, about risks of corporate failures, about the true prospect for inflation. Confidence is lacking.

4. I found in Brussels on Monday that Community Finance Ministers shared many of these impressions of the US scene. They, like me, are concerned to secure what independence we can from US interest rates. The German view, which is clearly the most important, is that some independence is possible, but within limits. That is our own experience.

5. This situation suggests an unfavourable international economic climate with a slow OECD recovery attended by an unusual degree of risk. Against this background I am sure we are right to continue our policy of gradual reduction of interest rates as the situation permits, and yesterday's ½ per cent reduction in base rates is a move in the right direction. But we cannot risk a break in confidence which could rapidly oblige us to reverse the interest rate gains we have made and the negative differential against US rates we now enjoy.

6. That is why it is particularly important to avoid the wrong outcome on public expenditure this year. If, against a very uncertain international background, the announcement - or even rumours - of big public expenditure increases were to undermine market confidence, that could prove very damaging to interest rates and so to the prospects of growth.

7. Copies of this minute go to the Foreign Secretary and to Sir Robert Armstrong.

G.H.

July 1982

CONFIDENTIAL

JU425

AW

DEPARTMENT OF INDUSTRY
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Secretary of State for Industry

13 July 1982

Rt Hon Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1

Prime Minister (1)

Mr Jenkin argues for an autumn package for industry of £1 billion!

MCS 13/7

Dear Geoffrey,

THE OUTLOOK FOR INDUSTRY

We are to have a discussion in Cabinet on Thursday about the economy, and it may be helpful to you and colleagues to have some advance indication of my views on the outlook for industry.

2 It is already clear that industrial performance has not picked up in the way we expected at the time of the Budget. So far this year neither total output nor manufacturing output has registered any increase on the low levels of the second half of 1981.* Mainly because of the flatness in manufacturing industry, output growth in 1982 is likely to be well below the Budget and MTFS forecast. More recent assessments, notably by the OECD, emphasise the deteriorating prospects for British industry in both home and especially export markets. The latest CBI survey shows no sign of a recovery in output and in certain respects eg export order books, the situation appears to have been worsening over the past few months. This is consistent with reports reaching me that some of the largest companies are considering further cuts in investment and employment.

3 Of course, there are some encouraging features for industry - an improvement in profitability, some recovery in competitiveness and above all the falling rate of inflation. The leading indicators and the forecasters without exception still predict a modest recovery next year.

4 However, the adjectives most commonly used by industrialists to describe their prospects are 'flat' and 'sluggish', and a delayed upturn is the picture that emerges, at best. I am concerned that the delay will have serious consequences for industry and employment. Moreover, any ground lost this year seems unlikely to be made good next year. I am also concerned about the considerable downside risks in the present situation which may delay the upturn even longer; particularly the risk of deteriorating prospects in export markets and our continuing vulnerability to import penetration. The basic cause for concern is that despite recent progress, industry's competitiveness is still 40% worse than 4 years ago.

*though I have just seen that the May figures are a little more encouraging.

5 Against this background we ought to consider seriously what further steps should be taken in the near future, primarily to reduce industry's costs and so improve its competitiveness, thereby enhancing the prospects for more secure jobs. The main objective should be to help UK manufacturers to secure a larger share of both their home and overseas markets.

6 Further reductions in interest rates would be welcome for this purpose. As well as having a significant direct effect on costs - 1% is worth £250m to industry - lower interest rates would also exert downward pressure on the exchange rate which has been responsible for about one quarter of industry's loss of competitiveness since 1979. I understand that interest rates were expected to drift downwards after the Falklands crisis, and I think it is important not to stand in the way of market forces which might help to bring about such a movement, accompanied by a modest depreciation in the effective exchange rate. However, as interest rates and exchange rates are subject to so many external forces, notably in the USA, I see a need for other, and more certain, ways of improving industry's competitive power.

7 My own judgement is that a carefully chosen package of measures to assist industry totalling at least £1 billion announced or implemented soon after the recess, would give a useful boost to industry without undue risk to our monetary strategy. I also note that some respectable commentators (eg Sam Brittan) are calling for a bigger stimulation to the economy as a whole. So far as industry is concerned, you will not be surprised that my first priority is a further reduction in the National Insurance Surcharge. The gloomier outlook for industry and employment strengthens the case for phasing out this tax on jobs and exports as quickly as possible. But this year's Budget arrangements mean that the rate will in fact increase from 2% to 2½% next April unless a decision to the contrary is taken by the autumn. Just to maintain the rate at 2% from next April would reduce industry's costs by some £400m in 1983/84 and at the very least an early announcement of this decision would help to raise industry's confidence in the meantime. However, I believe there is a sound case for a full percentage point reduction next April and I would like to urge that upon you. We must also look carefully at the related question of the size of next year's National Insurance Contributions by employers and employees, especially at the combined cash flow effect on industry.

8 Particularly because it would not take effect for 9 months, I do not consider a ½% reduction in the NIS rate would be a sufficient response to the present situation. We also need to take some action that will have a quicker effect. There are several possibilities.

9 A revival of the small engineering firms investment scheme (SEFIS) would make an almost immediate impact. This scheme is a most effective way of encouraging small firms to become more competitive through the acquisition of technologically advanced and

more productive equipment, and it also provides much needed additional orders for the vital machine tool sector. (Over 60% of orders under the scheme have been for British equipment). It has been an outstanding political and industrial success and the fact that the £30m allocated to the scheme was exhausted within a matter of weeks indicates that it has considerable further potential. I therefore recommend that we consider reviving this scheme, after reviewing its scope and coverage, with an allocation of £100m for this purpose.

10 Ending the 4 month deferment in the payment of Regional Development Grants is another measure which would give an immediate financial boost to industry in the Assisted Areas at a once for all cost of £140 million. This proposal was a late casualty in the run-up to this year's budget, and I strongly urge that it should now be implemented. It would also have the incidental but important benefit of saving Departmental manpower. A more modest alternative would be to end the deferment only for small firms employing up to 100, which would reduce the cost to £25 million.

11 More specifically related to our export performance, I would advocate more generous Aid/Trade Provisions under the aid programme. The terms of the international consensus governing officially supported export credit are hardening in ways which are bound to be detrimental to our exporters of heavy capital goods, and we must be ready to face an increasing resort to aid/trade mixtures if we are to gain a fair share of the available business. Such orders tend quickly to be reflected in jobs at home. Certainly I hope we can avoid the extraordinary agonising over marginal concessions of the kind involved in the current Klang Power Station case in Malaysia.

12 Finally, I think we should consider the scope for a stimulus to the civil engineering side of the construction industry. The Budget measures are having a beneficial effect on housing but the rest of the industry is being hit very hard by the recession. As you know, the CBI attach high priority to some help from Government in this quarter where there is very little import penetration. They claim that a quick and widespread effect on activity and employment with a useful spin off to other parts of industry could be achieved by a programme of infrastructure maintenance and repair eg on roads and sewers. So far as roads are concerned, a targeted programme could be helpful in promoting our proposals for implementing the Armitage report on heavy lorries thus reducing industrial transport costs. Altogether there would be direct and indirect benefit for industry here and I should be interested to hear the views of Michael Heseltine and David Howell on whether action on these lines might be feasible.

HP Controls

13 In addition to this package, I should also like to support

the idea of a relaxation of hire purchase controls. The Society of Motor Manufacturers and Traders have recently written to you renewing their request for a relaxation of the controls as they affect motor vehicles and I support their suggestion as a minimum step that we might take. Arthur Cockfield, in his letter of 28 June, has gone further and proposed total abolition of controls. He has put forward good reasons for taking this more radical course and I do not wish to argue against him. However, we do need to be careful that industry is not taken unawares by a major change of this sort with a possibly damaging influx of imports. Although I am in favour of abolition there is therefore something to be said for moving one step at a time.

14 In sum, what I am seeking is an autumn package of measures and announcements which will mitigate the heavy downside risk which now seriously threatens even the very modest growth forecasts following the budget. Measures worth about £1 billion to industry's cash flow ought to be feasible without undue risk to expectations about inflation, and would indeed serve to fend off a further round of cuts in manpower and investment and output which would be highly damaging to our longer term industrial prospects.

15 I am copying this to the Prime Minister and other Members of the Cabinet, to the Chief Whip, and to Sir Robert Armstrong.

Yours ever

Patrick

RECORD OF A DISCUSSION ON THE JUNE FORECAST IN THE TREASURY AT 11 A.M. ON 13TH JULY

Present:-

Chancellor	Mr. Burns	Mr. Cassell
Chief Secretary	Sir Kenneth Couzens	Mr. Kemp
Financial Secretary	Sir William Ryrie	Mr. Ridley
Economic Secretary	Mr. Middleton	Mr. Kerr
Minister of State (R)	Mr. Quinlan	Mr. Riley

Papers

1. The meeting considered the forecast report of 30 June, together with Mr. Burns' minutes of 30 June and 12 July; together with comments from the Financial Secretary, the Economic Secretary, the Minister of State (C), Mr. Ridley, and Professor Walters' letter of 5 July to Mr. Burns.

International Background

2. The Chancellor referred to the discussion of the international situation at his meeting with the Governor on 8 July. The US position remained threatening; but he and the Governor had concluded that our best course lay in continuing to do what we could, in consultation with our European partners, and particularly the Germans, to insulate ourselves from the effect of continuing high US interest rates. He had some sympathy for Mr. Ridley's argument (minute of 12 July) that the forecast might be rather bullish about the future price of oil. It was pointed out that the North Sea price might hold even if there were a fall of $1 or even $2 in the world price; and that the dollar's strength boosted our revenue take. But it was nevertheless agreed that OPEC's disarray strengthened the downside risks to future revenue though not by so much as to lead us to wish to take fiscal action, invoking the contingent threat in the Budget speech.

Are monetary and fiscal policies too tight?

3. The Chancellor referred to the Financial Secretary's view that some mild relaxation of the fiscal stance might be worth considering; to Professor Walters' concern that monetary policy might be too tight; and to Sam Brittan's article in the Financial Times on 8 July suggesting that money GDP was growing at a rate lower than would be consistent with the MTFS, and that a fiscal stimulus would be appropriate. Representations to him and to the Prime Minister from industry - and perhaps shortly from the Secretary of State for Industry - suggested that we were still bumping along the bottom of the recession, and that action to stimulate output was becoming urgent. Mr. Burns, however, pointed out that the adverse changes between the Budget and June forecasts were not particularly significant; and that post-Budget developments in the real economy had not out-dated the Budget judgements. To change course now would mean accepting that these judgements had been wrong. The Financial Secretary, while accepting that the June forecast reduced the expected increase in total output in 1982 and 1983 by only ½ per cent in each year, thought that the very fact of a deterioration in economic prospects, widely diagnosed outside, was politically and psychologically damaging. He would not wish to propose a "package" as such, but he thought that it might make sense to take whatever opportunities arose for modest measures of fiscal relaxation in particular areas.

4. Mr. Burns and the Chief Secretary were however reluctant to envisage early fiscal action. The revisions to the forecast did not amount to a case for such action, and fiscal policy was expected to be easier this year than last. Moreover, action now might create difficulties later in the year, when it might be politically necessary to act to make the 2 per cent NIS rate permanent, and a bad outcome from the Public Expenditure Survey could create a requirement for fiscal action in the opposite direction. Sir William Ryrie agreed that fiscal changes now were to be avoided: if mid-year action had to be taken, it should be in the autumn.

5. On Sam Brittan's argument about money GDP, Mr. Burns pointed out that the June forecast revised downward the 1982 growth of money GDP by only 1 per cent; and Mr. Middleton recalled that in the pre-Budget discussions about monetary targets, it had been decided that money GDP was not appropriate to prescriptive planning, since neither the pay nor the output levers were in the Government's grasp. The Chief Secretary pointed out, however, that the presentation of policy in the past had sometimes implied a very direct trade-off between inflation and output, and might thus have created an expectation of a fiscal adjustment to encourage increased output in a situation where both inflation and growth in money GDP were declining.

6. The Chancellor thought that fluctuations in output, inflation, and hence GDP forecasts were inevitable. He still did not regard money GDP as a measure appropriate to prescriptive targeting. What struck him most was the comparison (Mr. Burns' minute of 12 July) between the first half of this year and the same period in 1981. Domestic demand was almost 4 per cent higher, but exports had risen by only 1 per cent, while imports had gone up by 11 per cent. Clearly the drive for greater competitiveness must be maintained. Mr. Cassell, agreeing, pointed out that the June forecast was for a steeper increase in average earnings in 1982, and a markedly steeper increase in 1984, than had been suggested in the Budget forecast.

7. The Chancellor concluded that the case for a substantial fiscal stimulus, as made out by Sam Brittan, was not sustained. For the present, the main assistance we could give to industry lay in bringing interest rates down as far and as fast as was prudently possible. The Financial Secretary was concerned that much of the benefit of interest rate reductions went not to industry but e.g. to those with mortgages: he would favour targeted assistance to industry, through assistance on loan finance. The consensus however was that reductions in interest rates were of general benefit, and were entirely appropriate given the monetary figures.

8. <u>The Chancellor</u>, summing up the discussion, thought that the balance of fiscal policy had not been proved wrong. It would be right to examine the case for a concession on NIS, and perhaps on electricity prices, in the autumn; to continue the search, suggested by the Minister of State (C) (minute of 9 July) for further cost-effective measures to reduce unemployment; and to look again, as the Financial Secretary proposed, at the question of a small business loan finance package. But the current overall direction of policy, and emphasis on stimulus to output through reductions in interest rates, should be maintained.

J.O. KERR
14 July 1982

Distribution:-

Those present
Minister of State (C)
Sir Douglas Wass
Sir Anthony Rawlinson
Mr. Byatt
Mr. Evans
Mr. Moore
Mr. Dixon
Mr. Hall
Mr. French
Mr. Harris

010

Prime Minister

MS 13/7

Econ Pol

HOME OFFICE
QUEEN ANNE'S GATE
LONDON SW1H 9AT

Dear Private Secretary

ECONOMIC STRATEGY

The Home Secretary very much regrets that he will be unable to attend the meeting of the Economic Strategy Committee on Wednesday 14th July. He has had a long standing engagement to address the Association of Civil Defence and Emergency Planning Officers Annual Study at York.

I should be grateful if you could convey the Home Secretary's apologies to the Prime Minister on this occasion.

A copy of this letter goes to David Wright.

Yours sincerely

Karin R Fisher

KARIN R. FISHER
Assistant Private Secretary

M. Scholar, Esq.

13 JUL 1982

PPS/CHANCELLOR

file no TEB/CA/01

copied to:

Mr Salveson (for transmission to No.10)
PS/CST
PS/FST
PS/EST
PS/MST(C)
PS/MST(R)
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PS/Lord Chancellor
PS/Foreign Secretary
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PS/Lord President of the Council
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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 BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 5 July, are sidelined.

M M Deyes

M M DEYES

RIGA

R I G ALLEN

12 July 1982

EB Division
H M Treasury
01-233-3364

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ECONOMIC BRIEF: CONTENTS

A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

[Longer term economic policy objectives discussed by Chancellor in CPC lecture 3 July, and interview published FT 5 July.]

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. Economy still in recession?

Recession can be defined in different ways. What is quite clear is that activity reached a turning point in first half of last year, and that a modest recovery has begun - and is projected to continue.

3. Government policies caused recession by deflating demand?

[Industrial production down 11 per cent; GDP (output) down 5 per cent; total final expenditure down 1 per cent since first half 1979.]

No. Output had fallen much more strongly than demand during the current recession. At same time import penetration has continued on rising trend. Essential problems of economy lie on 'supply side' - lack of competitiveness etc. Government policies aimed at helping industry to redress these problems by : deregulating, restoring incentives and implementing a financial strategy under which inflation and interest rates can fall over the medium term.

4. Economic recovery in doubt?

[GDP figures for Q1 1982, published 22 June, show little change on Q4 1981. Industrial production also broadly flat since last autumn, but still 2 per cent higher than a year ago. NB May industrial production figures to be released Tuesday 13 July.]

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

5. What factors caused recent flattening out in recovery?

Recovery is slow and fragile.Number of factors - temporary rise in interest rates last summer/autumn; temporary pause in progress on reducing inflation; slower, and later than expected, world recovery - could all have weakened confidence and activity. But prospect is for resumed, if slow, recovery.

6. Tighter than expected fiscal policy to blame?

[Latest published estimate of 1981-82 PSBR £8.8 billion compared with Budget time estimate of £10.6 billion.]

Relationship between PSBR and output extremely complicated (especially since precise reasons for undershoot not well understood). Essential to consider influence of fiscal and monetary policies together. Firm control of Government borrowing essential to maintain downward pressure on interest rates; latter have fallen since last autumn and this can only improve prospects for recovery.

7. Recovery depends entirely on developments in the US?

Clearly cannot isolate ourselves from international developments. Lower world interest rates (particularly in US) would undoubtedly benefit the world economy and the UK. But UK policy certainly not determined in Washington, or Wall Street. At turn of year, UK short term interest rates were above those in US, currently below.

8. 1981-82 PSBR outturn inconsistent with MTFS?

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

9. Fiscal boost desirable?

[Sam Brittan FT 8 July argued money GDP growth in 1982-83 may under shoot MTFS figure of 9½ per cent per ~~/~~ hence fiscal boost could be accommodated 'in the context of a reaffirmation of the MTFS'.]

kent;

Last year's PSBR undershoot probably meant that fiscal policy was somewhat tighter than expected. But it helped fall in interest rates - now down from last September's peak of 16 per cent. There is no reason at this stage to depart from Budget forecast of PSBR for this year, or to challenge Budget judgement.

10. OECD comments on UK economy

[OECD Economic Outlook July 1982 published 7 July.]

Report presents reasonably balanced and fair assessment of policies and prospects, close in many respects to most recent independent forecasts. It predicts a resumption of gradual recovery, a further reduction in inflation, and encouraging further substantial improvements in productivity. (See also B, and T for view on World economy.)

11. Latest (June) Bank of England Quarterly Bulletin?

[Published 1 July].

It is for the Bank to comment on the detail of their assessment. But wrong to interpret Bulletin as particularly gloomy: sees continued progress in reducing inflation, further productivity gains, and resumption of (slow) recovery. While Bank is right to emphasise continuing difficulties and uncertainties of world economy, recently some more encouraging signs from US (eg further pick-up in leading indicators.)

12. Progress on inflation not being maintained?

[12-monthly increase in RPI rose from 9.4 per cent in April to 9.5 per cent in May-June RPI to be published 16 July.]

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

13. Unemployment accelerating again?

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

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

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

(See also Section C.)

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

[Report published 17 June.]

Government will want to consider its recommendations. We did draw attention in our evidence to the various practical and other constraints and also to the progress already made in the Armstrong direction under this Government (eg MTFS). Will be thinking carefully about recommendations to publish Green Book/PEWP in January etc. But cannot anticipate reply to the report.

BULL POINTS | As at 12.7.82

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

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

(iii) Total housing starts up 37 per cent in five months to May 1982 on 1981 average.

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

(v) Inflation. 12-monthly increase in RPI now in single figures - 9.5 per cent in May - more than halved since spring 1980 peak (21.9 per cent). Inflation in April and May lowest since January 1979, but trend now firmly downwards, not upwards as then. Manufacturers' output prices up just 8¼ per cent in year to June.

(vi) Costs.

- Increase in average earnings halved in 1980-81 pay round. Public sector pay in line. Further moderation in average level of settlements in current round. CBI pay databank for manufacturing settlements suggests average now around 7 per cent compared with 9 per cent in previous round.
- Little increase in manufacturers' unit wage and salary costs over last year - only 3 per cent up in year to 1Q 1982, below average of our major competitors and comparable to that of Germany and Japan.
- Manufacturers' input prices up just 5½ per cent in year to June.
- CBI April survey shows lowest degree of unit cost pressures for 15 years.

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

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

(ix) Profits: Industrial and commercial companies gross trading profits (net of stock appreciation excluding North Sea) risen since 1Q 1981. In 1Q 1982 40 per cent higher than a year earlier. Recovery in profits from very low base: ICC's pre tax real rate of return just 2½ per cent in 1981.

(x) Exports have held up better than many feared following 50 per cent loss of competitiveness between 1975 and 1Q 1981. In 9 months to May 1982 non-oil exports (excluding erratics) slightly (about 1 per cent) higher than in 1980.

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

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

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

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

ECONOMIC ACTIVITY AND PROSPECTS

[NB: Industrial production figures for May to be released Tuesday 13 July].

1. Recovery faltering?

- Taken together, all three measures of GDP suggest some hesitation in recovery in Q1 1982, but GDP remains above levels of last spring. In part reflects impact of very severe weather and industrial disputes at turn of year.
- Some recovery in industrial production in February and March, but little change in April. Underlying level of industrial/manufacturing output broadly flat over last 6 months.
- Manufacturing productivity risen 12 per cent since end 1980. Industrial and commercial companies' gross trading profits (net of stock appreciation) up 40 per cent in year to Q1 1982. Inflation 9.5 per cent in May. Interest rates fallen 3-4 points since autumn. Competitiveness improved by 10-15 per cent since Q1 1981.
- Prospect of resumed and continuing recovery broadly shared by business opinion surveys, bulk of outside forecasts and CSO's cyclical indicators. Leading indicators suggest continuation of recovery after some hesitation through early 1982.]

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

2. Other evidence of improvement in economy?

See Bull Points (following Section A).

3. Latest CBI assessment gloomy?

[CBI Enquiry for June reports little change in order books or stocks since last April, and expectations of broadly flat output over next four months. S. Brittan (FT 5 July) suggests 'preliminary evidence' of more pessimistic July CBI enquiry and lower CBI forecast of growth.]

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

4. Government's own forecasts?

[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)	4¼	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 major post-Budget assessments:

	NIESR (May)	LBS (June)	St James (Apr)	Phillips &Drew (July	CEPG (April)	CBI (May)	OECD (July)	FSBR (March)
Per cent change 1982 on 1981	+1	+1	+1¼	+1½	-½	+1	+1¼	+1½]

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

6. Outside forecasts for output growth in 1982 revised down?

[Several groups (eg P & D, LBS, NIESR) have revised downwards (slightly) their forecasts for assessment of growth in 1982. But downwards revisions largely reflect (following recent disappointing output figures) revised view of timing but not of strength of recovery. Latest OECD Economic Outlook forecasts 1¼ per cent growth in 1982 (compare ¼ per cent in December forecast) - more in line with other groups.]

True that some outside forecasters have revised their assessment of growth in 1982 downwards but only slightly. And this partly reflects a timing change; most see slow growth resuming later in year. Note that OECD now much more in line with other groups. (See also A3).

C LABOUR MARKET

1. Recent unemployment figures and other labour market indicators?

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

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

[Other labour market indicators (overtime, short-time, hours worked in manufacturing) improved during 1981, but have shown no further improvement since turn of year.]

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

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

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

2. Unemployment expected to continue rising rapidly?

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

Unemployment forecasts uncertain; independent forecasters encompass differing views for 1983 - several projecting stabilisation, some [a slight] decline. Rise in unemployment so far this year less than half that of a year ago. Employment situation will benefit from some further recovery in activity this year (see B1).

What is Government's own forecast of unemployment?

Government does not publish a forecast of unemployment, or employment, at Budget time (nor does it ever do so). However it was assumed in Cmnd 8494 that unemployment (GB, excluding school leavers) would average 2.9 million in 1982-83, and for rest of survey period. Current (June) figure is 2.91 million and, though this is still rising, it is not inconsistent with PEWP figure.

4. Employment continuing to fall?

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

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

5. Unemployment higher than in other countries?

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

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

6. What is Government doing to provide more jobs?

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

7. MSC Task Group proposals on youth training?

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

TAXATION

[NB 3rd Reading Finance Bill Tuesday 13 July]

1. Burden of taxation

[Total taxation (i.e including for example income tax, indirect taxes, corporation tax, rates and NIC) in 1978-79 was 34½ per cent of GDP (at market prices), 36 per cent in 1979-80, 37½ per cent 1980-81. It is forecast to be 40 per cent in 1981-82 and 39¾ per cent in 1982-83.]

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

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

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

3. Burden has fallen for the rich?

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

4. Burden has risen most for the poor?

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

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

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

1/1

6. No improvement in incentives?

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

7. Poverty trap/unemployment trap getting worse?

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

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

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

9. Budget reduction in NIS not enough for industry?

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

10. Excise duties increases inflationary/harmful to industries

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

11. How has Government used fiscal incentives to encourage wider share-ownership?

Total of over 460 profit-sharing and share option schemes now approved by Inland Revenue. Compares with less than 30 in May 1979. Reflects liberalisation and extension of arrangements to promote profit-sharing and share-option schemes contained in 1980 Finance Act. Further fiscal encouragement on way from 1982 Finance Bill.

12 Real weekly net income has fallen since 1979 ?
/Parliamentary Answer 7 July W 111-2 /

On basis of the Question asked ,yes. Lower paid family breadwinners of course now be entitled to more FIS as well .

E PUBLIC EXPENDITURE AND FINANCE

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

1. Public expenditure too high?

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

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

Ratios in 1980-81 (43 per cent) and 1981-82 (44½ per cent forecast) remain below 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.

3. Ratio to GDP must grow unless big improvement in economic performance?

[David Blake article The Times 30 June on official study of long-term public expenditure.]

An official study prepared on long-term public expenditure as part of normal, and continuing, process of controlling public expenditure and monitoring longer term effects. Has yet to be considered by Government. But report may point too pessimistic picture of level of public expenditure in long term. Government's policies are designed to secure real and lasting improvement in our economic performance; evidence that they are succeeding. Inflation is already coming down faster than expected at budget time.

4. Study on longer term public expenditure concludes that unemployment could stay at 3 million for rest of decade?

This is not a conclusion of the study. Report does not make any forecast of future unemployment - it uses a purely hypothetical assumption, intended to show what might happen to public expenditure if the worst is assumed about unemployment.

5. Increase spending in recession?

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

6. Spending Ministers seeking extra £5,000 million public expenditure in 1983-84?/Treasury once again seeking cuts in public expenditure?

Bids for additional expenditure have been put forward in usual way as part of annual public expenditure survey. Ministers collectively will have to decide which are to be allowed and, depending on size of any increase, to what extent the increase should be met by savings elsewhere.

7. 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. Planned capital expenditure also reflects decline in needs since early mid-1970s (e.g roads, schools). Planned spending should not jeopardise future standards and availability of public amenities and services.

8. What is being done to remedy inadequate appraisal of public investment revealed in recent C and AG report?

C&AG's report showed that when study on which it was based was made, two years ago, standards of investment appraisal in a number of areas were unsatisfactory. Improvement of these standards has since become an important part of the broader development of financial management throughout central government. Much has been achieved, through Treasury and departmental guidance and instructions, more training and closer monitoring. There is still a long way to go, but improvement of standards of investment appraisal remains a high priority.

9. 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.

10. End-year flexibility?

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

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

Only one third of current expenditure is on wages and salaries and much of that is for nurses, teachers, members of armed forces, police and so on. Provision for public service pay increases 1982-83 limited to 4 per cent. Administrative costs ae not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain drive for more efficient management throughout public sector.

12. What allowance will Government make for pay increase in public services next year?

Government attaches great important to realistic wage settlements next year, in both public and private sectors. Provision for public service pay will be made from within cash plans for 1983-84. (See also K12.)

13. Will Government's operation of cash limits for civil service [and NHS] pay change as result of Megaw Inquiry Report?

Government is committed to policy of using cash limits to control public expenditure. We will consider and discuss the implications of Megaw report in due course. (See also K12.)

LOCAL GOVERNMENT

14. Overspending in 1982-83? Government response?

Local authorities are budgeting to spend some £1½ billion above Government's plans (£1¼ billion in England, £200 million in Scotland, £60 million in Wales). Government cannot ignore this large planned overspend. In ENGLAND: Secretary of State for the Environment intends to implement scheme for grant abatement announced last year and is considering further across-the-board grant cut. In SCOTLAND: Secretary of State for Scotland is seeking to reduce grants of Lothian Regional Council (by £45 million) and Stirling District Council (by £1½ million). In WALES: Secretary of State for Wales has announced his intention to withhold grant. He also asked Welsh local authorities to submit revised budgets. Amount of grant to be withheld will be determined in light of these.

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

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

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

16. Effect of NIS reduction on local authorities?

As Chancellor announced in Budget, we intend that local authorities overall will be neither worse nor better off as a result of cut in NIS rate. We now propose that local authorities should pay the same rate of NIS for the whole of 1982-83. They will pay the lower rate of NIS for 1983-84, with an offsetting reduction in RSG.

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

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

CIVIL SERVICE STAFFING AND PAY

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

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

2. Civil service pay: non-industrial civil servants

[Settlement date 1 April 1982.]

Civil Service Arbitration Tribunal awarded pay increases ranging from 4.75 per cent to 6.25 per cent - worth 5.9 per cent overall - and increases in annual leave. Government accepted the award which is being implemented. Increases (announced 12 May) for the higher civil service (under-secretary and above) were larger; they were decided in the light of recommendations of Top Salaries Review Body. Cash limits and manpower targets not being adjusted. (See also Section K).

3. Megaw Inquiry

The report of the Megaw Inquiry into arrangements for deciding civil service pay in future has now been published (Cmnd 8590). Report contains a number of important recommendations which need careful consideration. (See also E12-13 and K9-10.)

4. Civil Service pay: industrials

[Settlement date 1 July 1982]

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

5. Scott Report/Public sector pensions?

See K 14.

G SOCIAL SECURITY

1. Increase in PSBR from deficit on National Insurance Fund?

[Government Actuary's Report, published 29 June, shows substantially increased deficits on NI Fund for 1981-82 (up from £153 million to £1,045 million) and 1982-83 (up from £94 million to £350 million). These figures distorted by CS strike; underlying deficits nearer £600 million in 1981-82 and £800 million in 1982-83.]

For 1981-82, the published outturn already takes this into account. For 1982-83, revised deficit is one of a number of factors which will affect PSBR but is not in itself, a sufficient reason to change our overall assessment of PSBR prospects.

2. Increase in National Insurance contributions because of NI Fund deficit?

The higher deficits for earlier years do not make inevitable an increase in contribution rates for 1983-84. A decision on the level of these rates will not be made until late Autumn and will take account of forecasts made at that time of Fund income and expenditure for 1983-84.

3. Restore abatement of Unemployment Benefit?

[17 Government backbenchers have put their names to an amendment to the Finance Bill intended to ensure restoration of the 5 per cent abatement of unemployment benefit.]

The abatement of unemployment benefit has been extensively discussed in House of Commons. We undertook to review the abatement when the benefit was brought into tax. This we have done. But this Government and Party is committed to reducing public expenditure. Restoring the abatement would cost £60 million in a full year. We are making good 2 per cent shortfall in last uprating. This applies to all benefits whether or not we are pledged to preserve their value. Including unemployment benefit - which we are not pledged to protect. (Cost of restoration for all benefits will be £515 million in full year.)

4. Death grant - increase to realistic level?

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

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

5. Merger of income tax and national insurance planned?

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

H PUBLIC SECTOR BORROWING

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

Budget forecast for 1982-83 was £9.5 billion. No reason to change this forecast. (See also A9.)

2. Implications of CGBR outturn in April and May for PSBR in 1982-83?

[CGBR for April to June inclusive (published 9 July) was £3.1 billion; April to June 1981 was £7.4 billion.]

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

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

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

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

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

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

[PSBR 1981-82 undershoot now appears to be less than originally thought: latest published estimate £8.8 billion, 1981-82 FSBR (published 9 March) estimated outturn of £10.6 billion.]

Reasons for undershoot still being assessed, but appear to be due to combination of factors. Central Government revenue was higher than forecast, and civil service dispute also contributed to unforeseen problems of interpretation on expenditure side.

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

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

7. Implications for fiscal policy and MTFS?

See A 6 and 8.

8. Effect of Civil Service dispute on PSBR?

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

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

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

10. Parliamentary control over borrowing?

[EST at Select Committee on Procedure 29 June].

Welcome interest shown in Procedure Committee. Will continue to provide information to help Parliament reach view on what is happening. Open mind to consider any suggestions from Committee about form of information. [IF PRESSED: Propositions for some form of control a different matter: could complicate policy decisions on spending and revenue].

J MONETARY AND FINANCIAL POLICY

1. Monetary growth in 1981-82

[Provisional figures for banking June (fourth month of target period) indicated that £M3, M1 and PSL2 grew by 0.8, 0.8 and 0.6 per cent respectively (seasonally adjusted). These changes bring annual rates of growth in 1982-83 target period to 9½, 6¼ and 9 per cent respectively, compared with target range of 8-12 per cent. NB Final money figures for June to be published 15 July.]

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

2. Monetary conditions too tight?

Exchange rate, money GDP and monetary aggregates suggest financial conditions have been moderately restrictive whilst allowing falls in interest rates. Growth of bank lending is still strong, however; we do not believe that monetary conditions have been too restrictive.

3. Bank lending

Banking June figure is again lower, indicating that growth may be slowing. But although part at least of recent growth is in substitution for building society lending and other forms of consumer credit, to the extent that it is additional it may add to inflationary pressures; so must continue to proceed cautiously on interest rates.

4. Interest rates still too high?

Interest rates have come down significantly over past 6 months. Bank base rates were cut by [a further ½ per cent] only [a few weeks] ago. Of course we would like to see rates lower still; but we must proceed cautiously if we are not to jeopardise progress made to date in reducing inflation. Lower inflation offers best prospect for sustainable lower levels of interest rates.

5. Bank of England and Treasury in conflict, one wanting hold up exchange rate, the other to get interest rates down?

Bank's operations in the money market represent an agreed course of action.

6. 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 interest rates have eased this year against US trend; but we cannot insulate ourselves from difficult international background. (See also T10.)

7. 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.

8. Why have you been 'over-funding' and providing large-scale money market assistance?

[Latest Bank of England Quarterly Bulletin carried small feature explaining process.]

The rapid growth of bank lending (much of which relates to structural changes) creates problems for conduct of monetary policy. By selling long-term Government debt on a larger scale outside the banking system it has been possible to contain the growth of money which the lending would otherwise have produced. If we had not intervened to relieve the resulting shortages in the money markets, the banks would have been forced to bid for deposits, raising short-term interest rates to levels which, according to other indicators of monetary conditions were not justified.

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

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

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

National Loans Act amendment is designed to remove an essentially fortuitous constraint on the Government's ability to borrow. Existing law could have prevented Government funding its borrowing requirement. Does not necessarily mean large increases in bill purchases. The scale of money market assistance will depend on the future course of bank lending etc.

Other measures designed to ensure it does not grow so rapidly - encouragement of corporate bond market and variable rate lending to local authorities.

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

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

12. Isn't Government simply acquiescing in rapid growth of bank lending and accommodating it?

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

K PRICES AND EARNINGS

PRICES

1. Inflation lower than under previous Government?

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

Year-on-year rate of inflation was 10.3 per cent and rising when previous Government left office. Now 9.5 per cent and falling on present forecasts we will be first Government for quarter of a century to successfully reduce the average rate of inflation during its term of office.

2. But inflation rising again?

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

3. How low inflation by end 1982?

[Budget time forecast Q4 1981 to Q4 1982 9 per cent and Q2 1982 to Q2 1983 7½ per cent.]

No new forecast to offer at this stage, but the year-on-year rate of inflation was already 9.5 per cent in May. In the coming months moderation in unit labour costs and competitive pressures on firms to limit price rises suggest Budget-time forecast of 9 per cent by this November could well be bettered.

4. Inflation still not as low as competitors?

[UK inflation 9.5 per cent in May, compared with 6.7 per cent in US, 5.3 per cent in West Germany, and 2.8 per cent in Japan.]

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

5. Movement in tax and prices index?

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

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

6. Nationalised industry prices

[Increase over 12 months to May 14.0 per cent, compared with an increase of 9.5 per cent in the RPI (see also R8)].

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

PAY

7. Current level of pay settlements

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

8. Average earnings index

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

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

9. NHS pay

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

10. Top Salaries Review Board increases too large?

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

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

11. Zero pay norm in next round?

[Chancellor's Speech 6 July.]

This Government is not in the business of setting pay norms. It is for individual employers and employees to make bargains they think right in their particular circumstances, bearing in mind that the greater the restraint, the better prospect for jobs for those on the dole. No right to automatic pay increases every year.

12. Will there be a new pay factor for public expenditure?

Not yet been decided whether plans for next financial year will be calculated on basis of an explicit 'pay factor'. However, Government finances large proportion of country's pay bill, and will have to ensure that its own actions are compatible with overall needs of the economy.

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

[Latest RPDI figures published 1 July show Q1 level much same as in Qs 2 and 3 1981 (Q4 discounted as 'erratically low'), and lower than Q1 1981.]

No. Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

14. Index-linked pensions and Scott report?

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

15. Incomes Policy

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

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

L. BALANCE OF PAYMENTS

1. May trade figures?

[Figures published 9 July show current account in around £35 million surplus in May, giving cumulative total of £0.9 billion so far this year. Exports fell by some £105 million, mainly due to a fall in oil exports and erratics. Imports rose by £205 million in May, due to higher imports of manufactured goods. Invisible surplus projected at £150 million a month].

Current account fell substantially during May, due to large fall in oil exports from April's high levels and £200 million increase in deficit on non-oil trade. Cumulative surplus this year approaching £1 billion.

2. Exports

Export volumes of manufactured goods now back at level of 1981 Q4, and holding up well. Export volumes (excluding oil and erratics) in three months to May were 7 per cent higher than a year earlier.

3. Imports

Imports of finished manufactures rose by £125 million, principally concentrated in capital and intermediate goods, reflecting a strengthening of investment activity. Imports of oil rose by some £35 million, accounting for some of the fall in the visible balance, while imports of basics, which also fell, remain 8 per cent higher than in 1981 Q1.

4. Geographical analysis of exports?

Exports to OPEC and other developing countries remain flat. Exports to North America have been adversely affected by the US recession and have fallen 1 per cent.

M EXCHANGE RATE AND THE RESERVES

1. Policy towards the exchange rate/falling £?

[Since last autumn sterling has remained broadly stable. The average £ effective rate in Q1 1982 was over 10 per cent lower than in Q1 1981. Previous lows were $1.7470 on 6 April, DM 4.098 on 21 May. Highs were $1.97 on 30 November, DM 4.407 on 9 February. Rates at noon on 9 July were $1.7205, DM 4.289 and an effective of 91.09. Reserves at end June stood at $17.7 billion, compared with $17.8 billion at end May.]

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

2. Bank of England intervening to support the rate?

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

3. Concerted intervention to reduce value of dollar?

All experience in recent years 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: matter for real concern is US fiscal/interest rate mix, a problem all countries are familiar with.

4. Improve UK competitiveness by devaluing exchange rate

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

5. Debt repayments

We have made excellent progress with our plans to reduce the burden of external debt substantially during this Parliament. We aimed to reduce official external debt to $14 billion by end of 1981. This has been more than achieved - external debt is now around $13 billion, compared with over $22 billion when the Government took office.

N EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. 1982 Budget - Parliament/Commission dispute

An agreement between the Parliament and the Council was signed on 30 June. If it is ratified by the European Parliament, it will provide the basis for settling the 1982 budget dispute, and also contribute to avoiding such disputes in future.

2. UK budget settlement

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

3. UK objectives for longer-term negotiations?

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

4. Implementation of budget settlement

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

5. Remainder of Commission 'Mandate' report

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

6. CAP prices 1982-83 and the Luxembourg Compromise

We made clear in Foreign Affairs Council on 25 May that we wished to have clarity about the EC's decision-making procedures. Four other member states shared our wish to re-establish the principle of unanimity when vital national interests are invoked. This is an improvement on 1966, though it is still an agreement to disagree.

7. Commission's ideas for changes to 'own resources' system

['EEC considers new source to boost budget': FT 5 July.]

Understand that Commission are considering measures to diversify Community's revenue sources. If they put forward proposals we will consider them. Our opposition to any increase in the 1 per cent VAT ceiling is well known.

8. Policy for CAP reform

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

9. 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

10. 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.

11. Join the EMS for exchange rate stability?

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

EXPORT CREDITS 'CONSENSUS'

12. Progress on Export Credit Consensus negotiations

In October 1981 participants of OECD-sponsored 'Consensus' reached an interim agreement on the new terms to be applicable for export credits. These terms were to be effective until 15 May 1982. The chairman of the Consensus's second set of compromise proposals were discussed at an EC Council of Ministers on 30 June. Proposals included reclassification of some countries and increase in interest rates charged to 'rich' and 'intermediate' country borrowers. These proposals have now been agreed subject to one outstanding issue concerning the country classifications of Greece and Ireland.

P INDUSTRY

1. NEDC meeting 7 July: union anger at call for lower pay rises?

Valuable exchange of views at July NEDC. True that TUC argued that Government was 'using unemployment to screw down wages'. Chief Secretary and Industry Secretary showed, however, that this was not the case. They argued that best way of improving outlook for employment was by becoming more competitive, and this meant reducing wage increases further and maintaining recent rapid increase in industrial productivity. High wage increases would only make matters worse.

2. Prospects for industry-recovery?

See A2 and B1.

3. Companies' financial position?

[Industrial and commercial companies (ICC's) - excluding North Sea - gross trading profits (net of stock appreciation) rose 40 per cent to Q1 1982. But rise was from very low base - ICC's real rate of return just 2½ per cent in 1981. ICC's finances showed some weakening in Q4, reflecting slowdown in destocking, and unwinding of civil service dispute, but finances better in 1981 as a whole -

£bn

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

Some apparent deterioration in financial position reflects slowdown in rate of destocking, and effects of unwinding of civil service dispute (which delayed companies' tax payments), but companies' finances much healthier in 1981 than in two previous years. Company liquidity improved considerably in first quarter of 1982 .

4. Rate of return still too low?

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

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

5. High interest rates damaging for industry and investment?

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

Budget measures have eased pressure on interest rates, and the recent ½ per cent fall in the banks' base rates is encouraging. But Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking. Continuing relatively high level of interest rates must be seen in context of priority attached to reducing inflation and need to control growth in money supply underlying the MTFS. (See brief J).

6. Government help for small firms

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

7. Response to Loan Guarantee Scheme?

[More than 4,440 guarantees already issued - about half to new businesses. Total lending under scheme just over £149 million. Budget provided for lending ceiling in first year (to May 1982) to be raised from £100 million to £150 million and for further £150 million to be available in second year (to May 1983). Thirty financial institutions now participating.]

Scheme operating successfully. Too early to assess overall cost . After first year, of the 4000 guarantees issued, only 48 have been 'called'. Cost has been more than covered by the premium income received over the period. Scheme is kept under continuous review.

8. Enterprise zones: response from private sector?

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

NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83 and future years?

Nationalised industries' total external finance increased by £1.3 billion in 1982-83 (£1.2 billion after allowing for NIS cut and other changes). Increase in 1982-83 was roughly half what the industries bid for. Government has given full recognition to problems faced by the industries in a period of recession. EFL's for 1982-84 will be announced later this year, as usual.

INVESTMENT

2. Investment plans unlikely to be attained?

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

3. But shortfall in capital spending 1981-82?

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

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

4. Take nationalised industry investment out of PSBR?

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

5. Is PM satisfied with the rate of return on capital in the nationalised industries?

[Pre-tax rate of return on nationalised industries' capital (including subsidies) has recently been announced as being minus-1 per cent (about the same as in 1979). This compares with 3 per cent for industrial and commercial companies.]

No. That is why we are continuing to press for greater efficiency within nationalised industries, and are setting realistic financial targets to ensure that the taxpayer and consumer get proper value for money.

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

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

7. Private finance for NI investment?

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

NATIONALISED INDUSTRY PAY AND PRICES

8. Nationalised industries' prices

[Having risen approximately in line with retail prices for several months, the May figures show bigger 12 months increase in nationalised industry, water and London Transport than all items RPI, ie 14.0 per cent compared 9.5 per cent. Restoration of this differential was expected; reflects March increase in LT fares and ending of electricity industry's rebates to consumers. Removal of these temporary distortions confirms that nationalised industry prices are still increasing somewhat faster than RPI, largely because of increases in energy sector. In May average gas and electricity charges were higher but average changes for telephone calls fell slightly following some price adjustments.]

Gap between nationalised industry price increases and RPI has been due in large measure to cumulative effect of years of artifical price restraint. World oil price rises of 1979 and 1980 have also played an important part. We greatly regret the need for these increases, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so. The differential between RPI and NI prices water charges and London Transport fares is now 4½ per cent compared with 14 per cent in January 1982. But sustained improvement will only be possible if the industries succeed in holding down their current costs, particularly pay.

PRIVATISATION

9. What further sales expected?

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

10. Special asset sales in 1981-82

Gross sales in 1981-82 totalled £481 million, so target published in 1981 Public Expenditure White Paper of £500 million nearly met. Pleasing result - included two large sales - Cable and Wireless (£182 million) and Amersham International (£64 million). True that delivery of BNOC oil in 1981-82 paid for in 1980-81 and taken into account in special disposals figure for that year reduced 1981-82 receipts by £573 million to total of -£92 million. But it is gross figure which is true measure of success of Government's privatisation programme. As Chancellor said in Cambridge 3 July, 'Public utilities and the so-called "natural monopolies" cannot be allowed permanently and without challenge to remain within State ownership'.

11. Government has sold assets too cheap?

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

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

12. Contribution to giving people satisfaction of property ownership?

Exercise of returning enterprises from State ownership to ownership by the public has included measures to promote employee share ownership in the enterprise they work for; for example free offers of shares (British Aerospace, Cable and Wireless, Amersham); preference in allocation of shares (B Ae, C & W, Amersham, BP); provision for matching shares - one for each share subscribed for - (B Ae, Amersham, BP). Most radical initiative taken by consortium of managers and employees who bought National Freight Company.

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S NORTH SEA AND UK ECONOMY

1. Onerous tax system damaging future field developments?

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

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

2. Chancellor's oil taxation package announced 9 June

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

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

3. Taxation of petrochemical feedstocks

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

Government convinced that new formula will give fair valuation. New valuation will not have effect of providing subsidy to ICI's competitors. Will do best to reassure ICI. Further consultations are taking place with ICI about the changes.

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

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

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

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

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

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve lower level of interest rates to benefit of industry and 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. 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.

7. Is the Government underestimating North Sea revenues?

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

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

8. Future North Sea oil prices?

A matter for commercial negotiation between oil companies and BNOC.

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

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

T WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

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

OECD's Economic Outlook (published 7 July) explains clearly why Western Governments are convinced 'a significant part of any stimulus to demand would increase public sector deficits, and dissipate itself rather quickly as an increase in inflation'. Furthermore, there is 'the possibility of re-igniting inflationary expectations, which became firmly established over a decade or more...' Remarkable unity on this at recent Finance Ministers' meetings and at Versailles Summit.

2. Western Governments' policies will increase unemployment to 32 million?

[OECD Economic Outlook forecasts unemployment 'approaching 32 million' in first half 1983 or 9 per cent of OECD Labour force (10½ per cent of Europe's. Also notes that unemployment is concentrated on the young, and that, in Europe, about one third of jobless have been unemployed 6 months and more.]

True that OECD forecasts rising unemployment - largely as result of increase in number of people looking for work. But OECD also forecasts employment to rise by over 2 million people in OECD area next year.

3. OECD says global recovery won't last?

[Economic Outlook warns investment so far shows little sign of pick-up needed for recovery to be self-sustaining. But same paragraph ends by emphasising importance of improving business outlook.]

Lower inflation should help reduce interest rates and coupling of these two with recovery in output will generate right climate for recovery in investment during 1983.

4. Versailles summit: international monetary undertaking

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

5. French government 'seen the light' over reflationary policies?

[French government announced package of austerity measures including 4 month prices and wages freeze (to reduce inflation to single figures), increases in social security and unemployment contributions and limit to budget deficit of 3 per cent of GNP in 1982]

Strength and stability of Western economies as a whole will benefit if France - and Italy - can control inflation. So we welcome French government's recognition that inflation is as serious a threat as unemployment and that reining in public sector borrowing is essential part of counter-inflation strategy. (See also M6.)

6. French prices and incomes policy more humane than massive deflation?

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

7. Anti-inflation policies are working

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

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

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

No. OECD's forecast for UK is close to most recent domestic forecasts and predicts average growth of about 1¼ per cent in 1982, rising to annual rate of 2 per cent in second half of 1982. That is very closely in line with OECD forecast for whole of Europe. Unemployment is expected to rise in all major countries except Japan. UK inflation still forecast to exceed OECD average in 1982 because of recent falls in inflation rates of USA, Germany and Japan, but UK should average OECD rate next year. Could do it this year if more responsibility in wage settlements.

9. Prospects for US economy?

[Leading indicators moved up for third successive month in May and preliminary Department of Commerce estimate of GNP showed slight rise in Q2, indicating recession has probably bottomed. But industrial production fell in April and May and seasonally adjusted unemployment is 9½ per cent. M1 near top of target range. Year-on-year rate of consumer price inflation down from 11 per cent in September 1981 to 6.7 per cent in May.]

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

10. US Budget?

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

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

11. US interest rate developments

[Prime rates still 16½ per cent, 3-month CD's dropped to 14.2 per cent]

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

12. 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.

U FALKLANDS CRISIS EFFECTS/COSTS

1. UK economy affected by Falklands crisis?

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

2. Effect of Falklands dispute on markets?

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

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

3. Will dispute with Argentina affect UK trade figures?

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

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

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

5. Effect of restrictions on Argentina?

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

6. Future of restrictions?

European Community have ended their measures; UK's remain in place. Waiting for cessation of hostilities to be confirmed; must also take into account Argentina's restrictions against us. Lifting of EC import ban (effective from 22 June) does not affect UK's own ecnomic measures (separately imposed under article 224 of Rome Treaty). Specifically agreed by the 10 Foreign Ministers that EC sanctions would immediately be re-instated if there were further acts of force in the South Atlantic.

7. Argentina's debts

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

Argentina may be seeking debt relief in talks with certain creditors about debt rescheduling. Not with British banks while freeze on assets continues. Proper rescheduling agreement would need to involve all creditors. [IF PRESSED on debt default possibility: banks have taken fairly relaxed at tude because ultimately overseas debt must be repaid by exports; Argentina's export sector is agriculture, which, according to most experts, is fundamentally healthy.]

8. Falklands defence costs?

[Specific figures for replacement of equipment, requisitioning merchant ships etc on BBC programme 8 July were speculative.]

Preliminary assessment of broad order of defence costs (excluding garrison costs) is about £550 million in 1982-83, and £200 million in each of the following two years. Non-defence costs (compensation, rehabilitation) are expected to be mi or in comparison. Totals should represent only a very small proportion of total public expenditure.

9. What will be costs of repairing damage and reconstructing the Islands' economy?

Too soon to say what these costs will be. Work has begun on restoration of essential services and on implementing Civil Commissioner's recommendations for priority action (accommodation, inter-Islands air service, education). Necessary financial provision is being made available. Not yet clear how existing FCO and ODA funds will be adequate and how far additional sums will be needed.

10. How will the various costs be met?

Intention is to try to absorb 1982-83 costs within the Contingency Reserve - and to some extent within existing budgets. Remains to be seen how far feasible. How future years' expenditure is to be funded will depend on decisions in forthcoming Public Expenditure Survey. Extra costs to defence budget (costs of the operation eg fuel, ship chartering, and equipment replacement) will be met out of monies additional to the 3 per cent annual rate of real growth already reflected in sums currently provided for defence. Decisions have yet to be taken on other programmes. In any case, the costs will be met in a way consistent with the Government's economic strategy.

AIDE MEMOIRE ON THE UK ECONOMY 12 July 1982

RECENT DEVELOPMENTS AND INDICATORS

(i) Activity. GDP fell by 6 per cent between 1979 H2 (last cyclical peak) and 1981 Q2 (trough of current recession), rose about 1 per cent between 1981 Q2 and 1981 4Q then declined by ½ per cent in 1982 Q1. Weakening at turn of year in part reflects impact of severe weather and strikes, but underlying level of output broadly flat in 6 months to March 1982; above levels of last spring. Most independent forecasts, business opinion surveys, and CSO's cyclical indicators expect resumed and continued recovery.

Volume of new engineering and construction orders in 1981 up 15 and 11 per cent on 2H 1980. Whilst home orders have continued to improve in early 1982 export orders tended to weaken around the turn of the year. Private housing starts up over one third between 2H 1980 and 1981. Total housing starts in 5 months to May 1982 up 37 per cent on 1981 average.

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

(ii) Lack of complete trade figures for 1981 and changed documentation procedures make recent figures difficult to interpret. Exports have held up better than many had feared. In 9 months to May non-oil exports slightly (about 1 per cent) higher than in 1980. Non oil imports have risen - up 13 per cent in same period - in part reflecting reduced rate of destocking and further rise in import penetration ratio. Current account estimated to be in surplus of £1 billion in first five months of 1982 following £7 billion surplus in 1981.

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

(iv) Wages and prices. Increase in earnings in 1980-81 pay round 11 per cent (settlements averaged about 9 per cent), half that of previous pay round. Settlements well inside single figures are now widespread (CBI average for manufacturing 7 per cent) suggesting further moderation in current pay round. 12-monthly increase in RPI 9.5 per cent in May; well inside single figures. Recent progress suggests outturn to November this year could well be within Budget time forecast of 9 per cent. Manufacturers' input prices up just 5½ per cent in 12 months to June. Corresponding rise in manufacturers' output prices 8¼ per cent.

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

(vi) Company finances. Gross trading profits of ICCs (net of stock appreciation excluding North Sea) rose about 40 per cent in year to 1Q 1982. But real pre tax rate of return just 2½ per cent in 1981. Despite rise in company borrowing and deterioration in liquidity in 4Q 1982 (largely reflecting reduced sale of destocking and unwinding of civil service dispute which delayed companies' tax payments), company finances healthier in 1981 as a whole than in 1979 and 1980. Company liquidity improved in 1Q 1982.

(vii) Monetary aggregates. £M3 grew at an annual rate of 13 per cent in 1981-82 target period (from mid-February 1981 to mid-April 1982) compared with target range of 6-10 per cent. At least part of excess reflected increased market share of banks in mortgage lending. Over the same period, M1 and PSL2 grew at rates of 7 and 12 per cent per annum respectively. In recent months monetary aggregates have grown more slowly; in first 4 months of 1982-83 target period M1, £M3 and PSL2 grew by 6¼, 9½ and 9 per cent at annualised rates respectively of target range of 8-12 per cent.

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

(ix) Government borrowing. Latest published provisional estimate suggests PSBR £8.8 billion in 1981-82 (3½ per cent of GDP, compared with 5 3/4 per cent in 1980-81) about £1¾ billion lower than estimated at Budget time. CGBR £3.1 billion in April-June 1982.

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Econ Pol

PPS/CHANCELLOR

file no TEB/CA/01

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 BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 28 June, are sidelined.

We continue to be particularly indebted to those still affected by transport troubles, for their contribution to keeping this document appearing.

M M Deyes

M M DEYES

RIG

R I G ALLEN

5 July 1982

EB Division
H M Treasury
01-233-3364

ECONOMIC BRIEF: CONTENTS

BULL POINTS

As at 5.7.82

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

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

(iii) Total housing starts up 30 per cent in five months to May 1982 on 1981 average.

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

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

(vi) Costs.

- Increase in average earnings halved in 1980-81 pay round. Public sector pay in line. Further moderation in average level of settlements in current round. CBI pay databank for manufacturing settlements suggests average now around 7 per cent compared with 9 per cent in previous round.
- Little increase in manufacturers' unit wage and salary costs over last year - only 3 per cent up in year to 1Q 1982, below average of our major competitors and comparable to that of Germany and Japan.
- Manufacturers' input prices up just 5½ per cent in year to June.
- CBI April survey shows lowest degree of unit cost pressures for 15 years.

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

(viii) Competitiveness. Cost competitiveness improved by 10-15 per cent during 1981 reflecting pay moderation, higher productivity and exchange rate fall, but remains 1/3 worse than in 1975.

(ix) Profits: Industrial and commercial companies gross trading profits (net of stock appreciation excluding North Sea) risen since 1Q 1981. In 1Q 1982 40 per cent higher than a year earlier. Recovery in profits from very low base: ICC's pre tax real rate of return just 2½ per cent in 1981.

(x) Exports have held up better than many feared following 50 per cent loss of competitiveness between 1975 and 1Q 1981. Recent months figures suggest non-oil exports (exluding erratics) slightly (about ½ per cent) higher than in 1980.

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

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

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

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

A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

[Longer term economic policy objectives discussed by Chancellor in CPC lecture 3 July, and interview published FT 5 July.]

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

2. Economic recovery in doubt?

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

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

3. FSBR forecast too optimistic?

[Press reports of 'gloomy' Bank of England assessment, published in latest Bulletin on 1 July; Treasury forecast showing lower growth in 1982; and downward revisions to LBS and P&D growth forecasts.]

Certainly recent output figures, have been disappointing but, against that, progress on inflation has been better than expected. Most outside forecasts continue to show renewed modest recovery into and during 1983.

4. Latest GDP figures?

[Provisional figures for Q1 1982 published 22 June by CSO].
Information adds little more to what already known about economic recovery. Activity remains higher than a year ago. [IF PRESSED: figures also confirm view of some hesitation in recovery; activity in Q1 little different from Q4 1981.] Some other encouraging signs eg fixed investment beginning to recover and industrial and commercial company profits sustaining higher level reached in H2 1981. And growth in money GDP continues to slow down - increase about 9 per cent in last 12 months.

8. Does recent flattening out in recovery reflect rise in interest rates last summer/ autumn?

Profile of a gradual economic recovery unlikely to be entirely smooth. Progress is slow and fragile; economy remains subject to shocks adversely affecting confidence and activity. Number of factors - temporary rise in interest rates last summer/autumn, temporary pause in progress on reducing inflation; slower and later than expected world recovery - could all have weakened confidence in this way. But prospect is far resumed, if slow recovery.

5. Recovery depends entirely on developments in the US?

Clearly cannot isolate ourselves from international developments. Lower world interest rates (particularly in US) would undoubtedly benefit the world economy and the UK. But UK policy certainly not determined in Washington, or Wall Street. At turn of year, UK short term interest rates were 1 per cent above those in US, currently 3 per cent below.

6. Tighter than expected fiscal policy caused recent flattening out in recovery?

[Latest published estimate of 1981-82 PSBR £8.8 billion compared with Budget time estimate of £10.6 billion.]

Relationship between PSBR and output extremely complicated (especially since precise reasons for undershoot not well understood). Essential to consider influence of fiscal and monetary policies together. Firm control of Government borrowing essential to maintain downward pressure on interest rates; latter have fallen 3½ percentage points since last autumn and this can only improve prospects for recovery.

7. 1981-82 PSBR outturn inconsistent with MTFS?

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

8. Does recent flattening out in recovery reflect rise in interest rates last summer/autumn?

Profile of a gradual economic recovery unlikely to be entirely smooth. See over

9. Latest (June) Bank of England Quarterly Bulletin?

[Published 1 July]. It is for the Bank to comment on the detail of their assessment. But wrong to interpret Bulletin as particularly gloomy: sees continued progress in reducing inflation, further productivity gains, and resumption of (slow) recovery. While Bank is right to emphasise continuing difficulties and uncertainties of world economy, recently some more encouraging signs from US (eg further pick-up in leading indicators.)

10. Progress on inflation not being maintained?

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

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

11. Unemployment accelerating again?

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

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

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

(See also Section C.)

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

[Report published 17 June.]

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

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

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

OECD ECONOMIC OUTLOOK: JULY
RESTRICTED UNTIL PUBLICATION 7 JULY

14. OECD comments on world economy

Welcome recognition by OECD of success of firm policies, first in restraining increase in inflation since the second oil shock, and now in achieving its rapid deceleration. Welcome also OECD's identification of structural problems, market rigidities, inflexible wage costs, squeezed profits and excessive public expenditure as major causes of high unemployment and low investment. Note that OECD expects steady recovery of activity in industrial countries and further progress in reducing inflation over next 18 months. This is forecast to be accompanied by recovery in employment, although rising number of job seekers will make it difficult to reduce unemployment totals quickly.

15. OECD comments on UK economy

Report presents reasonably balanced and fair assessment of policies and prospects, close in many respects to most recent independent forecasts. It predicts a resumption of gradual recovery, a further reduction in inflation, and encouraging further substantial improvements in productivity.]

B ECONOMIC ACTIVITY AND PROSPECTS

1. Recovery faltering?

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

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

2. Other evidence of improvement in economy?

See Bull Points (following Section A).

3. March 1982 FSBR forecast too optimistic?

See A3

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

[CBI Enquiry for June reports little change in order books or stocks since last April, and expectations of broadly flat output over next four months. S. Brittan (FT 5 July) suggests 'preliminary evidence' of more pessimistic July CBI enquiry and lower CBI forecast of growth.]

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

7. Outside forecasts

[GDP profile in major post-Budget assessments:

	NIESR (May)	LBS (June)	St James (Apr)	Phillips &Drew (June)	CEPG (April)	CBI (May)	FSBR (March)
Per cent change 1982 on 1981	+1	+1	+1¼	+1½	-½	+1	+1½]

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

[IF PRESSED: Agree that some outside forecasters have revised their assessment ofgrowth in 1982 slightly downwards. But this partly reflects a timing change, and most see slow growth resuming later in year.]

C LABOUR MARKET

1. Recent unemployment figures and other labour market indicators?

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

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

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

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

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

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

2. Unemployment expected to continue rising rapidly?

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

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

3. Government's own forecast of unemployment now more pessimistic?

[Observer report, 27 June; also alleged MSC internal forecast of long-term unemployment rising above 1 million for next 3 years.]

Since Government did not publish a forecast of unemployment, or employment, at Budget time (nor does it ever do so) it is somewhat disingenuous for the Observer to claim latest internal assessment is more pessimistic about employment prospects. It was assumed in Cmnd 8494 that unemployment (GB, excluding school leavers) would average 2.9 million in 1982-83, and for rest of survey period. Current (June) figure is 2.91 million and, though this is still rising, it is not obviously inconsistent with PEWP figure.

4. Employment continuing to fall?

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

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

5. Unemployment higher than in other countries?

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

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

6. What is Government doing to provide more jobs?

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

7. MSC Task Group proposals on youth training?

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

D. TAXATION

1. Burden of taxation

[Total taxation (i.e including for example income tax, indirect taxes, corporation tax, rates and NIC) in 1978-79 was 34½ per cent of GDP (at market prices), 36 per cent in 1979-80, 37½ per cent 1980-81. It is forecast to be 40 per cent in 1981-82 and 39¼ per cent in 1982-83.]

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

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

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

3. Burden has fallen for the rich?

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

4. Burden has risen most for the poor?

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

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

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

6. No improvement in incentives?

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

7. Poverty trap/unemployment trap getting worse?

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

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

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

[Published 21 June.]

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

9. Budget reduction in NIS not enough for industry?

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

10. Excise duties increases inflationary/harmful to industries

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

11. Merger of tax and social security planned?

See G4.

E PUBLIC EXPENDITURE AND FINANCE

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

1. Public expenditure too high?

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

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

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

3. Increase spending in recession?

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

4. Spending Ministers seeking extra £5,000 million public expenditure in 1983-84?/Treasury once again seeking cuts in public expenditure?

Bids for additional expenditure have been put forward in usual way as part of annual public expenditure survey. Ministers collectively will have to decide which are to be allowed and, depending on size of any increase, to what extent the increase should be met by savings elsewhere.

Public expenditure bound to grow as % of GDP unless there is big improvement in economic performance?

[David Blake article The Times 30 June on official study of long-term public expenditure.]

An official study has been prepared on long-term public expenditure as part of the normal and continuing process of controlling public expenditure and monitoring its longer term effects. It has yet to be considered by the Government. But report may paint too pessimistic picture of level of public expenditure in the long term. Government's policies are designed to secure real and lasting improvement in our economic performance; the evidence is that they are succeeding. Inflation is already coming down faster than expected at Budget time.

6. Study on longer term public expenditure concludes that unemployment could stay at 3 million for rest of decade?

This is not a conclusion of the study. Report does not make any forecast of future unemployment - it uses a purely hypothetical assumption, intended to show what might happen to public expenditure if the worst is assumed about unemployment.

7. Real terms comparisons

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

8. 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 some increases between 1981-82 and 1982-83. 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.

9. What is being done to remedy inadequate appraisal of public investment revealed in recent C and AG report ?

C&AG's report showed that when study on which it was based was made, two years ago, standards of investment appraisal in a number of areas were unsatisfactory. Improvements of these standards has since become an important part of the broader development of financial management throughout central government. Much has been achieved, through Treasury and departmental guidance and instructions, more training and closer monitoring.

There is still a long way to go, but improvement of standards of investment appraisal remains a high priority.

10. 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.

11. End-year flexibility?

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

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

Only one third of current expenditure is on wages and salaries and much of that is for nurses, teachers, members of armed forces, police and so on. Provision for public service pay increases 1982-83 limited to 4 per cent. Administrative costs ae not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain drive for more efficient management throughout public sector.

LOCAL GOVERNMENT

13. Overspending in 1982-83? Government response?

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

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

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

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

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

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

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

15. Effect of NIS reduction on local authorities?

As Chancellor announced in Budget, we intend that local authorities overall will be neither worse nor better off as a result of cut in NIS rate. We now propose that local authorities should pay the same rate of NIS for the whole of 1982-83. They will pay the lower rate of NIS for 1983-84, with an offsetting reduction in RSG.

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

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

F CIVIL SERVICE STAFFING AND PAY

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

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

2. Civil service pay: non-industrial civil servants

[Settlement date 1 April 1982.]

Civil Service Arbitration Tribunal awarded pay increases ranging from 4.75 per cent to 6.25 per cent - worth 5.9 per cent overall - and increases in annual leave. Government accepted the award which is being implemented. Increases (announced 12 May) for the higher civil service (under-secretary and above) were larger; they were decided in the light of recommendations of Top Salaries Review Body. Cash limits and manpower targets not being adjusted. (See also Section K).

3. Megaw Inquiry

[Extensive advance description of contents published FT 1 July.]

The report of the Megaw Inquiry into arrangements for deciding civil service pay in future was delivered to the Chancellor on 29 June. Plans are in hand for early publication.

4. Civil Service pay: industrials

[Settlement date 1 July 1982]

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

5. Scott Report/Public sector pensions?

See K 17.

G SOCIAL SECURITY

1. Increase in PSBR from deficit on National Insurance Fund?

[Government Actuary's Report, published 29 June, shows substantially increased deficits on NI Fund for 1981-82 (up from £153 million to £1,045 million) and 1982-83 (up from £94 million to £350 million). These figures distorted by CS strike; underlying deficits nearer £600 million in 1981-82 and £800 million in 1982-83.]

For 1981-82, the published outturn already takes this into account. For 1982-83, revised deficit is one of a number of factors which will affect PSBR but is not in itself, a sufficient reason to change our overall assessment of PSBR prospects.

2. Increase in National Insurance contributions because of NI Fund deficit?

The higher deficits for earlier years do not make inevitable an increase in contribution rates for 1983-84. A decision on the level of these rates will not be made until late Autumn and will take account of forecasts made at that time of Fund income and expenditure for 1983-84.

3. Restore abatement of Unemployment Benefit?

[17 Government backbenchers have put their names to an amendment to the Finance Bill intended to ensure restoration of the 5 per cent abatement of unemployment benefit.]

The abatement of unemployment benefit has been extensively discussed in House of Commons. We undertook to review the abatement when the benefit was brought into tax. This we have done. But this Government and Party is committed to reducing public expenditure. Restoring the abatement would cost £60 million in a full year. We are making good 2 per cent shortfall in last uprating. This applies to all benefits whether or not we are pledged to preserve their value. Including unemployment benefit - which we are not pledged to protect. (Cost of restoration for all benefits will be £515 million in full year.)

4. Death grant - increase to realistic level?

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

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

5. Merger of income tax and national insurance planned?

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

H PUBLIC SECTOR BORROWING

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

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

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

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

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

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

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

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

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

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

[PSBR 1981-82 undershoot now appears to be less than originally thought: latest published estimate £8.8 billion, 1982-82 FSBR (published 9 March) estimated outturn of £10.6 billion.]

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

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

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

7. Implications for fiscal policy and MTFS?

See A6-7.

8. Effect of Civil Service dispute on PSBR?

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

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

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

10. Parliamentary control over borrowing?

[EST at Select Committee on Procedure 29 June.]

Welcome interest shown by Procedure Committee. Will continue to provide information to help Parliament reach view on what is happening. Open mind to consider any suggestions from Committee about form of information. [IF PRESSED: Propositions for some form of control a different matter: could complicate policy decisions on spending and revenue.]

J MONETARY AND FINANCIAL POLICY

1. Monetary growth in 1981-82

[In banking May (third month of target period) £M3, M1 and PSL2 grew by 1.1, 0.6 and 0.7 per cent respectively seasonally adjusted. These changes bring annual rates of growth in 1982-83 target period to 9¾, ¼ and 10 per cent respectively, compared with target range of 8-12 per cent. NB Provisional money figures for June to be published 6 July.]

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

2. Monetary conditions too tight?

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

3. Bank lending

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

4. Interest rates still too high?

Interest rates have come down significantly over past 6 months. Bank base rates were cut by a further ½ per cent only 4 weeks ago. Of course we would like to see rates lower still; but we must proceed cautiously if we are not to jeopardise progress made to date in reducing inflation. Lower inflation offers best prospect for sustainable lower levels of interest rates.

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

[US rates eased slightly over past month, but still high.]

US rates not sole determinant of UK rates, but high US rates certainly an adverse development and in September were a key factor in driving our rates up. Recently, however, sterling has remained reasonably firm, probably helped by improved prospects for wage round, and good trade figures. UK interest rates have eased this year against US trend; but we cannot insulate ourselves from difficult international background. (See also T10.)

6. MTFS being quietly shelved?

[3rd MTFS states Government's objectives 'to reduce inflation and to create conditions for sustainable growth in output and employment', by 'steady but not excessive downward pressure on monetary conditions'. Key financial indicators are the monetary aggregates and exchange rate. Target range for growth of M1, £M3, PSL2 in period February 1982 - April 1983 of 8-12 per cent. Illustrative path of 7-11, 6-10 per cent in 1983-84, 1984-85. Targets for later years to be set nearer the time. As Chancellor said in FT interview 5 July, British monetary policy has now received the good housekeeping seal of approval from most of the industrial countries.]

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.

7. 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.

8. Why have you been 'over-funding' and providing large-scale money market assistance?

[Bank of England Quarterly Bulletin last week carried small feature explaining process.]

The rapid growth of bank lending (much of which relates to structural changes) creates problems for conduct of monetary policy. By selling long-term Government debt on a larger scale outside the banking system it has been possible to contain the growth of money which the lending would otherwise have produced. If we had not intervened to relieve the resulting shortages in the money markets, the banks would have been forced to bid for deposits, raising short-term interest rates to levels which, according to other indicators of monetary conditions were not justified.

25 JUNE MONETARY PACKAGE

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

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

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

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

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

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

12. Isn't Government simply acquiescing in rapid growth of bank lending and accommodating it?

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

K PRICES AND EARNINGS

PRICES

1. Recent trends in inflation

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

2. Inflation lower than under previous Government?

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

Year-on-year rate of inflation had risen to 10.3 per cent when previous Government left office. And on present forecasts we will be first Government for quarter of a century to successfully reduce the average rate of inflation during its term of office.

3. But inflation rising again?

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

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

4. How low inflation by end 1982?

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

5. Could it be 7½ per cent?

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

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

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

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

7. Inflation still not as low as competitors

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

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

8. Movement in tax and prices index?

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

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

9. Nationalised industry prices

[Increase over 12 months to May 14.0 per cent, compared with an increase of 9.5 per cent in the RPI (see also R8)].

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

PAY

10. Current level of pay settlements

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

11. 4 per cent pay factor abandoned?

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

12. Government norm now 6 per cent?

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

13. NHS pay

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

14. Top Salaries Review Board increases too large?

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

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

15. Average earnings index

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

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

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

[Latest RPDI figures published 1 July show Q1 level much same as in Qs 2 and 3 1981 (Q4 discounted as 'erratically low'), and lower than Q1 1981.]

No. Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

17. Index-linked pensions and Scott Report?

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

18. Incomes Policy

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

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

L BALANCE OF PAYMENTS

1. April trade figures?

[Figures published 25 June show current account in around £350 million surplus during April, giving cumulative total of £0.9 billion so far this year. Exports increased £150 million (+3 per cent) due to higher oil exports. Imports rose £173 million (+4 per cent) due to higher imports of finished manufactured goods. Invisible surplus projected at £150 million a month. NB June trade figures to be published later this week.]

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

2. Non-oil export trends gloomy?

[Oil exports rose by £200 million to around £420 million; non-oil trade back in deficit after March surplus.]

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

3. Imports?

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

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

4. Disappointing trend in invisibles contrary to expectations

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

It would be wrong to read too much into these figures, which need careful interpretation. About half the fall from the earlier projection results from a new seasonal adjustment to the figure for EC refunds. This will add the same amount to the figures over the rest of the year. Most of the rest reflects a substantial [around £500 million] change to the CSO's estimate of net interest profit and dividend payments from and to countries abroad. This is a very erratic item, subject to revision. Trade in services remains in large and growing surplus around £1 billion in last two quarters (Q4 1981 and Q1 1982).

5. Overseas investment reflects abolition of exchange controls?

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

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

6. Overseas investment takes jobs away from UK?

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

M EXCHANGE RATE AND THE RESERVES

1. Policy towards the exchange rate/falling £?

[Since last autumn sterling has remained broadly stable. The average £ effective rate in Q1 1982 was over 10 per cent lower than in Q1 1981. Previous lows were $1.7470 on 6 April, DM 4.098 on 21 May. Highs were $1.97 on 30 November, DM 4.407 on 9 February. Rates at close on 2 July were $1.7335, DM 4.2812 and an effective of 91.28. Reserves at end June stood at $17.7 billion, compared with $17.8 billion at end May.]

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

2. Bank of England intervening to support the rate?

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

3. Concerted intervention to reduce value of dollar?

All experience in recent years 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: matter for real concern is US fiscal/interest rate mix, a problem all countries are familiar with.

4. Improve UK competitiveness by devaluing exchange rate

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

5. Debt repayments

We have made excellent progress with our plans to reduce the burden of external debt substantially during this Parliament. We aimed to reduce official external debt to $14 billion by end of 1981. This has been more than achieved - external debt is now around $13 billion, compared with over $22 billion when the Government took office.

6. French devalue to improve competitiveness

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

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

N EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. 1982 Budget - Parliament/Commission dispute

An agreement between the Parliament and the Council was signed on 30 June. If it is ratified by the European Parliament, it will provide the basis for settling the 1982 budget dispute, and also contribute to avoiding such disputes in future.

2. UK budget settlement

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

3. UK objectives for longer-term negotiations?

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

4. Implementation of budget settlement

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

5. Remainder of Commission 'Mandate' report

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

6. CAP prices 1982-83 and the Luxembourg Compromise

We made clear in Foreign Affairs Council on 25 May that we wished to have clarity about the EC's decision-making procedures. Four other member states shared our wish to re-establish the principle of unanimity when vital national interests are invoked. This is an improvement on 1966, though it is still an agreement to disagree.

7. UK refunds in respect of 1981

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

8. Commission's ideas for changes to 'own resources' system

['EEC considers new sources to boost budget: FT 5 July.]

Understand that Commission are considering measures to diversify Community's revenue sources. If they put forward proposals we will consider them. Our opposition to any increase in the 1 per cent VAT ceiling is well known.

9. Policy for CAP reform

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

10. 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

11. 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.

12. Join the EMS for exchange rate stability?

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

EXPORT CREDITS 'CONSENSUS'

13. Progress on Export Credit Consensus negotiaitons

Finance Ministers agreed on 30 June to accept the OECD compromise proposals - with minor modifications which seem to be acceptable to the other 'consensus' participants.

INDUSTRY

[NB Chancellor meeting CBI 5 July; next NEDC meeting 7 July].

1. Prospects for industry-recovery?

See A[ ] and B[ ].

2. Companies' financial position?

[Industrial and commercial companies (ICC's) gross trading profits (net of stock appreciation) rose by about a quarter between H1 and H2 1981; little changed between Q4 1981 and Q1 1982. But rise was from a very low base - ICC's real rate of return just 2½ per cent in 1981. ICC's finances showed some weakening in 4Q reflecting slowdown in destocking and unwinding of civil service dispute, but finances better in 1981 as a whole -

£bn

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

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

3. Rate of return still too low?

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

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

4. High interest rates damaging for industry and investment?

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

Budget measures have eased pressure on interest rates, and the recent ½ per cent fall in the banks' base rates is encouraging. But Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking.

Continuing relatively high level of interest rates must be seen in context of priority attached to reducing inflation and need to control growth in money supply underlying the MTFS. (See brief J).

5. Government help for small firms

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

6. Response to Loan Guarantee Scheme?

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

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

Too early to assess overall cost of scheme. After first year of the 4000 guarantees issued, 48 have been 'called'. Cost has been more than covered by the premium income received over the period.

8. Government thinking again about Loan Guarantee Scheme?

Scheme under continuous review.

9. Enterprise zones: response from private sector?

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

B. NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83 and future years?

Nationalised industries' total external finance increased by £1.3 billion in 1982-83 (£1.2 billion after allowing for NIS cut and other changes). Increase in 1982-83 was roughly half what the industries bid for. Government has given full recognition to problems faced by the industries in a period of recession. EFL's for 1982-84 will be announced later this year, as usual.

INVESTMENT

2. Investment plans unlikely to be attained?

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

3. But shortfall in capital spending 1981-82?

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

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

4. Take nationalised industry investment out of PSBR?

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

5. Is PM satisfied with the rate of return on capital in the nationalised industries?

[Pre-tax rate of return on nationalised industries' capital (including subsidies) has recently been announced as being minus 1 per cent (about the same as in 1979). This compares with 3 per cent for industrial and commercial companies.]

No. That is why we are continuing to press for greater efficiency within nationalised industries, and are setting realistic financial targets to ensure that the taxpayer and consumer get proper value for money.

● Finance more nationalised industry investment by cutting current spending?

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

7. Private finance for NI investment?

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

NATIONALISED INDUSTRY PAY AND PRICES

8. Nationalised industries' prices

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

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

PRIVATISATION

[NB. Chancellor in CPC lecture 2 July referred to scope for further privatisation of public sector eg local government, education, health, nationalised industries].

9. What further sales expected?

Special sales of assets in 1982-83 forecast at around £700 million and around £600 million in each of the later years. These figures well above those in last White Paper. This reflects primarily very large sales of energy assets - Britoil and the British Gas Corporation's major

offshore oil assets - to be made possible by Oil and Gas (Enterprise) Act (which received Royal Assent in June).

10. Special asset sales in 1981-82

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

11. But what about net figure?

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

12. Government has sold assets too cheap?

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

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

S NORTH SEA AND UK ECONOMY

1. Onerous tax system damaging future field developments?

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

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

2. Chancellor's oil taxation package announced 9 June

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

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

3. Taxation of Petrochemical feedstocks

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

Government convinced that new formula will give fair valuation. New valuation will not have effect of providing subsidy to ICI's competitors. Will do best to reassure ICI. Further consultations are taking place with ICI about the changes.

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

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

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

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

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

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve lower level of interest rates to benefit of industry and economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Less than 6 per cent of total General Government receipts in 1981-82.

6. Is the Government underestimating North Sea revenues?

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

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

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

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

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

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

T WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

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

OECD's Economic Outlook (published 7 July) explains clearly why. Western Governments are convinced 'a significant part of any stimulus to demand would increase public sector deficits, and dissipate itself rather quickly as an increase in inflation'. Furthermore, there is 'the possibility of re-igniting inflationary expectations, which became firmly established over a decade or more...' Remarkable unity on this at recent Finance Ministers' meetings and at Versailles Summit.

2. Western Governments' policies will increase unemployment to 32 million?

[OECD Economic Outlook forecasts unemployment 'approaching 32 million in first half 1983' or 9 per cent of OECD Labour force (10½ per cent of Europe's). Also notes that unemployment is concentrated on the young, and that, in Europe, about one third of jobless have been unemployed 6 months and more.]

True that OECD forecasts rising unemployment - largely as result of increase in number of people looking for work. But OECD also forecasts employment to rise by over 2 million people in OECD area next year.

3. OECD says global recovery won't last?

[Economic Outlook warns investment so far shows little sign of pick-up needed for recovery to be self-sustaining. But same paragraph ends by emphasising importance of improving business outlook.]

Lower inflation should help reduce interest rates and coupling of these two with recovery in output will generate right climate for recovery in investment during 1983.

4. Versailles summit: international monetary undertaking

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

5. French government 'seen the light' over reflationary policies?

[French government announced package of austerity measures including 4 month prices and wages freeze (to reduce inflation to single figures), increases in social security and unemployment contributions and limit to budget deficit of 3 per cent of GNP in 1982]

Strength and stability of Western economies as a whole will benefit if France - and Italy - can control inflation. So we welcome French government's recognition that inflation is as serious a threat as unemployment and that reining in public sector borrowing is essential part of counter-inflation strategy. (See also M6.)

6. French prices and incomes policy more humane than massive deflation?

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

7. Anti-inflation policies are working

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

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

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

No. OECD's forecast for UK is close to most of recent domestic forecasts and predicts average growth of about 1¼ per cent in 1982, rising to annual rate of 2 per cent in second half of 1982. That is very closely in line with OECD forecast for whole of Europe. Unemployment is expected to rise in all major countries except Japan. UK inflation still forecast to exceed OECD average in 1982 because of recent falls in inflation rates of USA, Germany and Japan, but UK should average OECD rate next year. Could do it this year if more responsibility in wage settlements.

9. Prospects for US economy?

[Leading indicators moved up for third successive month in May and preliminary Department of Commerce estimate of GNP showed slight rise in Q2, indicating recession has probably bottomed. But industrial production fell in April and May and seasonally adjusted unemployment is 9½ per cent. M1 near top of target range. Year-on-year rate of consumer price infaltion down from 11 per cent in September 1981 to 6.7 per cent in May.]

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

10. US Budget?

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

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

11. US interest rate developments

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

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

12. 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.

U FALKLANDS CRISIS EFFECTS/COSTS

1. UK economy affected by Falklands crisis?

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

2. Effect of Falklands dispute on markets?

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

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

3. Will dispute with Argentina affect UK trade figures?

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

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

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

5. Effect of restrictions on Argentina?

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

6. Future of restrictions?

European Community have ended their measures; UK's remain in place. Waiting for cessation of hostilities to be confirmed; must also take into account Argentina's restrictions against us. Lifting of EC import ban (effective from 22 June) does not affect UK's own economic measures (separately imposed under article 224 of Rome Treaty). Specifically agreed by the 10 Foreign Ministers that EC sanctions would immediately be re-instated if there were further acts of force in the South Atlantic.

7. Argentina's debts

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

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

8. How much has operation cost so far?

A preliminary assessment of the broad order of costs of the Falklands campaign is about £500 million in 1982-83, and £250 million in each of the following two years. But an exact assessment is not yet possible; costs are still being incurred in the South Atlantic. It is however clear that the costs represent a small proportion of total public expenditure.

9. How will the costs be met?

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

10. What about costs of reconstructing the islands' economy and repairing damage?

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

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AIDE MEMOIRE ON THE UK ECONOMY

5 July 1982

RECENT DEVELOPMENTS AND INDICATORS

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

Volume of new engineering and construction orders in 1981 up 15 and 11 per cent on 2H 1980. Whilst home orders have continued to improve in early 1982 export orders tended to weaken around the turn of the year. Private housing starts up over one third between 2H 1980 and 1981. Total housing starts in 5 months to May 1982 up 30 per cent on 1981 average.

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

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

(iii) Employment and unemployment. UK employment fell 2.1 million (9 per cent) between 2Q 1979 and 4Q 1981 (about two-thirds concentrated in manufacturing), though rate of decline has slowed down. UK adult unemployment risen by 1.7 million (less than fall in employment) and stood at 2.91 million (12.2 per cent) in May. Total unemployment (including school leavers) was 3.06 million (12.8 per cent). Underlying rate of increase in unemployment slowed sharply during 1981 (105,000 per month in 4Q 1980 cf 25,000 per month in H1 1982). Other labour market indicators improved during 1981; eg short-time working down by ⅔ during 1981, overtime up by over 10 per cent during 1981, and vacancies - despite slight weakening since February - up by 1/5 in 2Q 1982 on 2Q 1981, and with more rapid turnover. Little or no further improvement in unemployment or other labour market indicators since turn of year.

(iv) Wages and prices. Increase in earnings in 1980-81 pay round 11 per cent (settlements averaged about 9 per cent), half that of previous pay round. Settlements well inside single figures are now widespread (CBI average for manufacturing 7 per cent) suggesting further moderation in current pay round. 12-monthly increase in RPI 9.5 per cent in May; well inside single figures. Recent progress suggests outturn to November this year could well be within Budget time forecast of 9 per cent. Manufacturers' input prices up just 5½ per cent in 12 months to June. Corresponding rise in manufacturers' output prices 8¼ per cent.

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

(vi) Company finances. Gross trading profits of ICCs (net of stock appreciation excluding North Sea) rose about 40 per cent in year to 1Q 1982. But real pre tax rate of return just 2½ per cent in 1981. Despite rise in company borrowing and deterioration in liquidity in 4Q 1982 (largely reflecting reduced sale of destocking and unwinding of civil service dispute which delayed companies' tax payments), company finances healthier in 1981 as a whole than in 1979 and 1980. Company liquidity improved in 1Q 1982.

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

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

(ix) Government borrowing. Latest published provisional estimate suggests PSBR £8.8 billion in 1981-82 (3½ per cent of GDP, compared with 5 3/4 per cent in 1980-81) about £1¾ billion lower than estimated at Budget time. CGBR £1.9 billion in April-May 1982 at time when central government borrowing usually largest.

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Econ Pol

PS/CHANCELLOR

file no TEB/CA/01

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PS/Secretary of State for Northern Ireland
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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 BRIEF

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

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

M M Deyes

M M DEYES

R I G ALLEN

28 June 1982

EB Division
H M Treasury
01-233-3364

ECONOMIC BRIEF: CONTENTS

A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

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

2. Economic recovery in doubt?

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

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

3. Latest GDP figures?

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

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

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

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

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

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

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

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

6. 1981-82 PSBR outturn inconsistent with MTFS?

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

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

See Section J.

8. Progress on inflation not being maintained?

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

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

9. Unemployment accelerating again?

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

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

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

(See also Section C.)

10. Trade figures disappointing?

[April figures published 25 June.]

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

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

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

[Report published 17 June.]

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

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

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

14. Falklands conflict and after?

See Section U.

15. Labour party economic policies

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

BULL POINTS

As at 25.6.82

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

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

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

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

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

(vi) Costs.

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

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

(viii) Competitiveness. Cost competitiveness improved by 10-15 per cent during 1981 reflecting pay moderation, higher productivity and exchange rate fall, but remains 1/3 w[illegible]e than in 1975.

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

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

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

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

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

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

ECONOMIC ACTIVITY AND PROSPECTS

1. Recovery faltering?

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

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

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

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

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

3. Investment and stockbuilding?

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

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

3. June CBI Trends Enquiry?

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

4. Other evidence of improvement in economy?

See Bull Points (following Section A).

5. Government assessment of prospects

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

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

	NIESR (May)	LBS (~~Apr~~ June)	St James (Apr)	Phillips &Drew (June)	CEPG (April)	CBI (May)	FSBR (March)
Per cent change 1982 on 1981	+1	+1[illegible]	+1¼	+1½	-½	+1	+1½]

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

B3

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

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

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

C LABOUR MARKET

1. Recent unemployment figures and other labour market indicators?

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

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

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

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

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

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

2. Unemployment expected to continue rising rapidly?

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

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

3. Government forecasts for unemployment

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

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

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

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

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

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

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

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

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

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

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

7. Employment continuing to fall?

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

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

8. Unemployment higher than in other countries?

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

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

9. What is Government doing to provide more jobs?

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

10. MSC Task Group proposals on youth training?

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

D TAXATION

1. Burden of taxation

[Total taxation (i.e including for example income tax, indirect taxes, corporation tax, rates and NIC) in 1978-79 was 34½ per cent of GDP (at market prices), 36 per cent in 1979-80, 37½ per cent 1980-81. It is forecast to be 40 per cent in 1981-82 and 39¾ per cent in 1982-83.]

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

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

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

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

3. Burden has fallen for the rich?

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

4. Burden has risen most for the poor?

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

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

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

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

6. No improvement in incentives?

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

7. Poverty trap/unemployment trap getting worse?

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

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

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

[Published 21 June.]

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

9. Budget reduction in NIS not enough for industry?

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

10. Excise duties increases inflationary/harmful to industries

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

11. Merger of tax and social security planned?

See G4.

E PUBLIC EXPENDITURE AND FINANCE

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

1. Public expenditure too high?

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

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

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

3. Increase spending in recession?

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

4. Government has complacent attitude to public expenditure?

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

5. Real terms comparisons

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

6. Not enough capital expenditure?

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

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

7. Cuts in capital

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

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

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

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

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

10. End-year flexibility?

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

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

(See Sections F and K.)

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

Only one third of current expenditure is on wages and salaries and much of that is for nurses, teachers, members of armed forces, police and so on. Provision for public service pay increases 1982-83 limited to 4 per cent. Administrative costs ae not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain drive for more efficient management throughout public sector.

LOCAL GOVERNMENT

13. Overspending in 1982-83? Government response?

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

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

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

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

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

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

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

15. Effect of NIS reduction on local authorities?

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

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

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

F CIVIL SERVICE STAFFING AND PAY

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

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

2. Civil service pay: non-industrial civil servants

[Settlement date 1 April 1982.]

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

3. Civil Service pay: industrials

[Settlement date 1 July 1982]

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

4. Scott Report/Public sector pensions?

? See K 21

G SOCIAL SECURITY

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

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

2. Why cut child dependency additions to unemployment benefit?

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

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

3. Death grant - increase to realistic level?

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

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

4. Merger of income tax and national insurance planned?

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

H PUBLIC SECTOR BORROWING

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

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

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

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

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

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

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

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

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

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

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

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

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

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

7. Implications for fiscal policy and MTFS?

See A5- 6.

8. Effect of Civil Service dispute on PSBR?

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

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

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

J MONETARY AND FINANCIAL POLICY

1. Monetary growth in 1981-82

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

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

2. Monetary conditions too tight?

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

3. Bank lending

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

4. Over funding / monetary package of 25 June

See Questions and Answers on pages J3-4.

5. Recent falls in interest rates

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

6. Prospects for further falls

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

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

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

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

8. MTFS being quietly shelved?

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

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

9. Monetary targets discredited?

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

25 JUNE MONETARY PACKAGE

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

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

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

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

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

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

J4

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

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

K PRICES AND EARNINGS

PRICES

1. Recent trends in inflation

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

2. Inflation lower than under previous Government?

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

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

3. But inflation rising again?

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

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

4. How low inflation by end 1982?

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

5. Could it be 7½ per cent?

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

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

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

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

7. Inflation still not as low as competitors

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

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

8. Movement in tax and prices index?

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

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

9. Nationalised industry prices

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

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

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

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

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

PAY

11. Current level of pay settlements

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

12. 4 per cent pay factor abandoned?

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

13. Government norm now 6 per cent?

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

14. NHS pay

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

15. Top Salaries Review Board increases too large?

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

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

16. Average earnings index

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

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

17. Latest pay figures mean living standards rising?

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

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

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

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

No. Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

19. Index-linked pensions and Scott Report?

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

20. Incomes Policy

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

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

L BALANCE OF PAYMENTS

1. April trade figures?

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

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

2. Non-oil export trends gloomy?

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

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

3. Imports?

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

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

4. Disappointing trend in invisibles contrary to expectations

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

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

[NB. If the comparison is with the revised figures for Q4 1981 our net payments to the EC increased in Q1, and there was a fall in net interest and dividend receipts. But in that

comparison the seasonal adjustment point does not apply since the revised 1981 figures are also seasonally adjusted.]

5. Overseas investment reflects abolition of exchange controls?

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

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

6. Overseas investment takes jobs away from UK?

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

M EXCHANGE RATE AND THE RESERVES

1. Policy towards the exchange rate/falling £?

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

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

2. Bank of England intervening to support the rate?

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

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

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

4. Improve UK competitiveness by devaluing the exchange rate

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

5. Debt repayments

We have made excellent progress with our plans to reduce the burden of external debt substantially during this Parliament. We aimed to reduce official external debt to $14 billion by end of 1981. This has been more than achieved - external debt is now around $13 billion, compared with over $22 billion when the Government took office.

6. French devalue to improve competitiveness

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

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

N EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. 1982 Budget - Parliament/Commission dispute

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

2. UK budget settlement

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

3. UK objectives for longer-term negotiations?

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

4. Implementation of budget settlement

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

5. Remainder of Commission 'Mandate' report

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

6. CAP prices 1982-83 and the Luxembourg Compromise

As Agriculture Minister made clear in his statement on 19 May, we consider the adoption of the 1982-83 CAP prices to have been wholly contrary to the Luxembourg Accords, which were in existence before we joined the Community and which have been observed for 16 years. This action raises serious constitutional issues. Only progress made in Foreign Affairs Council was an agreement about right to disagree. Council will return to the

question later, but not to be raised explicitly at European Council. Practical effects may be felt in discussion of OECD export credit consensus, which will be raised at European Council.
(see 15 on page N3)

7. UK refunds in respect of 1981

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

8. UK a net recipient in 1981?

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

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

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

10. Do supplementary measures grants lead to additionality?

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

11. Policy for CAP reform

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

12. Costs of CAP to UK consumers

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

EUROPEAN MONETARY SYSTEM

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

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

14. Join the EMS for exchange rate stability?

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

15 Progress on Export Credit Consensus negotiations

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

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

INDUSTRY

1. Prospects for industry-recovery?

See A[ ] and B[ ].

2. SDP policy for industry?

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

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

3. Companies financial position?

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

£bn

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

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

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

4. Rate of return still too low?

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

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

5. High interest rates damaging for industry and investment?

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

Budget measures have eased pressure on interest rates, and the recent ½ per cent fall in the banks' base rates is encouraging. But Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking. Continuing relatively high level of interest rates must be seen in context of priority attached to reducing inflation and need to control growth in money supply underlying the MTFS. (See brief J).

6. Government help for small firms

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

7. Response to Loan Guarantee Scheme?

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

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

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

9 Government thinking again about Loan Guarantee Scheme?

[Article in FT 24 May]

Scheme under continuous review.

10. Enterprise zones: response from private sector?

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

R NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83 and future years?

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

INVESTMENT

2. Investment plans unlikely to be attained?

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

3. But shortfall in capital spending 1981-82?

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

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

4. Take nationalised industry investment out of PSBR?

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

5. Private finance for NI investment?

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

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

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

NATIONALISED INDUSTRY PAY AND PRICES

7. Nationalised industries' prices

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

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

PRIVATISATION

8. What further sales expected?

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

9. Special asset sales in 1981-82

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

10. <u>But what about net figure?</u>

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

11. <u>Government has sold assets too cheap?</u>

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

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

S NORTH SEA AND UK ECONOMY

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

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

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

2. Onerous tax system damaging future field developments?

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

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

3. Chancellor's oil taxation package announced 9 June

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

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

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

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

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

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

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

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve a lower level of interest rates to the benefit of industry and the economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Less than 6 per cent of total General Government receipts in 1981-82.

6. Is the Government underestimating North Sea revenues?

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

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

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

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

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

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

/ continued

9. Taxation of Petrochemical feedstocks

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

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

T WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

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

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

2. Versailles summit: international monetary undertaking

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

3. French and Italian devaluations?

[French franc devalued by 10 per cent and Italian lira devalued 7 per cent against Deutschemark on 12 June. Sixth and biggest revaluation in EMS's 3¼ year history. Simultaneously French government announced package of austerity measures including 4 month prices and wages freeze (to reduce inflation to single figures), increases in social security and unemployment contributions and limit to budget deficit of 3 per cent of GNP in 1982]

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

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

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

5. Anti-inflation policies are working

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

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

6. Governments' policies have failed or worsened situation?

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

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

No. Treasury and most independent forecasters expect UK growth this year of about 1½ per cent rising to an annual rate of 2 per cent by early next year. This is very closely in line with the OECD's forecast for OECD Europe. Unemployment is expected to rise in all major countries except Japan. UK inflation (GNP deflators) likely to be around the OECD average and below that in France, Italy and Canada.

8. Prospects for US economy?

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

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

9. US budget?

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

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

10. US interest rate developments

[Prime rates still 16½ per cent, 3-month CD's stayed at 15½ per cent]
True US interest rates rose recently. But prime rates well below peak of 21½ per cent last summer. Agreement on details of budget would improve prospects for lower interest rates.

11. Prospects for international interest rates?

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

12. OECD see bleak prospects for UK economy?

[Report in The Times 24 May]

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

13. Economic forecasts by EC leaked to Press ?

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

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

U FALKLANDS CRISIS EFFECTS/COSTS

1. UK economy affected by Falklands crisis?

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

2. Effect of Falklands dispute on markets?

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

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

3. Will dispute with Argentina affect UK trade figures?

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

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

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

5. Effect of restrictions on Argentina?

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

6. Future of restrictions?

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

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

7. Argentina's debts

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

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

8. How much has operation cost so far?

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

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

9. How will the costs be met?

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

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

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

AIDE MEMOIRE ON THE UK ECONOMY 25 June 1982

RECENT DEVELOPMENTS AND INDICATORS

(i) Activity. GDP fell by 6 per cent between 1979 H2 (last cyclical peak) and 1981 Q2 (trough of current recession), rose about 1 per cent between 1981 Q2 and 1981 4Q then declined by ½ per cent in 1982 Q1. Weakening at turn of year in part reflects impact of severe weather and strikes, but underlying level of output broadly flat in 6 months to March 1982; above levels of last spring. Most independent forecasts, business opinion surveys, and CSO's cyclical indicators expect resumed and continued recovery.

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

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

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

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

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

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

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

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

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

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

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Prime Minister ②

I asked Alan if he had any comments on the Chancellor's note.

MCS 29/6

PRIME MINISTER

ECONOMIC PROSPECTS: CHANCELLOR'S MEMORANDUM OF 25 JUNE

1. We believe that the general description of the prospects for the next two years is broadly correct. Furthermore the Chancellor's "positive actions" provide a consistent and welcome thrust to policy over the next two years.

The Prospects

2. i. GDP and Unemployment. I suspect that if our monetary policy is not too tight we shall see an expansion rather bigger than the Chancellor expects, comparable perhaps to the expansion in 1933. The Chancellor is, of course, reflecting the history of the last 20 years, and I suspect that he has not adequately allowed for the fact that the environment has changed substantially. Nevertheless, I think it is wise to plan for broadly what he has in mind, growing output and unemployment stabilised at perhaps a little less than three million, with no dramatic falls in prospect.

ii. Prices. The Chancellor has been shown to be pessimistic about inflation so far, and I think he continues in this vein. The Chancellor says, "on past experience some rise in inflation rates must be on the cards as the recovery proceeds".

But we have changed the relevance of "past experience", as we have shown in the productivity changes. It is quite usual for countries that have gone through a monetary reform such as the UK to experience rapidly rising output associated with sharply falling inflation rates. I think also the Chancellor is in error in believing that inflation may be generated by a sharply falling effective exchange rate or undue increases in pay. The former may be perfectly consistent with very low inflation, (as in Britain from 1931-33). And surely we know by now that increases in pay were

/primarily responsible

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primarily responsible for generating unemployment, not inflation. Our inflation rate is determined by the progress we make in controlling our monetary aggregate, which so far has been good.

iii. Interest Rates. The Chancellor says in 3(iii) that interest rates "depend crucially upon what happens in the US".

This line of argument is, at least to some extent, inconsistent with the fact that we have "decoupled" our interest rates from the United States, to the extent that there is currently three-and-a-half percentage points difference between three month dollar and sterling rates. Furthermore, the idea that US interest rates do, or should, determine our interest rates can lead to erroneous arguments - namely that the PSBR has no effect on interest rates. (This has encouraged the view that we need not be concerned about the PSBR - a very dangerous line of argument indeed.)

It is important to be clear that our interest rates should be determined by the monetary aggregates. In particular we should not be influenced by high United States interest rates causing an appreciation of the spot dollar, and a depreciation of sterling. In fact the exchange rate should be used only to check the consistency of the evidence on monetary conditions that we obtain from our monetary aggregates.

It is noteworthy, however, that the Chancellor's recommendations in para 14 substantially amount to an effort to decouple our interest rates from those in the United States. (In that sense it is

/somewhat inconsistent

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somewhat inconsistent with the report in para 3(iii)). There he lays stress on the appropriate degree of tightness in monetary conditions in determining interest rates. This we believe is right.

iv. The Tax Prospect. Given the projected rate of growth, the Chancellor is entirely correct. There is no room for manoeuvre now.

v. World Trade. The outlook is very uncertain, but I cannot second-guess the Chancellor.

vi. Oil Prices. I believe there is more likelihood of a collapse in oil prices over the next two years than does the Chancellor. OPEC's ability to control marginal supply is becoming less and less, but the Chancellor is entirely right to stress that the only risk of oil price explosions would come from a major political upheaval.

AW

28 June 1982

ALAN WALTERS

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Prime Minister.

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

25 June 1982

PRIME MINISTER

ECONOMIC PROSPECTS AND PRIORITIES FOR THE NEXT TWO YEARS

I have been considering the economic prospect and our priorities for the rest of this Parliament.

The prospects

2. Since the Budget the prospects, both here and world-wide, have not changed dramatically, though the outlook for US growth has worsened, perhaps dragging ours down a little, while the prospect for inflation here is probably rather better than it was.

3. Over the next two years the prospects seem to be:

i. GDP and Unemployment. The recovery has shown some hesitation in recent months but should resume soon. Forward indicators point to a modest but appreciable rise in output over the next year. This is unlikely to be fast enough to reverse the rising tide of unemployment, but may be sufficient to arrest it. The prospect therefore is one in which unemployment, on the wide definition, will remain around 3 million.

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ii. Prices. Inflation has declined more rapidly than we expected, partly because of weak world commodity prices, rapid increases in productivity and strong competitive pressures. Over the next year there should be a further fall. But it would not be safe to assume - certainly not at this stage - that it will go on getting better into 1984. The prospect becomes bound up with what happens to the recovery of output, particularly if at the same time world activity was recovering fast enough to lead to higher commodity prices. On past experience, some rise in the inflation rate must be on the cards as recovery proceeds, but any reversal of the downward trend is unlikely to be substantial - unless the effective exchange rate falls sharply or the coming pay round goes badly. - unemployment

But break with the past not so.

Depends on inflation in our trading partners

iii. Interest rates have fallen by about 3½ points since last autumn, and there seems a reasonable chance of some further fall. This, however, will obviously depend crucially upon what happens in the US, where rates, both nominal and real, are well above ours, and on confidence at home.

determined by monetary aggregates (see 14 "does not matter" about PSBR" - i der by US

iv. The Tax Prospect. Even at Budget time this looked tight for 1983 and 1984, with little room for reductions, particularly in the next financial year. Since then we have had major new expenditure bids which, if conceded on any scale, would certainly entail higher taxes.

No room for manoeuvre now

v. World Trade. The trade prospect has worsened, with growth in the major economies looking less

?

buoyant than was earlier expected. While the latest indications are that the fall in US output ceased in the second quarter, and this should permit some resumed world-wide growth in the rest of this year and through 1983, the level of world activity over this period seems likely to be lower than we had earlier hoped.

V. uncertain
upward - potential
downward - likely

vi. Oil Prices. Oil prices are higher than we had assumed at Budget time, partly reflecting the ability of OPEC to reduce supply when demand is weak. But, barring a major political upheaval in the Middle East, there seems little risk in the next two years of another major oil price rise of the sort experienced in 1973-74 and 1979-80.

4. In short, if things go as expected we can hope to face the country with an economy which is again growing, (though unspectacularly, and with unemployment still high); with major progress registered on inflation (though whether the figures will go on falling right through to 1984 must be an open question); and with substantial achievements to our credit on productivity and competitiveness: in short, a performance which will stand comparison with experience abroad, and enable us to claim that our attack on the fundamental malaise of the British economy is making progress and deserves to be sustained.

Hazards

5. This scenario is however at risk from three specific areas.

6. First, developments abroad. There remains the threat that US interest rates will remain high - worse still the risk of another upward surge. And there are the possibilities of international financial disorder deriving from e.g. loan defaults (Poland, the Argentine, and Mexico), private banking failures, or exchange rate volatility.

decouple

7. Second, there is the domestic pay scene. We shall be discussing this in E Committee shortly: the key point is that another pay explosion could blow away much that we have achieved, on inflation, productivity and competitiveness. (This underlines, of course, the importance of the current round of disputes.)

8. Thirdly, there is the risk that, by omission or commission, we lose the confidence of the markets, domestically and overseas. This could happen through a failure to encourage common-sense about pay; through any suggestion that we were relaxing our grip on public expenditure; or through our failing to carry conviction about our ability and determination to maintain non-inflationary monetary conditions. Loss of confidence would affect the recovery through the exchange rate and interest rates and more generally.

Preserving the Foundations

9. Our first priority therefore must be to maintain confidence.

10. This means holding to the monetary and fiscal policies we have followed for three years, and which are

paying off. To change course now, apart from putting the gains e.g. on inflation, at risk, would be welcomed by nobody; our opponents would accuse us of cynicism while our friends would feel let down.

11. It also means, specifically, that we need to be firm about public expenditure. We shall be discussing this in Cabinet on 15 July: if we are to keep open the possibility of the further tax cuts and interest rate reductions which would benefit industry and be electorally helpful it really is crucial that colleagues recognise that the starting presumption in the Survey has to be that the totals published in the White Paper only 3 months ago are to be held.

12. And it means that we must resist pressure to reduce the unemployment figures by throwing money at the problem, or changing macro-economic policy. Today's dole-queue is not the result of our efforts to reduce inflation: it results from others' past reluctance to tackle inflation. To drop our efforts would not work, would store up new problems for the future, and would have a confidence back-lash.

N.th-

Building on the Foundations

13. But there are also positive actions which we should take.

14. First, Interest rates represent not only one of industry's biggest perceived costs, but also affect individuals directly, e.g. through their mortgages. We must try to secure further reductions. This means ensuring that

Opposite of (M) Comp. European agreement. No one believed that we could have decoupled by 5½%

monetary conditions are not unnecessarily tight; seeking to safeguard our financial markets from the threat of another US interest rates crisis; and - which will support this - doing all we can to ease the problems for business finance and borrowing - especially medium-term finance. You will have seen that I have today announced some modestly helpful changes on this front.

15. We must encourage the restraint of industry's other costs, and in particular the recent welcome real reduction in unit costs. There are other elements beside pay in this. Industry may be further encouraged to improve efficiency, through investment and the necessary changes in working practices. This entails supporting those - e.g. British Rail - whose efforts to secure higher productivity lead to industrial action. And it means that we ourselves must keep up - indeed step up - our efforts to secure the removal of institutional and other obstacles to change, e.g. BR's 1919 wage agreement.

16. We have done less than enough, as yet, to publicise and effectively promote all the changes designed to encourage enterprise which we have made. We have now taken the steps necessary to launch the basic publicity campaign that Michael Heseltine suggested some time ago. But if this is to make a politically significant impact then it needs to be extended and maintained. This will call for major and co-ordinated efforts involving not only Ministers but many others. And, while I doubt whether there is much more that we can do by tax concessions, there are still obstacles to be identified and where possible removed. This, too, is not a job for Ministers alone.

PERSONAL AND CONFIDENTIAL

17. Action in these three areas should help quicken economic recovery, while not endangering the key priorities (paras 9-11 above). And on unemployment, a drive to make the most of what is now being spent by the MSC, to get programmes like the Community Work Scheme off the ground, and to overcome - or at least expose - trade union resistance to sensible low-cost means of getting people off the register and into useful work, is politically highly desirable.

Conclusion

18. We always knew we were setting our hand to a two Parliament job. And we knew that there would be a problem in securing our second term without jeopardising the gains we made. The economic prospects in the run-up to the Election are not unpromising, but there are risks. We must maintain our fiscal and monetary policies, so as to be able to bring interest rates down, and this means maintaining our grip on public expenditure. But while this is a necessary condition, we cannot count on it as sufficient. Positive action is required from us in the areas listed in paragraphs 13-17 above.

19. I look forward to discussing with you in due course how the 15 July Cabinet should be handled. Perhaps we might also have a word about how best to pursue with Cabinet colleagues the issues in paras 13-17. And it goes without saying that I would be happy to explain in greater detail the points of timing touched on in para 3 if you think that would be helpful.

GH

(G.H.)
25 June 1982

PPS/CHANCELLOR

file no TEB/CA/01

copied to:

Mr Salveson (for transmission to No.10)
PS/CST
PS/FST
PS/EST
PS/MST(C)
PS/MST(R)
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 BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 14 June, are sidelined.

MMDeyes

M M DEYES

RA

R I G ALLEN

21 June 1982

EB Division
H M Treasury
01-233-3364

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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. Versailles summit achievements?

Agreed to maintain prudent monetary policies and achieve greater control of budgetary deficits in order to reduce real interest rates. Also agreed to intensify economic and monetary co-operation, to resist protectionary measures, not to use exchange rates to gain unfair competitive advantages and on a cautious approach to financial and trade relations with the Eastern bloc.

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

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 particularly to help business, but also individuals, within responsible fiscal framework.

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

[Estimated PSBR outturn 1981-82 now about £8.9 billion (3½ per cent of GDP) cf £10½ billion forecast at time of Budget March 1981 and in 1982 FSBR.]

Not possible to answer this question until more known about why PSBR was lower in 1981-82. Need also to consider the wider context. Lower borrowing by public sector in first quarter of 1982 was factor in sharp fall in our interest rates relative to overseas rates in those months. Cannot assume 1981-82 shortfall will necessarily feed across to 1982-83; far less that Budget judgement needs revision.

5. 1981-82 PSBR outturn inconsistent with MTFS?

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

6. Government's impact on inflation disappointing?

[May RPI published 18 June; April average earnings 16 June.]

12-monthly RPI inflation rate in May 9½ per cent and trend is firmly downwards. Indeed, we may do rather better than FSBR forecast of 9 per cent by end-1982. (See also Section K.)

7. Economic recovery in doubt?

[April index of industrial production published 17 June. Figures show little change in underlying level of output in last 6 months; but index still 2 per cent higher than last spring.]

Profile of recovery likely to be uneven and jerky particularly when affected by such factors as very severe weather and industrial disputes. Activity is above levels of last spring. Prospect is for resumed and continued recovery. This is supported by business surveys, most independent forecasts, CSO cyclical indicators and other indicators. Most encouraging pointer for sustainable recovery is lower interest rates and progress being made against inflation. (See also Section B.)

8. Trade-figures disappointing?

No. Current answer remains in healthy surplus (£½ billion) in 1982 Q1. Exports recovered in March and in last six months have held up better than many feared, given earlier loss in competitiveness. Imports up sharply since 1981 H1, reflecting in part higher activity and end of destocking. (See also Section L.)

9. Investment remains depressed?

[1981 Q1 figures for capital expenditure in manufacturing, distribution and service sector published 20 May; new DOI Investment Intentions Survey published 27 May.]

Some encouraging signs. Manufacturing fixed investment stabilised in H2 1981 and has retained level into Q1 of this year following sharp falls from Q4 1979; latest Investment Intentions Survey points to some recovery in course of 1982, and stronger growth next year.

Strong growth in distributive and service industries' investment up 12½ per cent since Q1 1981.

10. Do FSBR forecasts still hold?

No reason to question broad shape of forecasts but in certain areas, eg inflation, progress faster than foreseen at Budget time. [NB: Not the practice to issue revisions between twice-yearly publication of forecasts under Industry Act ie Budget-time and autumn.]

11. House of Lords Select Committee on Unemployment

[Report published on 16 June. June unemployment figures to be published 22 June.]

See Section C.

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

[Report published 17 June.]

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

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

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

14. Treasury model of economy 'rigged' to produce discouraging results from alternative policy packages?

See Section P.

15. Implications of latest fall in interest rates?

[Short-term rates down over ½ percentage point on end-May; 3½ per cent on autumn 1981 peak.]

Continues welcome decline in interest rates seen earlier in year; Falklands crisis disguised underlying downward trend. Market perceived that conditions were right for a fall in rates and Bank acquiesed in this: monetary aggregates growing more moderately; inflation coming down and exchange rate strong. Sign of confidence in Government policies; and welcome assistance for business.

16. Implications of latest EMS realignment (12 June) for UK?

Little direct impact on us. But this third realignment in 9 months reinforces lesson that lasting currency stability must be based on success in controlling inflation - our first priority. (See also Section M)

17. Overfunding / money market assistance

See Section J.

18. SDP Policy Paper: Towards Full Employment
[Discussion Paper, first in series, published 7 June.]

Some proposals (eg emphasis on need to control growth in total money GDP) sensible, are not far removed from Government thinking (eg MTFS). But paper exaggerates extent to which expansion of special employment measures would provide genuine new jobs; advocat 'reflation' while largely ignoring possible damaging consequences (eg on confidence of business and markets); and advocates policies to control pay and prices very similar to those tried, and failed, in past.

19. International developments - France, US Budget, Versailles, etc?

See Section T.

20. Cost of Falklands?
See Section U.

BULL POINTS 21 June 1982

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

(ii) Investment. Manufacturers', distributors' and services' (MDS) investment rose 5 per cent between 4Q 1981 and 1Q 1982. DOI investment intentions survey suggests 2 per cent rise in MDS investment in 1982. Suggests fall in investment all but over. Private sector investment, particularly in plant and machinery holding up well. Investment in plant and machinery in 1981 only slightly ($1\frac{1}{2}$ per cent) lower than 1980, 8 per cent higher than in 1H 1979.

(iii) Interest rates. Short-term rates have fallen 3-4 points since turn of year (now $12\frac{1}{2}$-13 per cent). Process temporarily interrupted by Falklands dispute, now resumed. Recent falls reflect several factors:- single figure inflation, M1, £M3 and PSL2 developing favourably in relation to target. Government borrowing under control exchange rate firm.

(iv) Inflation. 12-monthly increase in RPI now in single figures - 9.5 per cent in May - more than halved since spring 1980 peak (21.9 per cent). Inflation in April and May lowest since January 1979, but trend now firmly downwards, not upwards as then. Manufacturers' output prices up just $8\frac{3}{4}$ per cent in year to May.

(v) Costs. Increase in average earnings halved in 1980-81 pay round. Public sector pay in line. Further moderation in average level of settlements in current round. CBI pay databank for manufacturing settlements suggests average now around 7 per cent compared with 9 per cent in previous round.

- Little increase in manufacturers' unit wage and salary costs over last year - only 3 per cent up in year to 1Q 1982, below average of our major competitors and comparable to that of Germany and Japan.

- Manufacturers' input prices little changed since last August; up just 4¾ per cent in year to May (lowest increase since November 1978)
- CBI April survey shows lowest degree of unit cost pressures for 15 years

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

(vii) Competitiveness. Cost competitiveness improved by 10-15 per cent during 1981 reflecting pay moderation, higher productivity and exchange rate fall, but remains one-third worse than in 1975.

(viii) Profits: Industrial and commercial companies gross trading profits (excluding North Sea and net of stock appreciation) rose strongly during 1981, up over 25 per cent between 1H and 2H 1981, but from very low base.

(ix) Exports have held up better than many feared following 50 per cent loss of competitiveness between 1975 and 1Q 1981. Recent months' figures suggests non-oil exports (excluding erratics) running at about same level as in 1980. Engineering export orders up 17 per cent in 1981 on 2H 1980 to reach their highest level.

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

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

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

Economic Briefing Divison,
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01-233 3819/5809

B ECONOMIC ACTIVITY AND PROSPECTS

1. Recovery faltering?

[NB: Provisional estimates of all three measures of GDP, company profits in Q1 1982 and June unemployment figures to be released 22 June.

- GDP (output) fell about ¼ per cent in Q1 1982, but remains above levels of last spring. In part reflects impact of very severe weather and industrial disputes at turn of year.
- Some recovery in industrial production in February and March, but little change in April. Underlying level of industrial/manufacturing output broadly flat over last 6 months.
- Manufacturing productivity risen 12 per cent since end 1980. Company profits up by over one quarter between H1 and H2 1981. Inflation 9.5 per cent in May. Interest rates fallen 3-4 points since turn of year. Competitiveness improved by 10-15 per cent since Q1 1981.
- Prospect of resumed and continuing recovery broadly shared by business opinion surveys, bulk of outside forecasts and CSO's cyclical indicators. Leading indicators suggest continuation of recovery after some hesitation through early 1982.]

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

2. Investment and stockbuilding?

[Fixed investment flat in 1981 but manufacturers', distributors' and service industries' (MDS) investment rose 5 per cent in Q1 1982. DOI's investment intentions survey suggests 2 per cent rise in MDS investment in 1982. Despite slight fall between 1980 and 1981 plant and machinery investment in 1981 8 per cent higher than in H1 1979. Rate of destocking slowed sharply in H2 1981, some restocking in manufacturing and distributive industries in Q1 1982.]

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

3. May CBI Trends Enquiry/Forecast gloomy?

[In reviewing latest CBI situation report, FT (Monday 7 June) quotes CBI as claiming "Economy to remain in doldrums". Monthly Trends Enquiry suggests little change in order books in recent month and continuing approximate zero net balance of firms expected to raise output in next 4 months. The latest forecast suggests recovery to resume this year with 1 per cent growth in 1982, 2 per cent in 1983. Inflation forecast to fall to 9 per cent by end 1982, 7½ per cent 1983. CBI expect continued improvement in company profits and financial position.]

Taken together monthly enquiry and forecast point to continuation of recovery during course of 1982 and 1983, lower inflation and improved profitability and financial position of companies. Forecast closely in line with Budget forecast and bulk of outside forecasts.

4. Other evidence of improvement in economy?

See Bull Points (following Section A).

5. Government assessment of prospects

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

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

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

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

6. Outside forecasts

[GDP profile in major post-Budget assessments:

	NIESR	LBS	St James	Phillips &Drew	CEPG	CBI	FSBR
	(May)	(Apr)	(Apr)	(June)	(April)	(May)	(March)
Per cent change 1982 on 1981	+1	+1 ½	+1 ¾	+1 ½	−½	+1	+1 ½]

Nearly all see prospect of continued recovery in 1982 in line with FSBR, (as always, a range, with Cambridge forecast (CEPG) being the more pessimistic) and see inflation at 8-9 ½ per cent by Q4 1982 - also in line with FSBR. [See also C3 (unemployment), K3 (inflation) and L6 (balance of payments).]

C LABOUR MARKET

1. Recent unemployment figures?

[NB: Unemployment figures for June to be released 22 June. Separate briefing being supplied to No.10. In May, unemployment (UK adult seasonally adjusted) rose by 22,000 to 2,872,000 (12 per cent). Total unemployment fell by 38,000 to 2,969,000 (12.4 per cent). Average monthly underlying increase in adult unemployment (after allowing for men over 60 transferring to long term Supplementary Benefit) are:

1980 Q4	1981 Q1	Q2	Q3	Q4	First 5 months 1982
105	77	62	51	33	22]

May's rise (much the same as average monthly increase in Jan-April) suggests that unemployment has risen more slowly this year than last.

2. Vacancy figures disappointing?

[NB: June vacancy figures to be released 22 June. In May, vacancies (UK seasonally adjusted) fell slightly for third consecutive month to 107,000 compared with 113,000 in February. Vacancy flow data for April (latest month available) show inflow and outflow much improved - about 165,000 per month this year compared with about 145,000 per month in 2Q 1981.]

Despite recent falls vacancies still ¼ higher than at low point in Q2 1981 and turnover is also higher.

3. Unemployment expected to continue rising rapidly?

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

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

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

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

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

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

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

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

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

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

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

Report's figures no doubt based on careful study, but all such estimates depend on assumptions made and concepts followed. No single figure of this kind can really purport to show how changes in unemployment affect public finances. (See also C10.)

8. Employment continuing to fall?

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

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

9. Unemployment higher than in other countries?

[On standardised definitions in Q3 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.

10. High Exchequer costs of unemployment? Recent Treasury estimates suppressed?

Possible to produce wide range of estimates depending on assumptions made and concepts followed. No single figure of this kind can purport to show how changes in unemployment alter the public finances. [IF PRESSED on cost of benefit payments, rebates and administration only in current year: It is estimated that the 1982-83 cost of benefit payments, rent or rate rebates, and administration per extra 10,000 unemployed is around £18 million. IF PRESSED on total Exchequer cost: Estimates have been made of Exchequer cost of additional registered unemployment (eg for 1980-81 in February 1981 EPR). There has been continued work on the various elements included in that calculation. Treasury at present considering basis on which estimates of Exchequer cost prepared.]

11. What is Government doing to provide more jobs?

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

12. Government reaction to MSC Task Group report on future of training for young people?

Task Group's proposals are of considerable significance for future shape of training arrangements for young school leavers, both employed and unemployed. Government will consider recommendations carefully with a view to reaching a decision as soon as possible this summer.

D TAXATION

1. Burden of taxation

[Total taxation (i.e including for example income tax, indirect taxes, corporation tax, rates and NIC) in 1978-79 was 34½ per cent of GDP (at market prices), 36 per cent in 1979-80, 37½ per cent 1980-81. It is forecast to be 40 per cent in 1981-82 and 39¾ per cent in 1982-83.]

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

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

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

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

3. Burden has fallen for the rich?

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

4. Burden has risen most for the poor?

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

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

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

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

6. No improvement in incentives?

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

7. Poverty trap/unemployment trap getting worse?

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

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

8. Budget reduction in NIS not enough for industry?

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

9. 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.

10. Merger of tax and social security planned?

See G4.

E PUBLIC EXPENDITURE AND FINANCE

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

1. Public expenditure too high?

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

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

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

3. Increase spending in recession?

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

4. Government has complacent attitude to public expenditure?

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

5. Real terms comparisons

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

6. Not enough capital expenditure?

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

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

7. Cuts in capital

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

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

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

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

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

10. End-year flexibility?

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

11. Revised cash limits 1982-82 announced 27 May

[In his Budget statement, after allowing NIS surcharge cut to help industry, the Chancellor announced that, in order to leave them where they would have been without the change, appropriate reductions would be made in relevant cash limits and votes of central government, in rate support grant to LAs and in EFLs of NIs and other public corporations. Revised EFLs for nationalised industries and for three other public corporations were given in answer to a written PQ on 7 April. (The revised figures included also certain other changes.) Further revisions to central government cash limits - published in written PQ 27 May.]

Revisions implement 'clawback' consequent on reductions in national insurance surcharge - a move intended to reduce business costs in the private sector. But as public sector employment also liable to the surcharge, appropriate reductions have been made to leave public bodies where they would have been without the change.

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

(See Sections F and K.)

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

Only one third of current expenditure is on wages and salaries and much of that is for nurses, teachers, members of armed forces, police and so on. Provision for public service pay increases 1982-83 limited to 4 per cent. Administrative costs ae not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain drive for more efficient management throughout public sector.

LOCAL GOVERNMENT

14. Overspending in 1982-83? Government response?

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

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

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

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

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

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

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

16. Effect of NIS reduction on local authorities?

As Chancellor announced in Budget, we intend that local authorities overall will be neither worse nor better off as a result of decrease in NIS. We are aware of the difficulties involved in offsetting the reduction by a decrease in grant, and are looking constructively at possibility of postponing the reductions for local authorities until April 1983.

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

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

F CIVIL SERVICE STAFFING AND PAY

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

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

2. Civil service pay: non-industrial civil servants

[Settlement date 1 April 1982.]

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

3. Civil Service pay: industrials

[Settlement date 1 July 1982]

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

4. Scott Report/Public sector pensions?

See K 21

G SOCIAL SECURITY

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

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

2. Why cut child dependency additions to unemployment benefit?

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

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

3. Death grant - increase to realistic level?

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

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

4. Merger of income tax and national insurance planned?

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

H PUBLIC SECTOR BORROWING

1. Reasons for PSBR undershoot in 1981-82?

[PSBR 1981/82 undershoot originally thought to be around £2 billion now seems to be less than this: latest PSBR figure £8.9bn]

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

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

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

3. Implications for fiscal policy and MTFS?

See A

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

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

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

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

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

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

Last year's figures severely distorted by Civil Service dispute so comparisons can be seriously misleading. Too soon to make any amendment to forecast for the year.

7. Government's expectations for PSBR in 1982-83 ?

Latest estimates suggest that PSBR out-turn dof 1981-82 was £8.9 millic
Budget forecast for 1982-83 was £9.5 million. No reason to change this
forecast.

8. Effect of Civil Service dispute on PSBR?

PSBR in both 1981-82 and 1982-83 affected by Civil Service dispute. In 1981-82 some £¾ billion of receipts delayed from March 1981 were collected, but some £1½ billion of receipts due in 1981-82 will now be collected in 1982-83. Debt interest cost of the strike some £½ billion in 1981-82. Dispute also damaged our ability to interpret and forecast the PSBR reasonably accurately (see question 1).

9. Fiscal policy should be based on cyclically adjusted/real PSBR?

Some merit in inflation-adjusted measure as indicator of fiscal stance in some circumstances. But there are dangers here: it would be quite wrong to expand PSBR in cash terms in response to an upsurge in inflation merely to keep inflation-adjusted measure constant. Policies intended to eradicate inflation, not to adjust to it.

MONETARY AND FINANCIAL POLICY

1. Monetary growth in 1981-82

[In banking May (third month of target period) £M3 rose by 1.1 per cent, bringing growth in the target period to 9.7 per cent at an annualised rate; M1 rose by 0.6 per cent (0.2 per cent at an annual rate this target period); PSL2 rose by 0.7 per cent (10.1 per cent at an annual rate over the target period) - all figures seasonally adjusted].

Too early to judge outturn over target period as a whole, but recent figures encouraging. Figures point to continuing steady downward pressure on inflation.

2. Monetary conditions too tight?

Exchange rate, money GDP and monetary aggregates suggest financial conditions have been moderately restrictive whilst allowing recent further falls in interest rates. Bank lending is still growing rapidly, however; we do not believe that monetary conditions have been too restrictive.

3. Bank lending

Too early to say whether growth is slowing, though banking May figure lower than in preceding months. Part of recent rapid growth at least is in substitution for building society lending and other forms of consumer credit, but to the extent that it is additional it may add to inflationary pressures, so must continue to proceed cautiously on interest rates.

4. Why have you been over-funding and providing large-scale money market assistance?

The rapid growth of bank lending (much of which relates to structural changes) creates problems for conduct of monetary policy. By selling long- term Government debt on a large scale outside the banking system it has been possible to contain the growth of money which the lending would otherwise have produced. If we had not intervened to relieve the resulting shortages in the noney markets, the banks would have been forced to bid for deposits,raising short-term interest rates to levels which according to other indicators of monetary conditions were not justified .

5 Recent falls in interest rates

Base rates cut from 13-12½ per cent wef 8/9 June. Continues decline seen since last October when base rates were 16 per cent. Market unease over Falklands disguised underlying trend. Recently rates eased creating the conditions for 8 June base rate cuts as victory comes in sight. The latest falls are consistent with continued progress against inflation.

6. Prospects for further falls

Of course want to see rates lower still, but we have only just seen a further welcome cut in base rates and we have to be cautious about the future. We shall not jeopardise counter-inflation policy, but in due course further progress with MTFS should lead to rates being lower still.

7 Will high and unstable US rates affect UK rates?

[US rates became firmer last week. Prime rates 16½ per cent.]

US rates not sole determinant of UK rates, but high US rates certainly an adverse development and in September were a key factor in driving our rates up. Recently, however, sterling has remained reasonably firm, probably helped by improved prospects for wage round, and good trade figures. UK interest rates have eased this year against US trend; but we cannot insulate ourselves from difficult international background. (See also T11.)

8. MTFS being quietly shelved?

[3rd MTFS states Government's objectives 'to reduce inflation and to create conditions for sustainable growth in output and employment', by 'steady but not excessive downward pressure on monetary conditions'. Key financial indicators are the monetary aggregates and exchange rate. Target range for growth of M1, £M3, PSL2 in period February 1982 - April 1983 of 8-12 per cent. Illustrative path of 7-11, 6-10 per cent in 1983-84, 1984-85. Targets for later years to be set nearer the time.]

No. Updated MTFS is realistic and flexible, describes how monetary policy operated in practice. MTFS serves useful purpose. Right to retain and adjust in light of experience.

9. Monetary targets discredited?

Monetary targets have important role in defining medium term direction of policy. But short term movements in monetary aggregates not always reliable guide to monetary conditions. Policy decisions based on assessment of all available evidence.

K PRICES AND EARNINGS

PRICES

1. Inflation rising again?

[12 monthly rate of inflation 9.5 per cent in May compared with 9.4 per cent in April, 10.4 per cent in March and 21.9 per cent in May 1980.]

No particular significance is to be attached to the 0.1 per cent rise in the monthly inflation rate in May.

2. Inflation lower than forecast in Budget statement?

Inflation is now in single figures and is continuing to fall. We could well make rather faster progress in reducing inflation than we anticipated at the time of the Budget.

3. How low inflation by end 1982?

No new forecast to offer at this stage, but the year-on-year rate of inflation was already 9.5 per cent in May, and should decline further over the year.

3. Chance of 7½ per cent inflation by end of year?

[Industry Secretary Speech to CBI 24 May. Latest Reward Regional Survey also forecasts 7½ per cent.]

Fall to 7½ per cent by end of year not impossible - it is within the margins of error attached to the Budget forecast of 9 per cent. Recent figures have been encouraging and an outturn somewhat better than 9 per cent is quite possible.

5. Recent trends in inflation

Over the past year, the year-on-year rate of inflation has fallen from 11.7 per cent in May 1981 to 9.5 per cent in May 1982. Over the last year of the Labour Government, the year-on-year rate of inflation increased from 7.7 per cent in May 1978 to 10.3 per cent in May 1979.

6. What reason is there to expect a further decline in inflation?

Over next year or so, moderation in unit labour costs should continue to exert downward pressure on rate of inflation, as should weak commodity prices. Competitive pressures on firms to limit price rises are also likely to remain strong.

7. Inflation lower than under previous Government?

[Average year-on-year rate of inflation between February 1974 and May 1979 was 15.4 per cent; average level of inflation since May 1979 has been 14.2 per cent.]

Year-on-year rate of inflation had risen to 10.3 per cent when previous Government left office. And on present forecasts average level of inflation will be lower under this Government than under its predecessor - first time this has happened in over 30 years.

8. Inflation still not as low as competitors

[UK inflation 9.4 per cent in April, compared with 6.6 per cent in US, 5 per cent in West Germany, and 2.8 per cent in Japan.]

UK inflation now lower than Western European (OECD Europe) average, and well below many countries - such as France and Italy. Still some way to go to match US, West Germany and Japan, but good progress being made in right direction.

9. Movement in tax and prices index?

[Increase over 12 months to May 9.8 per cent, compared with increase of 9.5 per cent in RPI].

Fact that TPI has been increasing faster than RPI reflects measures taken to restrain Government borrowing, which is essential if inflation is to be controlled. But following recent Budget, difference is now small.

10. Nationalised industry prices

71 [Increase over 12 months to May 14.0 per cent, compared with an increase of 9.5 per cent in the RPI (see also R8)].

Gap between nationalised industry price increases and RPI due in large measure to cumulative effect of years of artifical price restraint. World oil price rises of 1979 and 1980 have also played important part. Increases regrettable, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so, but sustained improvement only possible if industries succeed in holding down current costs, particularly pay.

11. Effect on retail prices of EC farm price settlement?

[EC Agriculture Ministers agreed on 18 May, by majority decision, to raise level of farm support prices under CAP by average of just over 10 per cent].

Estimates of effect of the CAP price settlement on retail prices can only be made in general terms, and will depend on such factors as the type of support operated and the prevailing market conditions in the sectors concerned. Agriculture Minister (in statement to House 19 May) estimated that direct impact of total package would add about ¼ per cent to retail prices index and 1¼ per cent to retail food price index in full year. [NB Treasury believes this may be under-estimate because assumes constant absolute profit margins.]

PAY

12. Current level of pay settlements

The recent decisions on public service pay which the Government has announced confirm the downward trend of settlements since the last pay round, when they generally averaged 8-9 per cent. Settlements are also well below rate of inflation for second year running.

13. 4 per cent pay factor abandoned?

The 4 per cent factor is not a pay norm, but a broad measure of what Government thinks reasonable and can be afforded in fixing provision from which public service wage bill has to be met. Government has decided to accommodate cost of Civil Service arbitration award within the relevant provision. Only if expectional difficulties arose later in the year would limited calls on the contingency reserve be considered.

14. Government norm now 6 per cent?

There is no norm, nor has there been. The 4 per cent factor remains the basis on which provision for public service pay has been set. Where extra provision has been needed to help finance proposed higher increases, as with nurses, doctors and dentists, it has been found partly from other savings on programmes concerned and partly from contingency reserve.

15. Government satisfied with 6 per cent?

Increases of 6 per cent are higher than provision which the Government made for pay within programmes. They will have implications for level of non-pay expenditure.

16. Will Government climb down on NIS pay?

No. Government wants negotiations to continue. Talks are continuing with the RCN, and the Chairman of ACAS is exploring the issues between the Government and the health unions on a personal basis. We await the outcome of these contacts.

17. Top Salaries Review Board increases too large?

[Government announced on 12 May increases of 14.3 per cent for senior civil servants and senior members of the Armed Forces, and 18.6 per cent for the judiciary.]

Government believes these increases are fully justified. Essential to ensure adequate supply of candidates of sufficient calibre for the Bench, and to provide adequate career structure and differentials in higher levels of Civil Service and Armed Forces. TSRB are only group whose present salaries are below those recommended for April 1980.

18. Average earnings index

[Year on year growth 10.2 per cent in April compared with 11.0 per cent in March. Underlying unpublished increase also around 10¼ per cent.]

Encouraging that underlying rate of growth continues to fall. But must remember change over the 12 months to March straddles two pay rounds - not entirely indicative of recent trends. Also, earnings index inflated recently by some increase in hours worked.

19. Living standards rising?

[Financial Times has pointed out that 10.2 per cent increase in average earnings in April exceeds 9.7 per cent TPI increase for that month.]

Must remember that 12 month earnings increase is slill influenced by last pay round. But figures dispose of wilder claims about living standards.

20. Government aiming to cut living standards?

[Although RPDI was 1 per cent higher in 1981 Q4 than in 1979 Q1, it is likely to fall below the 1979 Q1 level during 1982]

No. Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

21. Index-linked pensions and the Scott Report?

The Government ~~is~~ considering whole question in light of Scott Report. Our aim is to ensure that public servants' pensions are fair to taxpayers, as well as to current employees and pensioners and their dependants.

22. Incomes Policy

[SDP Green Paper "Towards Full Employment" (published 8 June) includes proposal for permanent incomes policy]

Proposals for incomes policies, including recent refinements, do not avoid many of the familiar problems of norms, administrative costs, and interference with market forces. Experience gives no encouragement to the idea that incomes policy can be made to work on a permanent basis. They always succumb to the distortions they create.

L BALANCE OF PAYMENTS

1. March trade figures?

[Figures published 7 June show current account in estimated £330 million surplus during March. Non-oil trade back in surplus for first time since October. Invisible surplus of £110 million lower than earlier projected in part reflects change in statistical treatment of EC Budget refunds (see 4 below). Current account surplus of about £½ billion in 1Q 1982 compares with £2½ billion in 1Q 1981 and about £1½ billion in 1Q 1981. For 1981 as a whole, estimated current amount surplus (still partial data) now £7 billion cf Budget estimate of £8 billion.]

Figures still incomplete for 1981, and difficult to interpret. But current account remains in substantial surplus and exports holding up well.

2. Export trends gloomy?

[Figures remain extremely difficult to interpret, following last year's Civil Service dispute and changed documentation procedures. Latest figures show apparent weakening in non-oil volumes in Jan-Feb reversed in Feb-March. Volume of non-oil exports (excluding erratics) in September 1981 - March 1982 much the same as 1980 average.]

Exports held up better than many feared following earlier fall in competitiveness. Present months figures suggest non-oil exports running at about same levels as in 1980.

3. Imports?

[Figures remain difficult to interpret (see 2 above). Non-oil import volumes between March 1981 and September 1981 higher than in low levels of 1Q 1981, since then broadly stable.]

Imports bounced back in 1981 as destocking came to an end. But increase in the volume of imports of finished manufactured goods since September 1981, suggesting that UK firms are being more successful in home market.

4. Disappointing trend in invisibles contrary to expectations

[Figures published 8 June show Q1 current account surplus of £0.6 billion, a visible trade surplus of £0.2 billion but a reduced surplus on invisibles of £0.3 billion against the £1.4 billion projection published with February Trade figures].

It would be wrong to read too much into these figures, which need careful interpretation. About half the fall from the earlier projection results from a new seasonal adjustment to the figure for EC refunds. This will add the same amount to the figures over the rest of the year. Most of the rest reflects a substantial [around £500 million] change to the CSO's estimate of net interest profit and dividend payments from and to countries abroad. This is a very erratic item, subject to revision. Trade in services remains in large and growing surplus (£1043 million in Q1, up from £1006 million in Q4 1981).

[NB. If the comparison is with the revised figures for Q4 1981 our net payments to the EC increased in Q1, and there was a fall in net interest and dividend receipts. But in that

comparison the seasonal adjustment point does not apply since the revised 1981 figures are also seasonally adjusted.]

5. Overseas investment takes jobs away from UK?

30 per cent of UK exports are bought by overseas firms connected to UK companies. By increasing the links between UK and overseas companies, overseas investment helps UK exports and production producing more jobs. If the UK does not take profitable opportunities to invest overseas, others will.

M EXCHANGE RATE AND THE RESERVES

1. Policy towards the exchange rate / falling £ ?

[Since last autumn sterling has remained broadly stable. The average £ effective rate in Q1 1982 was over 10 per cent lower than in Q1 1981. Previous lows were $1.7470 on 6 April, DM 4.098 on 21 May. Highs were $1.97 on 30 November, DM 4.407 on 9 February. Rates at close on 12 June were $1.7395, DM 4.696 and an effective of 91.21. Reserves at end May stood at $17.8 billion, compared with $18.2 billion at end April.]

The Government has no target for the exchange rate. The rate is taken into account in interpreting domestic monetary conditions and taking decisions on policy. Level of the effective exchbnge rate for £ continues to show its underlying strength.

2. Bank of England intervening to support the rate?

Policy is unchanged. The Bank do intervene to smooth excessive fluctuations and preserve orderly markets particularly when conditions are unsettled. But as the Chancellor has already stated we have no target - undisclosed, secret or otherwise - for the exchange rate. Most recent reserves figures confirm that policy is unchanged.

3. Concerted intervention to reduce the value of the dollar?

All the experience in recent years is that exchange rates for major currencies cannot be manipulated by intervention alone. Intervention can help to steady markets, but not counter major exchange rate trends. That takes changes in real policies, affecting interest rates, monetary conditions and fiscal policies. Lower US inflation is in everyone's interest: the matter for real concern is the US fiscal/interest rate mix, a problem all countries are familiar with.

4. Improve UK competitiveness by devaluing the exchange rate

Experience shows that exchange rate cannot be manipulated by Government against underlying market trends. Any attempt to lower it by intervention or by relaxing monetary control leads to higher inflation. For example although effective exchange rate depreciated by over a quarter between 1972 and 1976 competitiveness was unchanged, this remedy has been tried and it has failed.

5. Debt repayments

We have made excellent progress with our plans to reduce the burden of external debt substantially during this Parliament. We aimed to reduce official external debt to $14 billion by end of 1981. This has been more than achieved - external debt is now around $13 billion, compared with over $22 billion when the Government took office.

6. French devalue to improve competitiveness

[At EMS realignment on 12 June the Deutschemark and Dutch guilder were revalued by 4.25 per cent; the French franc devalued by 5.75 per cent and the Italian lira devalued by 2.75 per cent]

EMS realignment conference on 12 June - at which the Chancellor assisted - adjusted exchange rates to allow for underlying market trends. The realignment - and accompanying measures taken - show that other European countries have the same priority as ourselves: to defeat inflation and so create the conditions for sustained economic growth.

N EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. UK budget settlement

Foreign Ministers agreed on 25 May to a settlement for the UK budget contribution for 1982. The settlement provides for a basic refund of £490 million in respect of 1982, with provision for changes to this figure if our unadjusted net contribution varies from the Commission estimate of £880 million. It was also agreed that the problem for the longer term would be settled by the end of November.

2. Implementation of budget settlement

This is to be settled at Foreign Ministers' meeting on 21 June, and embodied in a Regulation thereafter. 25 May agreement envisaged partial rebates to Germany, Italy, Greece and Ireland for their share in financing UK refunds, making France bear a larger burden - but France will remain a substantial net recipient from the budget.

3. Remainder of Commission 'Mandate' report

The other member states broke the link between the different parts of the mandate report when they voted through the agricultural prices. But we are prepared to continue to work on the basis of previous agreements where applicable.

4. CAP prices 1982-83 and the Luxembourg Compromise

As Agriculture Minister made clear in his statement on 19 May, we consider the adoption of the 1982-83 CAP prices to have been wholly contrary to the Luxembourg Accords, which were in existence before we joined the Community and which have been observed for 16 years. This action raises serious constitutional issues. Foreign Ministers are to consider the implications on 20 June.

5. UK objectives for longer-term negotiations?

Government has made it clear that, in spite of our relative economic position, UK is prepared to remain a net contributor - but only on a very modest scale.

6. UK refunds in respect of 1981

Commission paid us before 31 March £813 million for supplementary measures as first instalment of our refunds in respect of 1981. This represents 81 per cent of our entitlement for that year. Our net contribution for 1981-82 is now put at some £200 million - very substantially less than it would have been without the 30 May 1980 budget agreement.

7. UK a net recipient in 1981?

In fact we remained a small net contributor to the allocated Community budget. We also, of course, contribute to aid etc. which is part of the unallocated budget. Very satisfactory that the outturn was better than expected: for we remain one of the less prosperous member states.

8. Will UK have to repay or forego refunds if net contribution less than originally estimated?

No. The UK is clear that minimum net refunds payable under 30 May agreement are 1175 million ecus (European Currency Units) for 1980 and 1410 million ecus for 1981.

9. 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.

10. Policy for CAP reform

Key measures are price restraint, curbs on surplus production and strict control of the growth of guarantee expenditure.

11. 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

12. 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.

13. Join the EMS for exchange rate stability?

There is no reason to suppose that by the simple act of joining the EMS exchange rate mechanism we would guarantee exchange rate stability. This has not been the experience of the current participants. Genuine stability requires a return to low inflation rates throughout the Community.

P INDUSTRY

1. Treasury simulations for April meeting of NEDC: TUC accusation that Treasury 'rigged' results, on Chancellor's orders.

No truth whatsoever in this charge. Treasury model is designed, operated and, where necessary, modified, purely on basis of professional judgement of economists within Treasury. Treasury Ministers in no way involved in its design or operation. (TUC charges were fully answered in a detailed statement issued by the Treasury on May 14.)

2. Will technical discussions between Treasury and TUC (and other NEDC partners) now take place?

We hope so (but no date has been fixed).

3. Prospects for industry-recovery?

See B1 and 3.

4. Company financial position?

[Non-oil industrial and commercial companies (ICC's) gross trading profits (net of stock appreciation) rose by over a quarter between 1H and 2H 1981, but from a very low base - ICC's real rate of return just 2½ per cent in 1981. ICC's finances showed some weakening in 4Q reflecting slowdown in destocking and unwinding of civil service dispute, but finances better in 1981 as a whole -

£bn

	1979	1980	1981 Year	H1	H2
Net borrowing requirement (+)/repayments (-)	+6.1	+5.7	+4.4	-1.2	+5.6
Financial surplus (+)/deficit (-)	-2.7	- 1½	+1.2	+1.5	-0.3

NB: Q1 1982 company profits figures to be published 22 June.]

Increase in profits (albeit from low level) encouraging. Some apparent deterioration in financial position reflects slowdown in rate of destocking, and effects of unwinding of civil service dispute (which delayed companies' tax payments), but companies' finances much healthier in 1981 than in two previous years. Company liquidity improved considerably in first three months of 1982 [new DOI Survey figures published 4 June].

5. Births and deaths of firms

[Report in FT 11 May of Henley Management College Paper showing 'more firms now dying than being born'?]

No really satisfactory statistics to measure this. Henley used lists of firms registered under Companies Acts - not same thing as list of actively trading companies (eg sole traders and partnerships excluded, firms sold in liquidation to other companies counted as 'deaths'). A better guide might be the list of 1.3 million firms registered for VAT: latest available figures (1980) show births and deaths roughly in balance.

6. Rate of return still too low?

[Real pre-tax rate of return of ICCs was 2½ per cent in 1981 - half the previous lowest figure in 1975.]

Yes, but Government can only help in limited ways. Fundamental improvement in ICC's profits and real rates of return depend on improved performance by companies, both management and employees. Much encouraged by recent productivity gains and trend towards moderate pay settlements.

7. High interest rates damaging for industry and investment?

[Each 1 per cent in interest rates raises interest payments on industry's borrowing by around £250 million.]

Budget measures have eased pressure on interest rates, and the recent ½ per cent fall in the banks' base rates is encouraging. But Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking. Continuing relatively high level of interest rates must be seen in context of priority attached to reducing inflation and need to control growth in money supply underlying the MTFS. (See brief J).

8. Government help for small firms

Budget provided further help for small businesses, increasing the number of measures taken so far to over ninety. Enterprise package included further reduction in weight of corporation tax; further increases in VAT registration limits; increase in global amount available for loans under Loan Guarantee Scheme (see below); and doubling of investment limit under Business Start-Up Scheme to £20,000 a year. New measures will encourage start-ups and existing firms.

9. <u>Response to Loan Guarantee Scheme?</u>

Scheme operating successfully. We have already issued more than 4,440 guarantees - about half to new businesses. Total lending under scheme is just over £149 million. Budget provided for the lending ceiling - in year to May 1982 - to be raised from £100 million to £150 million. Further £150 million available in year to May 1983. Three more banks admitted to scheme in April making total of thirty financial institutions now participating.

10 <u>Government thinking again about Loan Guarantee Scheme?</u>

[Article in FT 24 May]

Scheme under continuous review.

11. <u>High failure rate under Loan Guarantee Scheme expensive for Government?</u>

Too early to assess overall cost of scheme. After first year of the 4000 guarantees issued, 45 have been 'called'. Cost has been more than covered by the premium income received over the period.

12. <u>Enterprise zones: response from private sector?</u>

All eleven zones now in operation. Response has been very encouraging. Many new firms are setting up in the zones, existing firms are expanding their activities and vacant land has been brought into use. Too early to assess success of zones.

R NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83 and future years?

Nationalised industries' total external finance increased by £1.3 billion in 1982-83 (£1.2 billion after allowing for NIS cut and other changes). Increase in 1982-83 was roughly half what the industries bid for. Government has given full recognition to problems faced by the industries in a period of recession and is currently considering future years.

INVESTMENT

2. Investment plans unlikely to be attained?

No Government can unconditionally guarantee a level of investment by the nationalised industries. Approved levels set out in last White Paper (Cmnd 8494) are consistent with the industries' agreed external financing requirements, on the basis of their internal resource forecasts. But perfectly possible that plans might need to be revised, for example if the industries fail to restrain their current costs, including pay.

3. But shortfall in capital spending 1981-82?

[Figures in FSBR imply shortfall of £¾ billion, latest estimates suggest that this may be nearer £1 billion.]

Not easy to establish firm reasons after the event. Such evidence as we have suggests a mixture of reasons. Most important has been cut in investment in response to changed circumstances such as lower market demand. These cuts have been extraneous and have not borne any direct relationship to EFL pressures. Other cuts have been for wholly beneficial reasons, such as lower than expected inflation and cost savings.

4. Take nationalised industry investment out of PSBR?

Real problem of pressure on resources cannot be solved by changing statistical definitions. Since nationalised industries are part of public sector, their borrowing - for whatever purpose - must by definition form part of public sector borrowing requirement.

5. Private finance for NI investment?

We have indicated our willingness to consider new financing proposals, provided they can be structured so as to induce improvements in efficiency at least sufficient to offset the extra cost, and provided the finance is raised in fair competition with the private sector.

6. Finance more nationalised industry investment by cutting current spending?

Yes. As in private sector, moderate pay settlements and control of other costs are essential. Ability to finance new investment in nationalised industries bound to diminish if excessive pay settlements agreed. Each 1 per cent off wages saves about £140 million this year; and each 1 per cent off total costs saves £330 million this year.

NATIONALISED INDUSTRY PAY AND PRICES

7. Nationalised industries' prices

[Having risen approximately in line with retail prices for several months, the May figures again showed nationalised industry domestic prices increasing more rapidly than the RPI, by 14.0 per cent for NI against 9.5 per cent for all items RPI over the 12 months to mid-May. The restoration of this differential was expected, and reflects March increase in London Transport fares and ending of electricity industry's rebates to consumers. The removal of these temporary distortions confirms that nationalised industry prices are still increasing somewhat faster than the RPI, largely because of increases in the energy sector. In May average gas and electricity charges were higher but average charges for telephone calls fell slightly following some price adjustments.]

Gap between nationalised industry price increases and RPI has been due in large measure to cumulative effect of years of artifical price restraint. World oil price rises of 1979 and 1980 have also played an important part. We greatly regret the need for these increases, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so, but sustained improvement will only be possible if the industries succeed in holding down their current costs, particularly pay.

PRIVATISATION

8. What further sales expected?

Special sales of assets in 1982-83 forecast at around £700 million and around £600 million in each of the later years. These figures well above those in last White Paper. This reflects primarily very large sales of energy assets - Britoil and the British Gas Corporation's major offshore oil assets - to be made possible by Oil and Gas (Enterprise) Bill currently before the House.

9. Special asset sales in 1981-82

Gross sales in 1981-82 totalled £481 million, so target published in 1981 Public Expenditure White Paper of £500 million nearly met. Pleasing result - included two large sales - Cable and Wireless (£182 million) and Amersham International (£64 million).

10. But what about net figure?

Delivery of BNOC oil in 1981-82 paid for in 1980-81 and taken into account in special disposals figure for that year reduced 1981-82 receipts by £573 million to total of -£92 million. But it is the gross figure which is the true measure of success of Government's privatisation programme.

11. Government has sold assets too cheap?

[Heavy oversubscription for British Aerospace, Cable and Wireless, Amersham International, followed by large increases in prices when shares first traded.]

Not in Government's interest to see shares underpriced, given the loss to the PSBR, but also risks in pitching price too high. Getting balance right not easy - especially when company's shares have not previously been traded. Government will continue to consider alternative forms of sale eg tender, but critics should note that sale by tender could make it harder for small investor to buy shares.

S NORTH SEA AND UK ECONOMY

1. Impact of $2.50/barrel rise in North Sea oil price on Government revenues?

[$2.50/barrel rise is a figure quoted in the press for negotiations involving BNOC and oil companies.]

Treasury estimate that a sustained $1/barrel rise in the North Sea oil price all other thing being equal would directly raise Government North Sea revenues by about £350 million in a full financial year.

2. In view of falls in price of oil earlier this year, why did HMG not reduce tax burden on North Sea oil producers?

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.

3. Onerous tax system damaging future field developments?

[Shell/ESSO announcement plans for Tern shelved partly because of tax system; reports that Phillips are postponing T-block complex and BP their Andrew field].

Other adverse factors - falling oil prices; high development costs - much more important. No evidence that tax system is the determining factor inhibiting future development.

4. Government should do more to stimulate UK Continental Shelf oil production in 1990's?

[Select Committee on Energy's Report on depletion policy published 18 May: recommends reserve powers to impose production cuts but main emphasis on promoting development of fields to come into production in 1990s - increase pace of licensing rounds and overhaul fiscal regime].

Government's considered reply will be given in due course. Accept need to prolong high levels of UKCS production until end of century at least. Energy Secretary announced 17 May Government's plans for Eighth Round of licensing. Do not accept that fiscal regime makes North Sea development unattractive. On Committee's general proposal for overhaul of regime, would point out that industry does not want a structural upheaval: it would create serious uncertainty and major transitional problems.

5. Benefits of North Sea should be used to strengthen the economy?

[FSBR projections (in money of the day) of Government revenues from North Sea: £6.4 billion in 1981-82, £6.2 billion in 1982-83, £6.1 billion in 1983-84, and £8.0 billion in 1984-85. Lower than last year's projections, principally because of downward revision to oil price expectations. Projections incorporate March fall to $31 a barrel for Forties oil.

Contribution of North Sea to GNP estimated at 4 per cent of GNP in 1981. Not projected to rise before 1985.]

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve a lower level of interest rates to the benefit of industry and the economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Less than 6 per cent of total General Government receipts in 1981-82.

6. Is the Government underestimating North Sea revenues?

[Stockbrokers Scott Goff Hancock reported to be estimating Government revenues of £7.4 - £8.1bn in 1982-83, compared with FSBR estimate of £6.2bn]

No. Other estimates of Government revenues based on assumptions that seem over-optimistic eg on future production.

7. North Sea revenues should be channelled into a special fund to finance new investment, particularly in energy?

North Sea revenues are already committed. Setting up a special Fund would make no difference. More money would not magically become available. So the money for this Fund would have to come from somewhere else. This would mean higher taxes or lower public expenditure, if public sector borrowing is not to rise. If borrowing did rise, then so would interest rates. Not obvious that net effect would be good for investment.

8. Are we really any better off for our North Sea oil?

We are better off with oil - at current oil prices - than we would have been without it. We have been spared the fall in real national income that other industrial countries have suffered following oil price rises. But North Sea oil is costly to produce, so we are not necessarily any better off than we would have been had oil prices not risen. No need therefore for the possession of oil to require a contraction in our industrial base.

9. Chancellor's oil taxation package announced 9 June

[Summary: No field to pay APRT for more than 5 years; APRT repaid after 5 years if not set off against PRT; APRT allowed as a deduction in computing payback; further proposals to smooth PRT payments in second half of 1983; cost £55 million 1982-84]

Following Budget proposals, industry expressed concern on a number of specific matters; we have decided that some mitigation of the burden for less profitable, more marginal fields is appropriate to meet particular problems. The tax system introduced in the Budget, plus these changes, should enable the nation to get its fair share from the profits of this national asset, while leaving plenty of incentive to continue developing it.

T WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Why don't major industrial countries together lead revival of Western economy?

Road to revival lies through combating inflation. Remarkable unity at Versailles Summit, at OECD Finance Ministers meeting and at Interim Committee of International Monetary Fund - on which smaller industrialised and developing countries sit - that reduction in inflation must precede sustained revival. IMF's Interim Committee agreed "combating inflation is a necessary step for resumption of sustainable growth at a satisfactory pace". Most Summit partners have made good progress reducing inflation.

2. Versailles summit: international monetary undertaking

Major countries explicitly accepted "joint responsibility to work for greater stability in world monetary system". Could be significant step towards greater stability if five countries whose currencies make up SDR basket preserve value of their own individual currencies by reducing inflation at home. UK and France still some way to go in that respect.

3. French and Italian devaluations?

[French franc devalued by 10 per cent and Italian lira devalued 7 per cent against Deutschemark on 12 June. Sixth and biggest revaluation in EMS's 3¼ year history. Simultaneously French government announced package of austerity measures including 4 month prices and wages freeze (to reduce inflation to single figures), increases in social security and unemployment contributions and limit to budget deficit of 3 per cent of GNP in 1982]

Second EMS realignment this year was necessary because French and Italian inflation rates considerably above those of European partners. Strength and stability of Western economies as a whole will benefit if France and Italy can control inflation. So we welcome French government's recognition that inflation is as serious a threat as unemployment and that reining in public sector borrowing is essential part of counter-inflation strategy. (See also M6.)

4. French government 'seen the light' over reflationary policies? / OR French prices and incomes policy more humane than massive deflation?

Have seen that prices and incomes policies don't work in this country; nor is international experience encouraging. Our experience shows long term inflationary expectations not dented by policies lasting few months or even year or two; inflation always bounces back afterwards. French government not relying on prices and incomes policy alone but intend to curb Budget deficit and restrain growth of money supply.

5. Anti-inflation policies are working

[Inflation down from a year ago in 6 of major 7 economies - significantly down in US (from 10 to 6½ per cent), Japan (5 to 3), Italy (20 to 15) and UK (11½ to 9½). Small reductions in Germany (to 5 per cent) and Canada (to 11½), but increase in France (from 12½ to 14).]

Yes. Firm fiscal and monetary responses to 1979-80 vindicated by events. UK still some way to go to match US, Germany or Japan in bringing down inflation, but moving in right direction and ahead of some other European countries. Realism in wage settlements is growing, US, Germany, Japan and UK all have wage settlements in single figures. Other policies also working: oil savings have helped cut OECD oil demand. All point towards basis for sustainable recovery.

6. Governments' policies have failed or worsened situation?

No. Adjustment to second oil shock better than to first. Investment has performed better, impact on wages better contained and dependence on oil reduced. But these gains must be reinforced by continued firm policies.

7. Prospects for UK economy worse than for other countries?

No. Treasury and most independent forecasters expect UK growth this year of about 1½ per cent rising to an annual rate of 2 per cent by early next year. This is very closely in line with the OECD's forecast for OECD Europe. Unemployment is expected to rise in all major countries except Japan. UK inflation (GNP deflators) likely to be around the OECD average and below that in France, Italy and Canada.

8. Prospects for US economy?

[Commerce Department's index of leading indicators rose in April for first time in a year, but industrial production fell in first quarter and again in April and May. Seasonally adjusted unemployment is 9.5 per cent. M1 significantly above target range half way through year. Year on year rate of consumer price inflation down for the 7th consecutive month to 6.6 per cent in April.]

Seventh consecutive month of falling US inflation rate very good news - stabilising influence for the world economy. Helped by realistic and flexible wage settlements in which unions have given job security priority over wage increases. Reasonable prospect US economy should pick up later this year.

9. US Budget?

[House of Representatives passed budget plan with projected deficit for FY83 of $99 billion; Senate approved plan has deficit of $116 billion. Two chambers largely agree on total revenue to be raised next year but Senate wants smaller cut in social programme. Last week House and Senate Republicans agreed on a budget plan with deficit of $103 billion.]

Hope two Houses of Congress will soon reach agreement on budget for Fiscal year '83; must reach agreement on details as well as total expenditure and federal deficit.

10. US interest rate developments

[With all prime rates returning to 16½ per cent, real interest rates to borrowers are now 10 per cent. Secretary Regan recently dropped public hints about desirability of changes in monetary policy if unemployment and interest rates remained high. He added he agreed with prevailing view on Wall Street that next move in US interest rates more likely to be up than down. Next trading day, 3-month CD's rose over 15½ per cent, Eurodollar rates exceeded 16 per cent and upwards pressure on prime rates mounted.]

Prime rate well below peak of 21½ per cent last summer. Given recent rate of inflation in US, settlement of Budget for fiscal 83 would improve prospects for lower interest rates.

11. Prospects for international interest rates?

Always difficult to forecast interest rates with certainty, but firm and balanced policies should over a period bring lasting reduction in both inflation and interest rates.

12. OECD see bleak prospects for UK economy?

[Report in The Times 24 May]

Latest OECD forecast ('Economic Outlook') published in December; next not due to be published until 7 July.

U FALKLANDS CRISIS EFFECTS/COSTS

1. UK economy affected by Falklands crisis?

Possible economic consequences cannot of course be ignored. But UK is basically in a strong financial position: inflation is coming down; interest rates on downward trend; balance of payments remains healthy; output is higher than a year ago. Disturbance due to Falklands dispute small in relation to overall macro-economic picture. No question of requiring any change in basic economic strategy.

2. Effect of Falklands dispute on markets?

[Exchange rate strong; domestic interest rates now ¾ per cent lower than before crisis began]

Despite a few uncertain days, the markets have come through the crisis well, reflecting confidence in government handling of crisis, and in economic policies. Too early to say what long term effects will be, but Government determined not to be deflected from its path.

3. Will dispute affect UK trade figures?

Volume of UK-Argentine trade negligible (£20 million a month on either side).

4. Will freeze on Argentine assets affect standing of City?

We have not confiscated Argentine's assets, merely frozen them. This action was taken under extraordinary provocation; we believe international financial community will understand this.

5. Effect of restrictions on Argentina?

The crisis and our action will greatly reduce Argentina's capacity to raise loans on the international markets. A number of Argentine public foreign borrowing operations amounting to many hundreds of $ million have been suspended since crisis began.

6. Future of restrictions?

Waiting for cessation of hostilities; must also take into account Argentina's restrictions against us.

7. Argentina's debts

[NOT FOR USE: Argentine foreign debt at end 1981 estimated at $34 billion - about half size of Mexico's or Brazil's.]

Sign of times that Argentine military aggression should create instability in global capital markets. All more important to negotiate settlement quickly and to discourage similar acts in future. [IF PRESSED on debt default possibility: banks have taken fairly relaxed attitude because ultimately overseas debt must be repaid by exports; Argentina's export sector is agriculture, which, according to most experts, is fundamentally healthy.]

8. How much has operation cost so far?

It is not possible to give an accurate assessment of the costs so far. They have been and are being incurred thousands of miles away; and of course the task force is still operating in the South Atlantic. It is clear that they represent a small proportion of total public expenditure.

9. How will the costs be met within the Government's economic strategy?

This depends on exactly what the extra costs are. They could be financed in a variety of ways which do not depart from our central economic strategy. They will in any case be met in a non-inflationary way.

10. Will countervailing savings be made to contain expenditure within defence cash limit?

There is no cash ceiling on the costs of the operation. At this stage, however, the extra costs represent only a small proportion of the Defence Budget of over £14 billion. There is therefore no immediate cash problem. When the extra costs of the operation are known more accurately and the prospects for defence expenditure as a whole in 1982-83 are clearer we shall decide to what extent supplementary provision is required.

11. Implications for defence expenditure in future years?

Decisions on future defence expenditure will be taken in the course of the 1982 public expenditure survey.

AIDE MEMOIRE ON THE UK ECONOMY 21 June 1982

RECENT DEVELOPMENTS AND INDICATORS

(i) Activity. GDP fell by 6 per cent between 1979 H2 (last cyclical peak) and 1981 Q2 (trough of current recession), rose about 1 per cent between 1981 Q2 and 1981 4Q then declined by ¼ per cent in 1982 Q1. Weakening at turn of year in part reflects impact of severe weather and strikes, but underlying level of output broadly flat in 6 months to March 1982; above levels of last spring. Most independent forecasts, business opinion surveys and CSO's cyclical indicators expect resumed and continued recovery.

Volume of new engineering and construction orders in 1981 up 15 and 11 per cent on 2H 1980. Private housing starts up over one third in same period. Total housing starts in 4 months to April 1982 up two-fifths on 1981 average.

Recovery in 1981 largely reflected sharp fall in rate of destocking. Q1 figures suggest period of rapid destocking now over. Consumers' expenditure and Government consumption broadly flat. Fixed investment broadly flat in 1981, but beginning to pick up. Manufacturers', distributors' and services (MDS) investment rose 5 per cent in 1981 Q1; DOI investment intentions survey suggests rise of 2 per cent in MDS fixed investment in 1982.

(ii) Lack of complete trade figures for 1981 and changed documentation procedures make recent figures difficult to interpret. Exports have held up better than many had feared. In 7 months to March non-oil exports no lower than in 1980. Non oil imports have risen - up 11 per cent in same period - in part reflecting reduced rate of destocking and higher output. Current account estimated to be in surplus of £½ billion in 1Q 1982 following £7 billion surplus in 1981.

(iii) Employment and unemployment. UK employment fell 2.1 million (9 per cent) between mid 1979 and 4Q 1981 (about two-thirds concentrated in manufacturing), though rate of decline has slowed down. UK adult unemployment risen by 1.6 million (less than fall in employment) and stood at 2.8 million (12 per cent) in May. Total unemployment (including school leavers) was 2.97 million (12.4 per cent). Underlying rate of increase in unemployment slowed sharply during 1981 (105,000 per month in 4Q 1980 cf 22,000 per month so far in 1982). Other labour market indicators improved during 1981 eg short-time working down by $\frac{3}{4}$ during 1981, overtime up over 10 per cent during 1981, and vacancies - despite slight weakening since February - up by 1/5 in 3 months to May on 2Q 1981, and with more rapid turnover. Little or no further improvement in unemployment or other labour market indicators since turn of year.

(iv) Wages and prices. Increase in earnings in 1980-81 pay round 11 per cent (settlements averaged about 9 per cent), half that of previous pay round. Settlements well inside single figures now widespread (CBI average for manufacturing 7 per cent) suggesting further moderation in current pay round. 12-monthly increase in RPI 9.5 per cent in May; well inside single figures. Recent progress suggests outturn to November this year could well be within Budget time forecast of 9 per cent. Manufacturers' input prices now no higher than last August; in 12 months to May they rose just $4\frac{3}{4}$ per cent. Corresponding rise in manufacturers' output prices $8\frac{3}{4}$ per cent.

(v) Productivity and Competitiveness (manufacturing). Output per man risen 12 per cent since end-1980. Output per man and output per man hour 5 and 8 per cent respectively higher than previous cyclical peak (1H 1979). Together with pay moderation, resulted in little increase in unit wage and salary costs during 1981 - rise of less than 3 per cent in year to 1Q 1982 - a rate below average of our competitors and comparable to Germany and Japan. Competitiveness (relative normalised unit labour costs) improved by 10-15 per cent during 1981, but remains about 1/3 worse than in 1975.

(vi) Company finances. Gross trading profits of ICCs (excluding North Sea) rose by over one quarter between 1H and 2H 1981, but real pre tax rate of return just $2\frac{1}{2}$ per cent in 1981. Despite rise in company borrowing and deterioration in liquidity in 4Q 1982 (largely reflecting reduced scale of destocking and unwinding of civil service dispute which delayed companies' tax payments), company finances healthier in 1981 as a whole than in 1979 and 1980. Company liquidity improved in 1Q 1982.

(vii) Monetary aggregates. £M3 grew at an annual rate of 13 per cent in 1981-82 target period (from mid-February 1981 to mid-April 1982) compared with target range of 6-10 per cent. At least part of excess reflected increased market share of banks in mortgage lending. Over the same period, M1 and PSL2 grew at rates of 7 and 12 per cent per annum respectively. In recent months monetary aggregates have grown more slowly; in first 3 months of 1982-83 target period developing favourably in relation to 8-12 per cent target range.

(viii) Interest rate/exchange rates. Interest rates have fallen since turn of year; process temporarily interrupted by Falklands crisis, but now resumed. 3 month inter-bank rate fell from 16 per cent in December to 12¾ per cent early June. After falling over 10 per cent during spring and summer 1981, effective exchange rate broadly constant at around 90 since last August.

(ix) Government borrowing. Provisional estimate suggests PSBR £8.9 billion in 1981-82 (3½ per cent of GDP, compared with 5¾ per cent in 1980-81) about £2 billion lower than estimated at Budget time. CGBR £1.9 billion in April-May 1982 at time when central government borrowing usually largest.

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Prime Minister (2)

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MF

Michael Scholar Esq
Private Secretary
10 Downing Street
LONDON SW1

18 June 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

PAY BRIEF: POSITION AT MID-JUNE

SETTLEMENTS

1 Since the May pay brief 134 settlements covering 1,960,000 employees have been recorded. In the private sector (115 settlements covering 1,015,000 employees) the weighted average level of settlements in the last month was just under $7\frac{1}{2}$%. The average in the public sector (19 settlements covering 945,000 employees) was just under $6\frac{1}{2}$%. The principal settlements in the private sector were Building and Civil Engineering (450,000) and Building and Allied Trades (250,000) at 7.0% to 7.5% and Mobil Oil Tanker Drivers (500) at 7%. In the public sector Electricity Supply manuals (94,000) settled for 7.4% and British Telecom engineers (130,000) for 7.0%, also Gas Supply manuals (41,300) were awarded 7.6% after arbitration - 7.9% in a full year - and Teachers E & W (460,000) were awarded 6%.

2 The cumulative average level of settlements for the whole economy this round - 890 settlements covering 7,934,000 employees is 7%. Almost 2/3 of employees about whom the Department expects to receive information have reached settlements.

3 In the <u>private sector</u> the cumulative average remains unchanged at 7% for the third successive month (831 settlements covering 4,164,000 employees). For manufacturing the average level is just over 6% and in non-manufacturing is just over $7\frac{1}{2}$%. About $\frac{3}{4}$ of settlements and of employees are covered by settlements in a 5% to 8% range. 22 settlements covering 12,000 employees, all in manufacturing, are for NIL increases.

4 In the <u>public sector</u> (59 settlements covering 3,769,000 employees) the cumulative average is about 7%, similar to last month. The average in the public trading sector is just under $7\frac{1}{2}$% and in the services sector is just over $6\frac{1}{2}$%.

5 <u>Coverage</u>: The limitations of the Department's coverage of settlements were explained in the March pay brief (para 5).

NEGOTIATIONS

6 In the PUBLIC SECTOR, <u>Gas Supply staff</u> (1 June - 57,700) are considering an offer worth about 5% on average earnings. The claim is for an increase to

maintain living standards and a reduction in hours. Next meeting to be arranged. Electricity Supply power engineers (1 February - 29,300) have submitted a claim for a substantial increase in pay, reduced hours, improved holidays and other benefits. An offer of 7% on rates has been rejected. British Rail clerical and conciliation grades (20 April - 150,000) have been made an offer of a 5% general pay increase from 6 September. Guards have accepted 50p per shift (3% on rates) for implementing flexible rostering. All 3 unions (NUR, ASLEF and TSSA) have rejected the 5% offer. The NUR Executive have voted for strike action from 28 June. The claim is for increases in line with inflation and other benefits. Unions representing London Transport rail supervisory and conciliation grades (19 April - 18,000) are considering an offer of 5% on basic rates and, if the offer is accepted, an undertaking to review relativities, holidays and bonus arrangements, with a 1 hour reduction in the working week. The claim is for a substantial increase and shorter hours. An offer to London Transport buses platform staff (29 March - 19,800) of 7% including 0.5% from a self-financing productivity scheme has been rejected. Water Services staff (1 July - 35,300) union is considering an improved offer of 7% plus minor holiday improvements. The claim for increases in line with inflation, a reduction in hours and extra holidays. Next meeting 22 June. Local Authority APT and C Grades (1 July - 590,000) are considering an offer of 5% on salary scales plus 0.25% for restructuring. The claim is for an increase to protect living standards and a reduction in the working week. Unions on behalf of the Industrial Civil Service (1 July - 140,000) have opened negotiations with a claim for an increase in line with the cost-of-living, shorter hours and other benefits. The claim is still under consideration. In the National Health Service generally, co-ordinated industrial action, including 24-hour strikes, is being taken by the TUC Health Service Committee unions. NHS Nurses and Midwives (1 April - 492,000) have rejected an offer of 4% for senior nursing managers and 6.4% for all other grades except tutorial staff, who have been offered increases ranging from 4% to 8.3%. The total offer represents 6.4% on the paybill. At a meeting with the Secretary of State on 9 June it was made clear that no new money was available. The claim is for 12% increase in basic rates, reduced hours and extra holidays. Next scheduled meeting 13 July. NHS ancillaries (1 April - 211,000) and NHS admin and clerical (1 April - 125,000) have presented similar claims to that for nurses. The unions have rejected 4% offers. Next scheduled meeting for ancillaries is 9 July. NHS ambulancemen (1 April - 17,700) have submitted a claim for an increase in line with inflation, a shorter working week and other improvements. An offer of 4% plus the implementatio of a salaried structure, if found feasible, worth 5% overall, has been rejected. Next scheduled meeting 20 July. The Review Body for Doctors and Dentists (1 April - 85,000) has recommended an increase of 9%, but Ministers are limiting the average increase to about 6%. A formal offer of this amount has now been made. Consultants and General Practitioners have accepted.

7 In the PRIVATE SECTOR, unions representing ICI manuals (2 June - 38,000) are recommending acceptance of an 8% offer. In the Milk Distribution Industry (3 April - 94,500) an offer of about 7.4% on basic rates (8% on the wage bill) was rejected following a ballot of members. After further clarification the unions have agreed to re-submit the offer to members with a recommendation to accept. International Publishing Corporation clericals (1 April - 5,700) have submitted a claim for 20% on personal earnings or £30 per week on basic rates. An offer of a 2 year staged agreement of 8½% from 1 April 1982, with a further 8½% from 1 April 1983 is being considered. British Sugar Corporation process workers (1 April - 4,000) are threatening industrial action following rejection of an offer of 8% on basic rates, holiday bonuses and staff status, estimated to be worth 9.5% to 10% overall.

PRICES AND EARNINGS INDICES

PRICES

8 In May the year on year increase in retail prices was 9.5 % compared with 9.4% in April.

EARNINGS

9 In April the year on year increase in average earnings for the whole economy was 10.2% compared with 11.0% in March. The underlying increase in April was 10¼% and this continues the slight downward trend in the underlying rate which was 11% in January, 10¾% in February and 10½% in March.

REAL DISPOSABLE INCOME

10 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 no other tax liabilities or allowances and not contracted out of the State Pension Scheme) fell by about 2% in the year to March.

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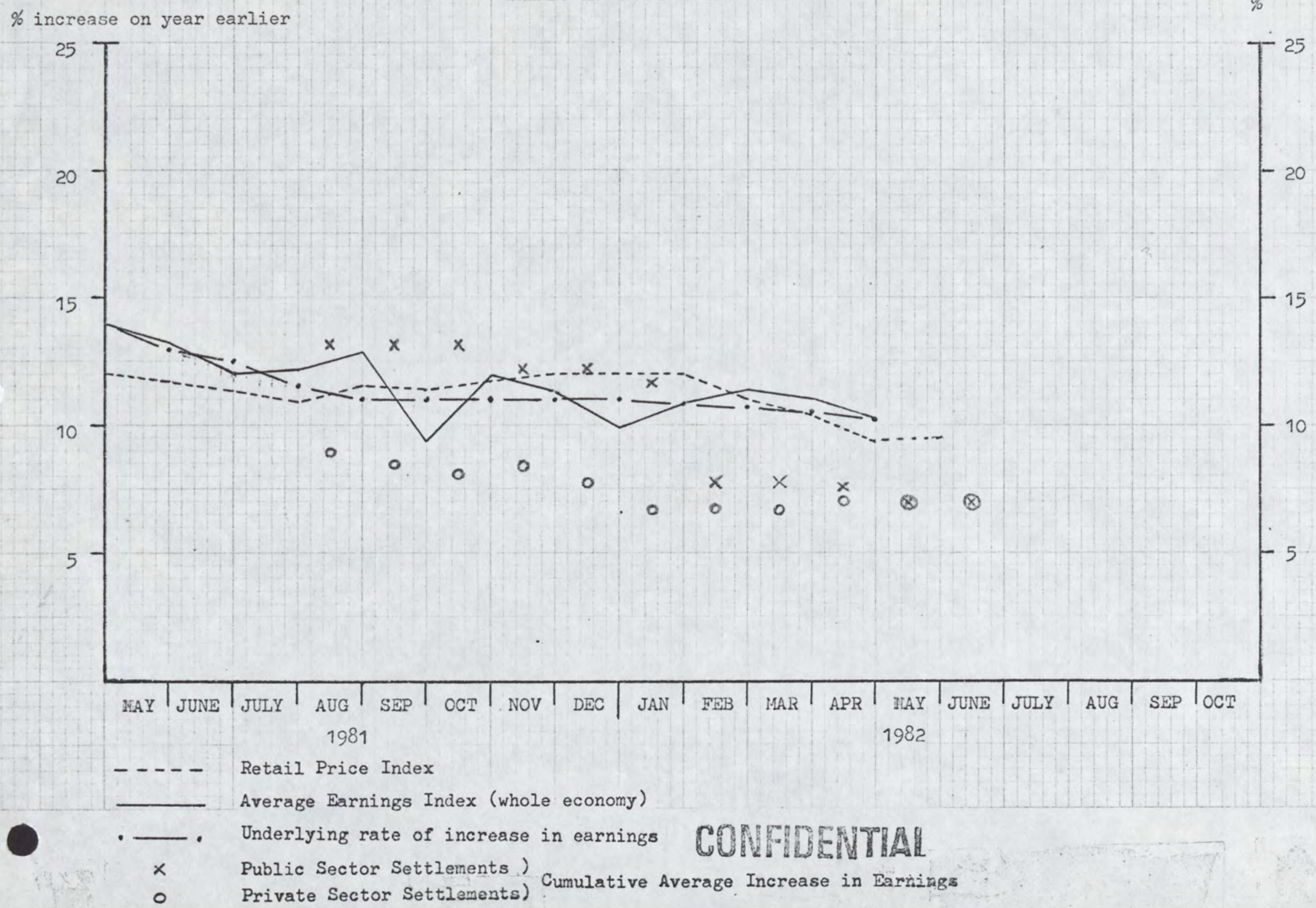
APPENDIX 1

TRENDS IN EARNINGS AND PRICES



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DISTRIBUTION OF SETTLEMENTS IN THE PRIVATE SECTOR BY LEVEL OF SETTLEMENT APPENDIX 2
FROM 1 AUGUST 1981

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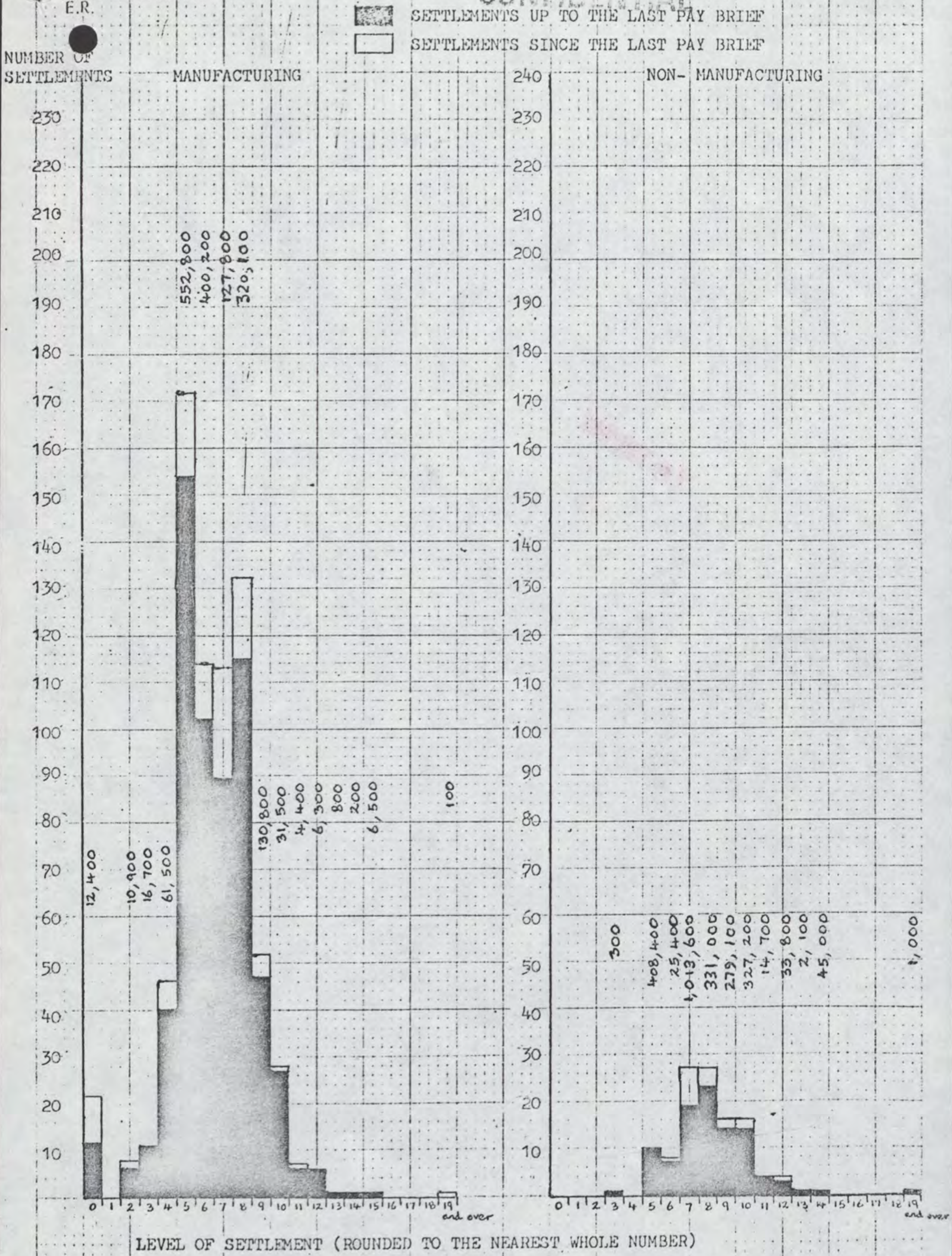
E.R.



NOTE - THE NUMBER OF WORKERS (TO THE NEAREST HUNDRED) INCLUDED IN THE SETTLEMENTS IS GIVEN ABOVE THE APPROPRIATE INDICATOR.

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1/1

Econ Pol

PPS/CHANCELLOR

file no TEB/CA/01

copied to:

Mr Salveson (for transmission to No.10)
PS/CST
PS/FST
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PS/MST(C)
PS/MST(R)
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
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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 BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 8 June, are sidelined.

B A Collins

B A COLLINS

RA

R I G ALLEN

14 June 1982

EB Division
H M Treasury
01-233-3364

ECONOMIC BRIEF: CONTENTS

A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

Main objectives are to achieve, over a period, a sustained improvement in the economy through reduction of inflation and promotion of enterprise and initiative. Reduction of inflation requires maintaining steady but not excessive downward pressure on monetary variables, and complementary fiscal policies. Improvement of supply side depends on restoration of flexible and competitive market economy and better incentives.

2. Versailles summit achievements?

Agreed to maintain prudent monetary policies and achieve greater control of budgetary deficits in order to reduce real interest rates. Also agreed to intensify economic and monetary co-operation, to resist protectionary measures, not to use exchange rates to gain unfair competitive advantages and on a cautious approach to financial and trade relations with the Eastern bloc.

3. Contribution made by 9 March Budget to economic strategy?

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 particularly to help business, but also individuals, within responsible fiscal framework.

4. Lower than forecast 1981-82 PSBR means fiscal policy tighter than intended?

[Estimated PSBR outturn 1981-82 now about £8.9 billion (3½ per cent of GDP) cf £10½ billion at time of Budget March 1981 and still predicted in 1982 FSBR.]

Not possible to answer this question until more known about why PSBR was lower in 1981-82. Need also to consider the wider context. Lower borrowing by public sector in first quarter of 1982 was factor in sharp fall in our interest rates relative to overseas rates in those months. Cannot assume 1981-82 shortfall will necessarily feed across to 1982-83; far less that Budget judgement needs revision.

5. 1981-82 PSBR outturn inconsistent with MTFS?

Misleading to look at PSBR for individual years in isolation. Government's aim remains to reduce PSBR as ratio of GDP over medium-term. Latest estimates for outturn in 1981-82 suggest a ratio of about 3½ per cent, similar to ratio planned for 1982-83. But looking over a longer run of years trend is clearly downward. (See also Section H.)

6. Government's impact on inflation disappointing?

12-monthly RPI inflation rate in April 9½ per cent - down from 10½ per cent in March. Lowest figure for over three years. Then, inflation was accelerating. Now, trend is firmly downwards. Indeed, we may do rather better than FSBR forecast of 9 per cent by end-1982. [But NB credence should not be given to DOI press release reporting Mr Jenkin as claiming inflation would fall to 7½ per cent this year.]

7. Economic recovery in doubt?

Profile of recovery likely to be uneven and jerky particularly when affected by such factors as very severe weather and industrial disputes. It remains the case that activity is above levels of last spring. Prospect is for resumed and continued recovery. This is supported by almost all independent assessments, CSO's cyclical indicators and latest CBI assessment. Most encouraging pointer for sustainable recovery is progress being made against inflation. (See also Section B.)

8. Trade figures disappointing?

No. Current answer remains in healthy surplus (£½ billion) in 1982 Q1. Exports recovered in March and in last six months have held up better than many feared, given earlier loss in competitiveness. Imports up sharply since 1981 H1, reflecting in part higher activity and end of destocking. (See also Section L.)

9. Investment remains depressed?

[1982 Q1 figures for capital expenditure in manufacturing, distribution and services sector published 20 May; new DOI Investment Intentions Survey published 27 May.]

Some encouraging signs. Manufacturing fixed investment stabilised in H2 1981 and has retained level into Q1 of this year following sharp falls from Q4 1979; intentions surveys point to some recovery in course of 1982. Strong growth in distributive and service industries' investment - up 12½ per cent since Q1 1981.

10. Do FSBR forecasts still hold?

No reason to question broad shape of forecasts but in certain areas, eg inflation, progress is faster than foreseen at Budget time. [NB: Not the practice to issue revisions between twice-yearly publication of forecasts under Industry Act ie Budget-time and autumn.)]

11. Outlook for unemployment?

[House of Lords Select Committee on Unemployment due to publish report on 16 June. June unemployment figures to be published 22 June.]

Not the practice to publish forecasts of unemployment. But current policies to tackle inflation provide only basis for sustained recovery and more jobs. (See also Section C)

12. Report on Budgetary Reform by the TCSC ("Armstrong" Report)

[Report to be published 17 June.]

Government cannot be expected to agree with all it says, but it seems carefully thought out and constructive, and the Government will want to consider its recommendations thoroughly. Reply will be made when the Government's study of the report's recommendations is complete. Will not attempt to predict a date at this stage.

13. Do you accept the TCSC's criticisms of the way decisions are taken and announced?

No, not wholly. Government drew attention in its evidence to the various practical and other contraints and also to the progress which had been made in the Armstrong direction under this Government (eg MTFS). Committee did not perhaps give full weight to what had been achieved. But cannot anticipate reply to the report. Will be thinking carefully about recommendations to publish Green Book /PEWP in January etc. Cannot anticipate reply.

14. Treasury model of economy 'rigged' to produce discouraging results from alternative policy packages?

See Section P.

15. Implications of latest fall in interest rates?

[Short-term rates down over ½ percentage point on week ago; 3½ per cent on autumn 1981 peak.]

Continues welcome decline in interest rates seen earlier in year; the Falklands crisis disguised underlying downward trend. Market perceived that conditions were right for a fall in rates and Bank acquiesed in this: monetary aggregates growing more moderately; inflation coming down and the exchange rate strong. Sign of confidence in Government policies; and welcome assistance for business.

16. SDP Policy Paper: Towards Full Employment

[Discussion Paper, first in series, published 7 June.]

Some proposals (eg emphasis on need to control growth in total money GDP) sensible, are not far removed from Government thinking (eg MTFS). But paper exaggerates extent to which expansion of special employment measures would provide genuine new jobs; advocates 'reflation' while largely ignoring possible damaging consequences (eg on confidence of business and markets); and advocates policies to control pay and prices very similar to those tried, and failed, in past.

17. Cost of Falklands?

[Mr ~~Brittan~~ Biffen's remarks 4 June.]

See Section U.

BULL POINTS As at 14.6.82

(i) Activity. Slight decline in GDP (output) in 1Q 1982 in part reflects effects of very severe weather and industrial disputes at turn of year. Most recent major independent forecasts, latest CBI assessment and cyclical indicators see prospect of further recovery in 1982-83.

(ii) Investment. Private sector investment, particularly in plant and machinery, held up well relative to output investment in plant and machinery in 1981 only slightly (1½ per cent) lower than 1980, 5 per cent higher than 1979. DoI investment intentions survey suggests 2 per cent rise in manufacturer's distributor's and services' investment in 1982.

(iii) 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.]

(iv) Manufacturing productvity. Output per head rose 12 per cent since end 1980. Output per head and output per hour 5 and 8 per cent higher than previous peak in 1H 1979.

(v) Unit labour costs: Pay moderation and higher productivity has meant dramatically low increase in manufacturers unit wage costs over last year - about 3 per cent in Q1 1982 on a year earlier. Recent rate of increase below the average of our major competitors and comparable to that of Germany and Japan.

(vi) Competitiveness. Cost competitiveness improved by at least 10 per cent during 1981, reflecting pay moderation combined with exchange rate fall.

(vii) Profits: Industrial and commercial companies gross trading profits (excluding N.Sea and net of stock appreciation) rose strongly during 1981, up over 25 per cent between 1H and 2H 1981.

(viii) Exports have held up better than many feared following earlier loss of competitiveness. Recent months figures suggest non-oil exports (exluding erratics) running at about same level as in 1980. Engineering export orders up 17 per cent in 1981 on 2H 1980 to reach their highest level.

(ix) Unemployment. Rate of increase in unemployment has slowed further this year to just 1/4 that of a year earlier. Vacancies improved since mid 1981. Short-time working in manufacturing reduced by over ¾'s since January 1981 and overtime working has increased.

(x) 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.

(xi) 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 1983 represents major step towards comprehensive provision for young people.

(xii) 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.

(xiii) Inflation. 12 monthly RPI increase in single figures in April (9.4 per cent); more than halved since peak (21.9 per cent) in Spring 1980; lowest since January 1979. Trend now clearly downwards, not upwards as then. Manufacturers' input prices little changed since last August; up just 4¼ per cent in year to May (lowest increase since November 1978). Manufacturers' output prices up just 8¾ per cent in same period. CBI April survey shows lowest degree of unit cost pressure for 15 years.

(xiv) Examples of export successes reported in the Press include: design supply and installation over 300 miles of railway of carrier and audio telecommunications cable for Zimbabwe's railway electrification programme (BICC Telecommunications, Merseyside); contract for converting to leadfree petrol consumption of first 1000 BL Minis destined for Japan (Carbodies Ltd, Coventry).

(xv) Overseas investment in UK: US direct investment in Britain amounted to stock of over $14 billion in 1980. Nearly 60 per cent of all US outward non-oil direct investment now takes place in EC - over half of that in UK. Half of all Japanese investment in the EC also comes to Britain.

(xvi) Overseas debt repayments. Official external debt reduced from over $22 billion in May 1979 to around $13.7 billion at end-May 1982.

(xvii) Innovation. Total of industrial robots in use in UK reached 713 last year; expected to pass 1000 this summer, UK is fifth in World league table of robot users.

Economic Briefing Division, HM Treasury, 01-233 3819/5809

B ECONOMIC ACTIVITY AND PROSPECTS

1. Recent figures not encouraging?

[NB April industrial production figures to be published Wednesday 16 June]

[GDP(O) is provisionally estimated to have fallen slightly (about ¼ per cent) in Q1 1982, but remains ½ per cent up on Q2 1981. Some stockbuilding in manufacturing and distributive industries in Q1 1982 following sharp slow down in rate of destocking in H2 1981. (First stockbuilding for two years). Volume of investment in manufacturing, distributive and service industries some 5 per cent higher in Q1 1982 than average for 1981].

Latest figures not uniformly unencouraging. While disappointing that rise in activity did not continue for third consecutive quarter, not unexpected that profile of recovery be uneven and jerky, particularly when affected by such factors as very severe weather and industrial disputes. Remains case that activity is above levels of last spring. Latest (20 May) figures also show rise in investment and also some stockbuilding during first quarter.

The prospect is for resumed and continued recovery. This is supported by almost all independent assessments, CSO's cyclical indicators, and business opinion survey indicators. Most encouraging pointer to sustainable recovery is the continued progress against inflation.

2. Investment intentions survey?

[DOI's investment intentions survey for May suggests rise in fixed investment in manufacturing distributive and service industries (MDS) of 2 per cent in 1982 and more substantial increase in 1983. Manufacturers investment (including leasing) expected to recover during course of 1982, volume for 1982 as a whole much the same as 1981 and to rise about 5 per cent in 1983.]

Survey, taken with rise in first quarter (see question 1 above) suggests trough in MDS investment passed in 1981, recovery gaining momentum during 1982 and 1983.

3. May CBI Trends Enquiry/Forecast Gloomy?

[In reviewing latest CBI situation report, FT (Monday 7 June) quotes CBI as claiming "Economy to remain in doldrums" Monthly Trends Enquiry suggests little change in order books in recent month and continuing approximate zero net balance of firms expected to raise output in next 4 months. The latest forecast suggests recovery to resume this year with 1 per cent growth in 1982, 2 per cent in 1983. Inflation forecast to fall to 9 per cent by end 1982, 7½ per cent 1983. CBI expect continued improvement in company profits and financial position.]

Taken together monthly enquiry and forecast point to continuation of recovery during course of 1982 and 1983, lower inflation and improved profitability and financial position of companies. Forecast closely in line with Budget forecast and bulk of outside forecasts.

4. Other evidence of improvement in economy?

See Bull Points (following Section A).

5. Government assessment of prospects

[FSBR forecast (9 March) assesses recovery to have begun. Main points are:

	per cent increase on year earlier	
	1982	1983 H1
GDP	1 ½	2
Manufacturing output	3	2
Consumers expenditure	½	½
Investment (private sector and public corporation)	4½	5
Exports	3 ½	3

Forecast expects some stockbuilding in 1982, Government expenditure flat.]

FSBR forecast sees prospect of some recovery continuing into 1983. (Last two Government assessments of economy were broadly correct). Healthy rise in private sector investment and exports. Inflation well into single figures (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 major post-Budget assessments:

	NIESR (May)	LBS (Apr)	St James (Apr)	Phillips &Drew (June)	CEPG (April)	CBI (May)	FSBR (March)
Per cent change 1982 on 1981	+1	+1 ½	+1 ¼	+1 ½	-½	+1	+1 ½]

Nearly all see prospect of continued recovery in 1982 in line with FSBR, (as always, a range, with Cambridge forecast (CEPG) being the more pessimistic) and see inflation at 8-9½ per cent by Q4 1982 - also in line with FSBR. [See also C (unemployment), K (inflation) and L (balance of payments).]

C LABOUR MARKET

1. Recent unemployment figures?

[In May, unemployment (UK adult seasonally adjusted) rose by 22,000 to 2,872,000 (12 per cent). Total unemployment fell by 38,000 to 2,969,000 (12.4 per cent). Average monthly underlying increase in adult unemployment (after allowing for men over 60 transferring to long term Supplementary Benefit) are:

1980 Q4	1981 Q1	Q2	Q3	Q4	First 5 months 1982
105	77	62	51	33	22]

May's rise (much the same as average monthly increase in Jan-April) confirms that unemployment has been rising more slowly this year than last.

2. Vacancy figures disappointing?

In May, vacancies (UK seasonally adjusted) fell slightly for third consecutive month to 107,000 compared with 113,000 in February. Vacancy flow data for April (latest month available) show inflow and outflow much improved - about 165,000 per month this year compared with about 145,000 per month in 2Q 1981.]

Despite recent falls vacancies still ¼ higher than at low point in Q2 1981 and turnover is also higher.

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, some broadly flat (LBS, St James) others (P&D, S & Coats) expect slight (roughly 50-100,000) fall in 1983. Liverpool foresee fall of 400,000.]

Unemployment forecasts uncertain; independent forecasters encompass differing views for 1983 - several projecting stabilisation, some [a slight] decline. Rise in unemployment drastically reduced since end 1980. 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; depends on so many factors. Following well-established precedent of previous administrations in not publishing. Public Expenditure White Paper figures are planning assumptions not forecasts.

IF PRESSED that PEWP figures show Government planning sustained higher level of unemployment: No. Maintaining constant figure for the Survey period is conventional assumption adopted by previous Administration. Greater the progress that can be made in reducing inflation and maintaining moderation in pay settlements, the better the prospects for unemployment.

5. Employment continuing to fall?

[Total employment declined 1.9 million or 8 per cent in 2 years to Sept 1981. Provisional Q4 figures indicate decline of about 200,000 compared with 150,000 in Q3 and 300,000 per quarter in H1 1981.]

Decline in H2 1981 almost half that in H1. Other labour market indicators improving (see C1-3 above).

6. Unemployment higher than in other countries?

[On standardised definitions in Q3 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. High Exchequer costs of unemployment? Recent Treasury estimates suppressed?

Possible to produce wide range of estimates depending on assumptions made and concepts followed. No single figure of this kind can purport to show how changes in unemployment alter the public finances. [IF PRESSED on cost of benefit payments, rebates and administration only in current year: It is estimated that the 1982-83 cost of benefit payments, rent or rate rebates, and administration per extra 10,000 unemployed is around £18 million. [Answer given to PQ 13 May col W314.] IF PRESSED on total Exchequer cost: Estimates have been made of Exchequer cost of additional registered unemployment (eg for 1980-81 in February 1981 EPR). There has been continued work on the various elements included in that calculation. Treasury at present considering basis on which estimates of Exchequer cost prepared.]

8. What is Government doing to provide more jobs?

Government pursuing sensible fiscal and monetary policies to curb inflation and creating conditions for enterprise - only measures that will ensure sustainable increase in employment. Nevertheless Government expanding schemes to meet special difficulties and improve training - eg plan to spend £1½ billion in cash on 1982-83 (40 per cent more than in 1981-82) on special employment and training measures; new Youth Training Scheme costing £1 billion a year from 1983-84; and MSC working on proposed new non-profit-making scheme announced in Budget Speech.

9. Government reaction to MSC Task Group report on future of training for young people?

Task Group's proposals are of considerable significance for future shape of training arrangements for young school leavers, both employed and unemployed. Government will consider recommendations carefully with a view to reaching a decision as soon as possible this summer.

D TAXATION

1. Burden of taxation

[Total taxation (i.e including for example income tax, indirect taxes, corporation tax, rates and NIC) in 1978-79 was 34½ per cent of GDP (at market prices), 36 per cent in 1979-80, 37½ per cent 1980-81. It is forecast to be 40 per cent in 1981-82 and 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 total burden in 1982-83 compared with 1981-82. [NB: Not true of burden on persons.]

2. Burden of tax has risen for most households since 1978-79?

[Comparisons given in Parliamentary Answers to Mr Straw 3 December, 17 February and 18 March col W199.]

Slow growth of output and difficulty of restraining public expenditure have inevitably meant higher tax burden. But real personal income after direct taxes still higher than under last Government. And more honest to raise taxes to finance necessary higher expenditure than to increase borrowing, with the increased interest rates and inflation that would bring.

3. Burden has fallen for the rich?

Abolition of absurdly high marginal rates and raising of thresholds in 1979 essential to remove disincentives. Reimposition of an 83 per cent top rate of income tax would finance a reduction of less than one quarter of 1p in the basic rate.

4. Burden has risen most for the poor?

Proportion of income paid in income tax and NICs will fall in 1982-83 for lowest paid taxpayers. And low paid with children entitled to benefits such as FIS.

5. Scope for tax cuts because of lower than expected PSBR in 1981-82?

No reason to believe that PSBR in 1982-83 will be lower than forecast (see A6) Government want to cut taxes further, when economic circumstances permit, but more tax cuts too soon could jeopardise recovery.

6. Personal tax burden increased by recent Budget - when NICs taken into account?

[Full explanation given in Parliamentary Answer 11 March OA col 955].

The real increase in personal allowances and tax thresholds will reduce income tax as a percentage of income at all levels of incomes. Those over pension age who are taxpayers will benefit from income tax changes and will be unaffected by NIC rise, and, of course, State pensions are being uprated from November. [IF PRESSED: In immediate cash terms, increases in personal allowances etc will compensate for NIC increase for majority of taxpayers. Taking into account increased earnings in 1982-83 (for example using the Government Actuary's 7½ per cent assumption) percentage of income paid in income tax plus NIC will rise for most people, but will fall for the lowest paid (below about ½ average earnings (married) and below about 1/3 average earnings (single).]

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. Poverty trap/unemployment trap getting worse?

[Joint (Treasury/DHSS/Inland Revenue) memorandum submitted to TCSC Sub-Committee.]

The poverty and unemployment traps are a matter for concern. Must be remembered that result from attempts to relieve poverty over a period of years when the economy has shown little growth. The answer is to get sustained growth going again - this is the objective of our economic policies.

9. Budget reduction in NIS not enough for industry?

Cut welcomed by CBI and industry generally. Provides substantial help on business costs. 1 per cent reduction maximum possible without risks for PSBR: outright abolition too costly. And other measures to help business directly - energy, construction, innovation and enterprise packages plus helpful - and welcomed - improvements in capital tax regime (see also Section P).

10. Excise duties increases inflationary/harmful to industries

Increases in excise duties as a whole slightly less than broadly compensate for past year's inflation. Variations between duties take account of industrial considerations e.g supplementary increase last July on tobacco/Scotch whisky industry/help for industry by smaller increases on e.g derv - mainly used by industry.

11. Government take from North Sea oil too high?

~~See S~~

12. Merger of tax and social security planned?

~~See G~~

E PUBLIC EXPENDITURE AND FINANCE

[Public Expenditure White Paper (Cmnd 8494) published 9 March. Gives planning totals of £115.2 billion in 1982-83, £121.1 in 1983-84 and £128.4 in 1984-85. About £5 billion higher than last White Paper in 1982-83 and £7 billion in 1983-84. Net effect of changes announced in Budget is to reduce totals to £114.9 billion, £120.4 billion and £127.6 billion].

1. Public expenditure too high?

Spending in 1982-83 planned to be about £5 billion (4½ per cent) lower than intended by last Government even if higher than planned when this Government first took office. Decisions to increase spending represent flexible but prudent response to changed circumstances e.g additional spending to help young unemployed. Drive to improve management in public sector and reduce administration expenses continues.

2. Ratio of public spending to GDP is getting back to peak levels of mid 1970's?

Ratios in 1980-81 (43½ per cent) and 1981-82 (45 per cent forecast) remain below level of 1974-75 and 1975-76 (46 per cent in both years). [NB 1981-82 ratio could be nearer 44½ per cent. See H5.] Rise in ratio in 1981-82 mainly reflects higher expenditure on social security at a time when real GDP falling. Ratio expected to fall in next few years: assumptions in MTFS would mean figures of 44½ per cent in 1982-83, 42½ per cent in 1983-84 and 41 per cent in 1984-85. Reflects assumed GDP growth and curbing of public expenditure.

3. Increase spending in recession?

No good trying to spend way out of recession. Any benefits would be short-term. If increased spending not financed responsibly, would soon lead to more inflation. If financed prudently, would lead to higher interest rates and/or higher taxes. We are responding, within limits of prudence, to needs of current circumstances.

4. Government has complacent attitude to public expenditure?

No. The Chief Secretary told a Conservative Party Conference on Saturday 12 June that "the momentum of public spending programmes is frighteningly great. Unless all of you are able and willing to join us in pressing for new initiatives to control the escalation of public spending the prospect for greater tax incentives is bleak indeed".

5. Real terms comparisons

No volume equivalents of cash plans. But cash increase in plans between years is 9 per cent in 1982-83, 5 per cent in 1983-84 and 6 per cent in 1984-85 (and projection of GDP deflator in MTFS is rather lower than this in 1982-83, rather higher in 1983-84 and about same in 1984-85). So in cost terms [i.e cash inflated/deflated by general movement in prices] there is an increase in 1982-83, a decrease in 1983-84 and a small decrease in 1984-85.

6. Not enough capital expenditure?

Government prepared to give priority to worthwhile capital projects wherever this can be done within overall spending totals. Plans do allow for changes between 1981-82 and 1982-83 as follows:

- public sector spending on new construction increased by 14 per cent;
- nationalised industries investment to rise by 26 per cent;
- increase in housing investment output [NOTE: if LAs take full advantage of receipts from sales, gross new investment can be as high as £3 billion next year];
- slight increase in work done on water and sewerage projects even though provision reduced).

7. Cuts in capital

Some reductions in cash provision necessary, but recent falls in tender prices (following sharp increases between 1978 and 1980) will mean that programmes mainly affected (roads, water, local environmental services) should be carried out as planned. Planned capital expenditure also reflects decline in needs since early mid-1970s (e.g roads, schools). Planned spending should not jeopardise future standards and availability of public amenities and services.

8. Cash planning means concentration on first year, not enough on services in later years?

Government recognise case for medium-term planning. But planning must be related to availability of finance as well as prospective real resources. Cannot accept unconditional commitment to forward plans for services. Volume plans formerly had to be cut when conflicted with financial constraints - e.g after IMF intervention in 1976.

9. Cash figures should be accompanied by constant price figures to give some idea of levels of service?

Constant price figures of limited value in new situation. Cash programmes intended to have primacy. Necessary to get away from old system of volume planning and destroy idea that programme managers automatically entitled to be compensated for effects of inflation by revaluing their programmes. In any case old 'volume' figures not a measure of level of service. Simply measured resources put into programmes - inputs. The level of service provided - output - takes account not only of resource inputs, but efficiency and effectiveness of their use. We are continuing to review and develop use of output measures in planning and management of public expenditure.

10. End-year flexibility?

Possibility of end year flexibility is being looked at again. There could be some managerial advantages in such a scheme. But we also have to consider question of cost.

11. Revised cash limits 1982-82 announced 27 May

[In his Budget statement, after allowing NIS surcharge cut to help industry, the Chancellor announced that, in order to leave them where they would have been without the change, appropriate reductions would be made in relevant cash limits and votes of central government, in rate support grant to LAs and in EFLs of NIs and other public corporations. Revised EFLs for nationalised industries and for three other public corporations were given in answer to a written PQ on 7 April. (The revised figures included also certain other changes.) Further revisions to central government cash limits - published in written PQ 27 May.]

Revisions implement 'clawback' consequent on reductions in national insurance surcharge - a move intended to reduce business costs in the private sector. But as public sector employment also liable to the surcharge, appropriate reductions have been made to leave public bodies where they would have been without the change.

12. Cash limits 1982-83 and public sector pay?

(See Sections F and K.)

13. Cut public sector pay bill/administrative costs of central government?

Only one third of current expenditure is on wages and salaries and much of that is for nurses, teachers, members of armed forces, police and so on. Provision for public service pay increases 1982-83 limited to 4 per cent. Administrative costs ae not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain drive for more efficient management throughout public sector.

LOCAL GOVERNMENT

14. Overspending in 1982-83? Government response?

Local authorities are budgeting to spend some £1½ billion above Government's plans (£1¼ billion in England, £200 million in Scotland, £60 million in Wales). Government cannot ignore this large planned overspend.

Action in ENGLAND: Secretary of State for the Environment intends to implement scheme for grant abatement announced last year and is considering further across-the-board grant cut.

<u>Action in SCOTLAND</u>: Secretary of State for Scotland is seeking to reduce grants of Lothian Regional Council (by £45 million) and Stirling District Council (by £1½ million).

<u>Action in WALES</u>: Secretary of State for Wales has announced his intention to withhold grant. He also asked Welsh local authorities to submit revised budgets. Amount of grant to be withheld will be determined in light of these.

Local authorities have only themselves to blame for these grant penalties.

15. <u>Large rate increases this year are Government's fault</u>?

Not at all. If local authorities had sought to spend in line with Government's plans, rate increases should be very low. Where they are high, it is because local authorities have chosen to overspend.

16. <u>Effect of NIS reduction on local authorities</u>?

As Chancellor announced in Budget, we intend that local authorities overall will be neither worse nor better off as a result of decrease in NIS. We are aware of the difficulties involved in offsetting the reduction by a decrease in grant, and are looking constructively at possibility of postponing the reductions for local authorities until April 1983.

17. <u>Green Paper on Domestic Rating System: Government response</u>?

Government is considering carefully all representations received. We wish to produce proposals for a scheme that will remedy shortcomings of present system while commanding wide support.

F CIVIL SERVICE STAFFING AND PAY

1. Civil Service too big/does too much/is over staffed?

Since Government came to office, Civil Service has been reduced by 9 per cent to 666,400. This is smallest since 1966. Results from reduction in functions, privatisation and improvements in efficiency. On course to achieve aim of having Civil Service of 630,000 by April 1984. This is 102,000 fewer staff in post than in April 1979, and will mean the smallest Civil Service since the end of the Second World war.

2. Civil service pay: non-industrial civil servants

[Settlement date 1 April 1982.]

Civil Service Arbitration Tribunal awarded pay increases ranging from 4.75 per cent to 6.25 per cent - worth 5.9 per cent overall - and increases in annual leave. Government have accepted the award which is now being implemented. Increases (announced 12 May) for the higher civil service (under-secretary and above) are larger; they have been decided in the light of the recommendations of the Top Salaries Review Body. Cash limits and manpower targets are not being adjusted. (See also Section K) The report of the Megaw Inquiry into arrangements for deciding civil service pay in future may be made at the end of this month.

3. Civil Service pay: industrials

[Settlement date 1 July 1982]

Claim for increase in pay in line with inflation, shorter working week and longer holidays, is under discussion with the unions.

4. Scott Report/Public sector pensions?

See K

G SOCIAL SECURITY

1. Now that unemployment benefit is to be brought into tax why not restore November 1980 5 per cent abatement ?

Decision to abate UB not simply taken as proxy for tax but to reduce public expenditure and improve incentives to find and keep work. (Chancellor's Budget statement in March 1980 made that perfectly clear.) Those reasons remain valid. Any improvement on rates announced would seriously worsen incentives. Cost too would be high - £60 million in full year [net of reduced claims for supplementary benefit, but gross of tax].

2. Why cut child dependency additions to unemployment benefit?

[In line with practice in recent years, uprated level of child dependency additions to unemployment benefit (not Supplementary Benefit) abated by amount of increase in Child Benefit. In consequence, CDAs will drop from current level (80p) to 30p next November.]

Child dependency additions to unemployment benefit are being phased out, and will eventually be replaced entirely by Child Benefit. In this we are following practice adopted by last Labour Government.

3. Death grant - increase to realistic level?

[Consultative document about death grant published 3 March, comments asked for by 30 July.]

Social Services Secretary would welcome comments on recently published consultative document on death grant. As have made clear, aim is to redistribute in more sensible fashion resources now devoted to death grant - cannot afford to add to those resources.

4. Merger of income tax and national insurance planned?

Government's written evidence to TCSC did not suggest such a merger. Committee asked about feasibility of merging the two systems, and the evidence gave an illustration of what a joint system would look like.

H PUBLIC SECTOR BORROWING

1. Reasons for PSBR undershoot in 1981-82?

[PSBR 1981/82 undershoot originally thought to be around £2 billion now seems to be less than this: latest PSBR figure £8.9bn]

A study of the reasons for the shortfall has revealed possible improvements which can be made to improve our forecasting technique. However the Civil Service dispute added considerably to the unccertainties at the time of the Budget and was the main influence on most of the errors.

2. Why treat PSBR as a crucial statistic when forecasting errors of this size can occur?

Importance of balance between government's spending and income recognised by all governments, whatever the difficulties of forecasting.

3. Implications for fiscal policy and MTFS?

See A

4. If PSBR higher in 1982-83 than in 1981-82 won't interest rates have to rise?

As percentage of GDP, outturn for 1981-82 is more or less equal to the forecast for 1982-83 ie around 3½ per cent. The 1982-83 forecast is still a low figure both by comparison with deficits abroad and in relation to size of deficits over past decade.

5. Implications for public expenditure in 1981-82 and 1982-83?

Detailed public expenditure outturn information for 1981-82 will not be available until early next month. Until then, implications for 1982-83 are uncertain. [IF PRESSED: It is estimated, on very incomplete information, that the planning total will fall from £105.2 billion in the FSBR to around £104.5 billion (around £104 billion was provisional estimate given in other briefing) and that ratio of public expenditure to GDP will fall from 45 per cent to 44½ per cent].

6. Implications of CGBR outturn in April and May for 1982-82?

[CGBR for April = £0.8 billion, for May (published 9 June) = £1.1 billion. April 1981 = £2.4 billion, May 1981 = £2.7 billion].

Last year's figures severly distorted by Civil Service dispute so comparisons can be seriously misleading. Too soon to make any amendment to forecast for the year.

7. Effect of Civil Service dispute on PSBR?

PSBR in both 1981-82 and 1982-83 affected by Civil Service dispute. In 1981-82 some £¾ billion of receipts delayed from March 1981 were collected, but some £1½ billion of receipts due in 1981-82 will now be collected in 1982-83. Debt interest cost of the strike some £½ billion in 1981-82. Dispute also damaged out ability to interpret and forecast the PSBR reasonably accurately (see question 1).

8. Fiscal policy should be based on cyclically adjusted/real PSBR?

Some merit in inflation-adjusted measure as indicator of fiscal stance in some circumstances. But there are dangers here: it would be quite wrong to expand PSBR in cash terms in response to an upsurge in inflation merely to keep inflation-adjusted measure constant. Policies intended to eradicate inflation, not to adjust to it.

J MONETARY AND FINANCIAL POLICY

1. Monetary growth in 1981-82

[In banking May (third month of target period) £M3 rose by 1.2 per cent, bringing growth in the target period to 9.9 per cent at an annualised rate; M1 rose by 0.6 per cent (0.3 per cent at an annual rate this target period); PSL2 also rose by 0.6 per cent (9.8 per cent at an annual rate over the target period) - all figures seasonally adjusted].

Too early to judge outturn over target period as a whole, but recent figures encouraging. Figures point to continuing steady downward pressure on inflation.

2. Monetary conditions too tight?

Exchange rate, money GDP and monetary aggregates suggest financial conditions have been moderately restrictive whilst allowing recent further falls in interest rates. Bank lending is still growing rapidly, however; we do not believe that monetary conditions have been too restrictive.

3. Bank lending

Too early to say whether growth is slowing, though Banking May figure lower than in preceding months. Part of recent rapid growth at least is in substitution for building society lending and other forms of consumer credit, but to the extent that it is additional it may add to inflationary pressures, so must continue to proceed cautiously on interest rates.

4. Recent falls in interest rates

Base rates cut from 13-12½ per cent wef 8/9 June. Continues decline seen since last October when base rates were 16 per cent. Market unease over Falklands disguised underlying trend. Recently rates eased creating the conditions for 8 June base rate cuts as victory comes in sight. The latest falls are consistent with continued progress against inflation.

5. Prospects for further falls

Of course want to see rates lower still, but we have only just seen a further welcome cut in base rates and we have to be cautious about the future. We shall not jeopardise counter-inflation policy, but in due course further progress with MTFS should lead to rates being lower still.

6. Will high and unstable US rates affect UK rates?

[US rates eased slightly over past month, but still high.]

US rates not sole determinant of UK rates, but high US rates certainly an adverse development and in September were a key factor in driving our rates up. Recently, however, sterling has remained reasonably firm, probably helped by improved prospects for wage round, and good trade figures. UK interest rates have eased this year against US trend; but we cannot insulate ourselves from difficult international background. (See also T10.)

7. MTFS being quietly shelved?

[3rd MTFS states Government's objectives 'to reduce inflation and to create conditions for sustainable growth in output and employment', by 'steady but not excessive downward pressure on monetary conditions'. Key financial indicators are the monetary aggregates and exchange rate. Target range for growth of M1, £M3, PSL2 in period February 1982 - April 1983 of 8-12 per cent. Illustrative path of 7-11, 6-10 per cent in 1983-84, 1984-85. Targets for later years to be set nearer the time.]

No. Updated MTFS is realistic and flexible, describes how monetary policy operated in practice. MTFS serves useful purpose. Right to retain and adjust in light of experience.

8. 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.

K PRICES AND EARNINGS

PRICES

1. Inflation lower than forecast in Budget statement?

[12 monthly rate of inflation 9.4 per cent in April, compared with 10.4 per cent in March and 21.9 per cent in May 1980. Budget forecast: 9 per cent by Q4 1982, falling to 7½ per cent by mid-1983].

Inflation is now in single figures and is continuing to fall. We could well make rather faster progress in reducing inflation than we anticipated at the time of the Budget.

2. How low by end 1982?

No new forecast to offer at this stage, but the year-on-year rate of inflation was already 9.4 per cent in April, and should decline further over the year.

3. Chance of 7½ per cent inflation by end of year?

[Industry Secretary Speech to CBI 24 May.]

Fall to 7½ per cent by end of year not impossible - it is within the margins of error attached to the Budget forecast of 9 per cent. Recent figures have been encouraging and an outturn somewhat better than 9 per cnt is quite possible.

4. What reason is there to expect a further decline in inflation?

Over next year or so, moderation in unit labour costs should continue to exert downward pressure on rate of inflation, as should weak commodity prices. Competitive pressures on firms to limit price rises are also likely to remain strong.

5. FSBR inflation forecast more optimistic than major outside forecasts?

All assessments released since Budget contain an improved inflation prospect. April CBI quarterly survey shows substantial decline in net balance of firms expecting higher prices and costs in next four months. Balance of firms expecting higher costs now lowest for 15 years. (See also 1 above and A.11).

6. Inflation still not down to 7.4 per cent reached under previous Government?

[Average year-on-year rate of inflation between February 1974 and May 1979 was 15.4 per cent; average level of inflation since May 1979 has been 14.4 per cent.]

Year-on-year rate of inflation had risen to 10.3 per cent when previous Government left office. And on present forecasts average level of inflation will be lower under this Government than under its predecessor - first time this has happened in over 30 years.

7. Inflation still not as low as competitors

[UK inflation 9.4 per cent in April, compared with 6.6 per cent in US, 5 per cent in West Germany, and 2.8 per cent in Japan.]

UK inflation now lower than Western European (OECD Europe) average, and well below many countries - such as France and Italy. Still some way to go to match US, West Germany and Japan, but good progress being made in right direction.

8. Effect of 1982 Budget on RPI?

Compared with full indexation of excise duties, direct effect of Budget is RPI reduction of 0.1 per cent (or an increase of 0.1 per cent including also the direct effect of the 2 December measures). [IF PRESSED on non-indexed basis: direct effect is 0.8 per cent increase in the RPI (or 1.4 per cent including also 2 December measures).]

9. Effect of 1982 Budget on TPI?

Compared with full indexation of excise duties, direct effect of Budget is TPI reduction of 0.4 per cent (or increase of 1.1 per cent including also direct effect of 2 December measures). [IF PRESSED on non-indexed basis: direct effect is 1.6 per cent reduction (or a 0.3 per cent increase including also 2 December measures).]

10. Movement in tax and prices index?

[Increase over 12 months to April 9.7 per cent, compared with increase of 9.4 per cent in RPI].

Fact that TPI has been increasing faster than RPI reflects measures taken to restrain Government borrowing, which is essential if inflation is to be controlled. But following recent Budget, difference is now small.

11. Nationalised industry prices

[Increase over 12 months to April 14.1 per cent, compared with an increase of 9.4 per cent in the RPI (see also R8)].

Gap between nationalised industry price increases and RPI due in large measure to cumulative effect of years of artifical price restraint. World oil price rises of 1979 and 1980 have also played important part. Increases regrettable, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so, but sustained improvement only possible if industries succeed in holding down current costs, particularly pay.

12. Effect on retail prices of EC farm price settlement?

[EC Agriculture Ministers agreed on 18 May, by majority decision, to raise level of farm support prices under CAP by average of just over 10 per cent].

Estimates of effect of the CAP price settlement on retail prices can only be made in general terms, and will depend on such factors as the type of support operated and the prevailing market conditions in the sectors concerned. Agriculture Minister (in statement to House 19 May) estimated that direct impact of total package would add about ½ per cent to retail prices index and 1¼ per cent to retail food price index in full year. [NB Treasury believes this may be under-estimate because assumes constant absolute profit margins.]

PAY

13. Current level of pay settlements

The recent decisions on public service pay which the Government has announced confirm the downward trend of settlements since the last pay round, when they generally averaged 8-9 per cent. Settlements are also well below rate of inflation for second year running.

14. 4 per cent pay factor abandoned?

The 4 per cent factor is not a pay norm, but a broad measure of what Government thinks reasonable and can be afforded in fixing provision from which public service wage bill has to be met. Government has decided to accommodate cost of Civil Service arbitration award within the relevant provision. Only if expectional difficulties arose later in the year would limited calls on the contingency reserve be considered.

15. Government norm now 6 per cent?

There is no norm, nor has there been. The 4 per cent factor remains the basis on which provision for public service pay has been set. Where extra provision has been needed to help finance proposed higher increases, as with nurses, doctors and dentists, it has been found partly from other savings on programmes concerned and partly from contingency reserve.

16. Government satisfied with 6 per cent?

Increases of 6 per cent are higher than provision which the Government made for pay within programmes. They will have implications for level of non-pay expenditure.

17. Why only 4 per cent for NHS ancillaries and white collar grades?

Cost of the Civil Service arbitration award will be accommodated within 4 per cent pay provison. Moreover, within the range of pay increases announced both for the Civil Service and the Armed Forces, many civil servants and Servicemen will get only a little above the 4 per cent being offered to some NHS groups.

18. Why only 4 per cent for MPs (announced 12 May)?

Problems of recruitment, career structure and differentials do not apply to MPs. Government therefore felt is appropriate to propose increases no higher than the pay factor included in Estimates.

19. Top Salaries Review Board increases too large

[Government announced on 12 May increases of 14.3 per cent for senior civil servants and senior members of the Armed Forces, and 18.6 per cent for the judiciary.]

Government believes these increases are fully justified. Essential to ensure adequate supply of candidates of sufficient calibre for the Bench, and to provide adequate career structure and differentials in higher levels of Civil Service and Armed Forces. TSRB are only group whose present salaries are below those recommended for April 1980.

20. Average earnings index

[Year on year growth 11.0 per cent in March compared with 11.4 per cent in February, though (unpublished) underlying increase slightly lower than in recent months at around 10½ per cent.]

Encouraging that underlying rate of growth continues to fall. But must remember change over the 12 months to March straddles two pay rounds - not entirely indicative of recent trends. Also, earnings index inflated recently by some increase in hours worked.

21. Government aiming to cut living standards?

[Although RPDI was 1 per cent higher in 1981 Q4 than in 1979 Q1, it is likely to fall below the 1979 Q1 level during 1982]

No. Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

22. But real take-home pay has fallen over past year

Yes. But this follows growth of 17½ per cent in personal living standards in 3 years 1977 to 1980.

23. Index-linked pensions and the Scott Report?

The Government is considering whole question in light of Scott Report. Our aim is to ensure that public servants' pensions are fair to taxpayers, as well as to current employees and pensioners and their dependants.

24. Incomes Policy

[SDP Green Paper "Towards Full Employment" (published 8 June) includes proposal for permanent incomes policy]

Proposals for incomes policies, including recent refinements, do not avoid many of the familiar problems of norms, administrative costs, and interference with market forces. Experience gives no encouragement to the idea that incomes policy can be made to work on a permanent basis. They always succumb to the distortions they create.

L BALANCE OF PAYMENTS

1. March trade figures?

[Figures published 7 June show current account in estimated £330 million surplus during March. Non-oil trade back in surplus for first time since October. Invisible surplus of £110 million lower than earlier projected in part reflects change in statistical treatment of EC Budget refunds (see 4 below). Current account surplus of about £½ billion in 1Q 1982 compares with £2½ billion in 1Q 1981 and about £1½ billion in 1Q 1981. For 1981 as a whole, estimated current amount surplus (still partial data) now £7 billion cf Budget estimate of £8 billion.]

Figures still incomplete for 1981, and difficult to interpret. But current account remains in substantial surplus and exports holding up well.

2. Export trends gloomy?

[Figures remain extremely difficult to interpret, following last years Civil Service dispute and changed documentation procedures. Latest figures show apparent weakening in non-oil volumes in Jan-Feb reversed in Feb-March. Volume of non-oil exports (excluding erratics) in September 1981 - March 1982 much the same as 1980 average.]

Exports help up better than many feared following earlier fall in competitiveness. Present months figures suggest non-oil exports running at about same levels as in 1980.

3. Imports?

[Figures remain difficult to interpret (see 2 above). Non-oil import volumes between March 1981 and September 1981 higher than in low levels of 1Q 1981, since then broadly stable.]

Imports bounced back in 1981 as destocking came to an end. But increase in the volume of imports of finished manufactured goods since September 1981, suggesting that UK firms are being more successful in home market.

4. Disappointing trend in invisibles contrary to expectations

[Figures published 8 June show Q1 current account surplus of £0.6 billion, a visible trade surplus of £0.2 billion but a reduced surplus on invisibles of £0.3 billion against the £1.4 billion projection published with February Trade figures].

It would be wrong to read too much into these figures, which need careful interpretation. About half the fall from the earlier projection results from a new seasonal adjustment to the figure for EC refunds. This will add the same amount to the figures over the rest of the year. Most of the rest reflects a substantial [around £500 million] change to the CSO's estimate of net interest profit and dividend payments from and to countries abroad. This is a very erratic item, subject to revision. Trade in services remains in large and growing surplus (£1043 million in Q1, up from £1006 million in Q4 1981).

[NB. If the comparison is with the revised figures for Q4 1981 our net payments to the EC increased in Q1, and there was a fall in net interest and dividend receipts. But in that

comparison the seasonal adjustment point does not apply since the revised 1981 figures are also seasonally adjusted.]

5. Overseas investment takes jobs away from UK?

30 per cent of UK exports are bought by overseas firms connected to UK companies. By increasing the links between UK and overseas companies, overseas investment helps UK exports and production producing more jobs. If the UK does not take profitable opportunities to invest overseas, others will.

M EXCHANGE RATE AND THE RESERVES

1. Policy towards the exchange rate

[Since last autumn sterling has remained broadly stable. The average £ effective rate in Q1 1982 was over 10 per cent lower than in Q1 1981. Recent lows were $1.7470 on 6 April, DM 4.098 on 21 May. Highs were $1.97 on 30 November, DM 4.407 on 9 February. Rates at close on 11 June were $1.7726, DM 4.238 and an effective of 90.43. Reserves at end May stood at $17.8 billion, compared with $18.2 billion at end April.]

The Government has no target for the exchange rate. The rate is taken into account in interpreting domestic monetary conditions and taking decisions on policy.

2. Bank of England intervening to support the rate?

Policy is unchanged. The Bank do intervene to smooth excessive fluctuations and preserve orderly markets particularly when conditions are unsettled. But as the Chancellor has already stated we have no target - undisclosed, secret or otherwise - for the exchange rate. Most recent reserves figures confirm that policy is unchanged.

3. Concerted intervention to reduce the value of the dollar?

All the experience in recent years is that exchange rates for major currencies cannot be manipulated by intervention alone. Intervention can help to steady markets, but not counter major exchange rate trends. That takes changes in real policies, affecting interest rates, monetary conditions and fiscal policies. Lower US inflation is in everyone's interest: the matter for real concern is the US fiscal/interest rate mix, a problem all countries are familiar with.

4. Improve UK competitiveness by devaluing the exchange rate

Experience shows that exchange rate cannot be manipulated by Government against underlying market trends. Any attempt to lower it by intervention or by relaxing monetary control leads to higher inflation. For example although effective exchange rate depreciated by over a-quarter between 1972 and 1976 competitiveness was unchanged, this remedy has been tried and it has failed.

5. Debt repayments

We have made excellent progress with our plans to reduce the burden of external debt substantially during this Parliament. We aimed to reduce official external debt to $14 billion by end of 1981. This has been more than achieved - external debt is now around $13 billion, compared with over $22 billion when the Government took office.

6. French devalue to improve competitiveness

[At EMS realignment on 12 June the Deutschemark and Dutch guilder were revalued by 4.25 per cent; the French franc devalued by 5.75 per cent and the Italian lira devalued by 2.75 per cent]

EMS realignment conference on 12 June - at which the Chancellor assisted - adjusted exchange rates to allow for underlying market trends. The realignment - and accompanying measures taken - show that other European countries have the same priority as ourselves: to defeat inflation and so create the conditions for sustained economic growth.

N EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. UK budget settlement

Foreign Ministers agreed on 25 May to a settlement for the UK budget contribution for 1982. The settlement provides for a basic refund of £490 million in respect of 1982, with provision for changes to this figure if our unadjusted net contribution varies from the Commission estimate of £880 million. It was also agreed that the problem for the longer term would be settled by the end of November.

2. Implementation of budget settlement

This is to be settled at Foreign Ministers' meeting on 21 June, and embodied in a Regulation thereafter. 25 May agreement envisaged partial rebates to Germany, Italy, Greece and Ireland for their share in financing UK refunds, making France bear a larger burden - but France will remain a substantial net recipient from the budget.

3. Remainder of Commission 'Mandate' report

The other member states broke the link between the different parts of the mandate report when they voted through the agricultural prices. But we are prepared to continue to work on the basis of previous agreements where applicable.

4. CAP prices 1982-83 and the Luxembourg Compromise

As Agriculture Minister made clear in his statement on 19 May, we consider the adoption of the 1982-83 CAP prices to have been wholly contrary to the Luxembourg Accords, which were in existence before we joined the Community and which have been observed for 16 years. This action raises serious constitutional issues. Foreign Ministers are to consider the implications on 20 June.

5. UK objectives for longer-term negotiations?

Government has made it clear that, in spite of our relative economic position, UK is prepared to remain a net contributor - but only on a very modest scale.

6. UK refunds in respect of 1981

Commission paid us before 31 March £813 million for supplementary measures as first instalment of our refunds in respect of 1981. This represents 81 per cent of our entitlement for that year. Our net contribution for 1981-82 is now put at some £200 million - very substantially less than it would have been without the 30 May 1980 budget agreement.

7. UK a net recipient in 1981?

In fact we remained a small net contributor to the allocated Community budget. We also, of course, contribute to aid etc. which is part of the unallocated budget. Very satisfactory that the outturn was better than expected: for we remain one of the less prosperous member states.

8. Will UK have to repay or forego refunds if net contribution less than originally estimated?

No. The UK is clear that minimum net refunds payable under 30 May agreement are 1175 million ecus (European Currency Units) for 1980 and 1410 million ecus for 1981.

9. 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.

10. Policy for CAP reform

Key measures are price restraint, curbs on surplus production and strict control of the growth of guarantee expenditure.

11. 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

12. 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.

13. Join the EMS for exchange rate stability?

There is no reason to suppose that by the simple act of joining the EMS exchange rate mechanism we would guarantee exchange rate stability. This has not been the experience of the current participants. Genuine stability requires a return to low inflation rates throughout the Community.

P INDUSTRY

1. Treasury simulations for April meeting of NEDC: TUC accusation that Treasury 'rigged' results, on Chancellor's orders.

No truth whatsoever in this charge. Treasury model is designed, operated and, where necessary, modified, purely on basis of professional judgement of economists within Treasury. Treasury Ministers in no way involved in its design or operation. (TUC charges were fully answered in a detailed statement issued by the Treasury on May 14.)

2. Will technical discussions between Treasury and TUC (and other NEDC partners) now take place?

We hope so (but no date has been fixed).

3. Prospects for industry-recovery?

Fall in output has now come to an end. Underlying level and manufacturing output now (ie February/March) about 2 per cent above level last spring. Budget forecast suggests there may be 3 per cent increase in manufacturing output in 1982 as a whole. Latest CBI survey encouraging (see B2).

4. Company financial position?

[Non-oil industrial and commercial companies (ICC's) gross trading profits (net of stock appreciation) rose by over a quarter between 1H and 2H 1981, but from a very low base - ICC's real rate of return just 2½ per cent in 1981. ICC's finances showed some weakening in 4Q reflecting slowdown in destocking and unwinding of civil service dispute, but finances better in 1981 as a whole -

£bn

	1979	1980	1981 Year	H1	H2
Net borrowing requirement (+)/repayments (-)	+6.1	+5.7	+4.4	-1.2	+5.6
Financial surplus (+)/deficit (-)	-2.7	- 1½	+1.2	+1.5	-0.3]

Increase in profits (albeit from low level) encouraging. Some apparent deterioration in financial position reflects slowdown in rate of destocking, and effects of unwinding of civil service dispute (which delayed companies' tax payments), but companies' finances much healthier in 1981 than in two previous years. Company liquidity improved considerably in first three months of 1982 [new DOI Survey figures published 4 June].

5. Births and deaths of firms

[Report in FT 11 May of Henley Management College Paper showing 'more firms now dying than being born'?]

No really satisfactory statistics to measure this. Henley used lists of firms registered under Companies Acts - not same thing as list of actively trading companies (eg sole traders and partnerships excluded, firms sold in liquidation to other companies counted as 'deaths'). A better guide might be the list of 1.3 million firms registered for VAT: latest available figures (1980) show births and deaths roughly in balance.

6. Rate of return still too low?

[Real pre-tax rate of return of ICCs was 2½ per cent in 1981 - half the previous lowest figure in 1975.]

Yes, but Government can only help in limited ways. Fundamental improvement in ICC's profits and real rates of return depend on improved performance by companies, both management and employees. Much encouraged by recent productivity gains and trend towards moderate pay settlements.

7. High interest rates damaging for industry and investment?

[Each 1 per cent in interest rates raises interest payments on industry's borrowing by around £250 million.]

Budget measures have eased pressure on interest rates, and the recent ½ per cent fall in the banks' base rates is encouraging. But Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking. Continuing relatively high level of interest rates must be seen in context of priority attached to reducing inflation and need to control growth in money supply underlying the MTFS. (See brief J).

8. Government help for small firms

Budget provided further help for small businesses, increasing the number of measures taken so far to over ninety. Enterprise package included further reduction in weight of corporation tax; further increases in VAT registration limits; increase in global amount available for loans under Loan Guarantee Scheme (see below); and doubling of investment limit under Business Start-Up Scheme to £20,000 a year. New measures will encourage start-ups and existing firms.

9. Response to Loan Guarantee Scheme?

Scheme operating successfully. We have already issued more than 4,440 guarantees - about half to new businesses. Total lending under scheme is just over £149 million. Budget provided for the lending ceiling - in year to May 1982 - to be raised from £100 million to £150 million. Further £150 million available in year to May 1983. Three more banks admitted to scheme in April making total of thirty financial institutions now participating.

10 Government thinking again about Loan Guarantee Scheme?

[Article in FT 24 May]

Scheme under continuous review.

11. High failure rate under Loan Guarantee Scheme expensive for Government?

Too early to assess overall cost of scheme. After first year of the 4000 guarantees issued, 45 have been 'called'. Cost has been more than covered by the premium income received over the period.

12. Enterprise zones: response from private sector?

All eleven zones now in operation. Response has been very encouraging. Many new firms are setting up in the zones, existing firms are expanding their activities and vacant land has been brought into use. Too early to assess success of zones.

R NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83 and future years?

Nationalised industries' total external finance increased by £1.3 billion in 1982-83 (£1.2 billion after allowing for NIS cut and other changes), £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.

INVESTMENT

2. How robust are the forecasts of nationalised industry demand/contributions to public expenditure, given the recent track record?

Plans published in PEWP at Budget time considerably less optimistic than those published last year.In particular, in increasing substantially the external finance available to the industries in each year of the Survey, Government recognised effect of lower demand on the industries' internal resources - 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 still expected to decline over Survey period, but from higher base and at more gradual rate than forecast last year.

3. 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 their internal resource forecasts. But perfectly possible that plans might need to be revised, for example if the industries fail to restrain their current costs, including pay.

4. But shortfall in capital spending 1981-82?

[Figures in FSBR imply shortfall of £¾ billion, latest estimates suggest that this may be nearer £1 billion.]

Not easy to establish firm reasons after the event. Such evidence as we have suggests a mixture of reasons. Most important has been cut in investment in response to changed circumstances such as lower market demand. These cuts have been extraneous and have not borne any direct relationship to EFL pressures. Other cuts have been for wholly beneficial reasons, such as lower than expected inflation and cost savings.

5. 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.

6. Private finance for NI investment?

We have indicated our willingness to consider new financing proposals, provided they can be structured so as to induce improvements in efficiency at least sufficient to offset the extra cost, and provided the finance is raised in fair competition with the private sector.

7. Finance more nationalised industry investment by cutting current spending?

Yes. As in private sector, moderate pay settlements and control of other costs are essential. Ability to finance new investment in nationalised industries bound to diminish if excessive pay settlements agreed. Each 1 per cent off wages saves about £140 million this year; and each 1 per cent off total costs saves £330 million this year.

NATIONALISED INDUSTRY PAY AND PRICES

8. Nationalised industries' prices

[Having risen approximately in line with retail prices for several months, the April figures again showed nationalised industry domestic prices increasing more rapidly than the RPI, by 14.1 per cent for NI against 9.4 per cent for all items RPI over the 12 months to mid-April. The restoration of this differential was expected, and reflects March increase in London Transport fares and ending of electricity industry's rebates to consumers. The removal of these temporary distortions confirms that nationalised industry prices are still increasing somewhat faster than the RPI, largely because of increases in the energy sector.]

Gap between nationalised industry price increases and RPI has been due in large measure to cumulative effect of years of artifical price restraint. World oil price rises of 1979 and 1980 have also played an important part. We greatly regret the need for these increases, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so, but sustained improvement will only be possible if the industries succeed in holding down their current costs, particularly pay.

PRIVATISATION

9. What further sales expected?

Special sales of assets in 1982-83 forecast at around £700 million and around £600 million in each of the later years. These figures well above those in last White Paper. This reflects primarily very large sales of energy assets - Britoil and the British Gas Corporation's major

offshore oil assets - to be made possible by Oil and Gas (Enterprise) Bill currently before the House.

10. Special asset sales in 1981-82

Gross sales in 1981-82 totalled £481 million, so target published in 1981 Public Expenditure White Paper of £500 million nearly met. Pleasing result - included two large sales - Cable and Wireless (£182 million) and Amersham International (£64 million).

11. But what about net figure?

Delivery of BNOC oil in 1981-82 paid for in 1980-81 and taken into account in special disposals figure for that year reduced 1981-82 receipts by £573 million to total of -£92 million. But it is the gross figure which is the true measure of success of Government's privatisation programme.

12. Government has sold assets too cheap?

[Heavy oversubscription for British Aerospace, Cable and Wireless, Amersham International, followed by large increases in prices when shares first traded.]

Not in Government's interest to see shares underpriced, given the loss to the PSBR, but also risks in pitching price too high. Getting balance right not easy - especially when company's shares have not previously been traded. Government will continue to consider alternative forms of sale eg tender, but critics should note that sale by tender could make it harder for small investor to buy shares.

S NORTH SEA AND UK ECONOMY

1. Impact of $2.50/barrel rise in North Sea oil price on Government revenues?

[$2.50/barrel rise is a figure quoted in the press for negotiations involving BNOC and oil companies.]

Treasury estimate that a sustained $1/barrel rise in the North Sea oil price all other thing being equal would directly raise Government North Sea revenues by about £350 million in a full financial year.

2. In view of falls in price of oil earlier this year, why did HMG not reduce tax burden on North Sea oil producers?

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.

3. Onerous tax system damaging future field developments?

[Shell/ESSO announcement plans for Tern shelved partly because of tax system; reports that Phillips are postponing T-block complex and BP their Andrew field].

Other adverse factors - falling oil prices; high development costs - much more important. No evidence that tax system is the determining factor inhibiting future development.

4. Government should do more to stimulate UK Continental Shelf oil production in 1990's?

[Select Committee on Energy's Report on depletion policy published 18 May: recommends reserve powers to impose production cuts but main emphasis on promoting development of fields to come into production in 1990s - increase pace of licensing rounds and overhaul fiscal regime].

Government's considered reply will be given in due course. Accept need to prolong high levels of UKCS production until end of century at least. Energy Secretary announced 17 May Government's plans for Eighth Round of licensing. Do not accept that fiscal regime makes North Sea development unattractive. On Committee's general proposal for overhaul of regime, would point out that industry does not want a structural upheaval: it would create serious uncertainty and major transitional problems.

5. Benefits of North Sea should be used to strengthen the economy?

[FSBR projections (in money of the day) of Government revenues from North Sea: £6.4 billion in 1981-82, £6.2 billion in 1982-83, £6.1 billion in 1983-84, and £8.0 billion in 1984-85. Lower than last year's projections, principally because of downward revision to oil price expectations. Projections incorporate March fall to $31 a barrel for Forties oil.

Contribution of North Sea to GNP estimated at 4 per cent of GNP in 1981. Not projected to rise before 1985.]

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve a lower level of interest rates to the benefit of industry and the economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Less than 6 per cent of total General Government receipts in 1981-82.

6. Is the Government underestimating North Sea revenues?

[Stockbrokers Scott Goff Hancock reported to be estimating Government revenues of £7.4 - £8.1bn in 1982-83, compared with FSBR estimate of £6.2bn]

No. Other estimates of Government revenues based on assumptions that seem over-optimistic eg on future production.

7. North Sea revenues should be channelled into a special fund to finance new investment, particularly in energy?

North Sea revenues are already committed. Setting up a special Fund would make no difference. More money would not magically become available. So the money for this Fund would have to come from somewhere else. This would mean higher taxes or lower public expenditure, if public sector borrowing is not to rise. If borrowing did rise, then so would interest rates. Not obvious that net effect would be good for investment.

8. Are we really any better off for our North Sea oil?

We are better off with oil - at current oil prices - than we would have been without it. We have been spared the fall in real national income that other industrial countries have suffered following oil price rises. But North Sea oil is costly to produce, so we are not necessarily any better off than we would have been had oil prices not risen. No need therefore for the possession of oil to require a contraction in our industrial base.

9. Chancellor's oil taxation package announced 9 June

[Summary: No field to pay APRT for more than 5 years; APRT repaid after 5 years if not set off against PRT; APRT allowed as a deduction in computing payback; further proposals to smooth PRT payments in second half of 1983; cost £55 million 1982-84]

Following Budget proposals, industry expressed concern on a number of specific matters; we have decided that some mitigation of the burden for less profitable, more marginal fields is appropriate to meet particular problems. The tax system introduced in the Budget, plus these changes, should enable the nation to get its fair share from the profits of this national asset, while leaving plenty of incentive to continue developing it.

T WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Versailles Summit offers no prospect for reducing unemployment?

Today's unemployment is the bill we pay for having allowed inflation to continue so long in the past. But glad to note most forecasters expect resumed growth in activity in Summit countries later this year and next, which should help to halt the rise in unemployment.

2. Versailles summit: international monetary undertaking

Major countries explicitly accepted "joint responsibility to work for greater stability in world monetary system". Could be significant step towards greater stability if five countries whose currencies makeup SDR basket preserve value of their own individual currencies by reducing inflation at home. UK and France still some way to go in that respect.

3. Why didn't Summit countries together lead revival of Western economy?

Road to revival lies through combatting inflation. Remarkable unity at Varsailles Summit at OECD Finance Ministers meeting and at Interim Committee of International Monetary Fund - on which smaller industrialised and developing countries sit - that reduction in inflation must precede sustained revival. IMF's Interim Committee agreed "combatting inflation is a necessary step for resumption of sustainable growth at a satisfactory pace". Most Summit partners have made good progress reducing inflation.

4. French and Italian devaluations?

[French franc devalued by 10 perr cent and Italian lira devalued 7 per cent against Deutschemark on 12 June. Sixth and biggest revaluation in EMS's 3¼ year history. Simultaneously French government announced package of austerity measures including 4 month prices and wages freeze (to reduce inflation to single figures), increases in social security and unemployment contributions and limit to budget deficit of 3 per cent of GNP in 1982]

Second EMS realignment this year was necessary because French and Italian inflation rates considerably above European partners. Strength and stability of Western economies as a whole will benefit if France and Italy can control inflation. So we welcome French government's recognition that inflation is as serious a threat as unemployment and that reining in public sector borrowing is essential part of counter-inflation strategy.

5. Anti-inflation policies are working

[Inflation down from a year ago in 6 of major 7 economies - significantly down in US (from 10 to 6½ per cent), Japan (6½ to 3), Italy (20 to 15½) and UK (12 to 9½). Small reductions in Germany (to 5 per cent) and Canada (to 11½), but increase in France (from 12½ to 14).]

Yes. Firm fiscal and monetary responses to 1979-80 vindicated by events. UK still some way to go to match US, Germany or Japan in bringing down inflation, but moving in right direction and ahead of some other European countries. Realism in wage settlements is growing, US, Germany, Japan and UK all have wage settlements in single figures. Other policies also working: oil savings have helped cut OECD oil demand. All point towards basis for sustainable recovery.

6. Governments' policies have failed or worsened situation?

No. Adjustment to second oil shock better than to first. Investment has performed better, impact on wages better contained and dependence on oil reduced. But these gains must be reinforced by continued firm policies.

7. Prospects for UK economy worse than for other countries?

No. Treasury and most independent forecasters expect UK growth this year of about 1½ per cent rising to an annual rate of 2 per cent by early next year. This is very closely in line with the OECD's forecast for OECD Europe. Unemployment is expected to rise in all major countries except Japan. UK inflation (GNP deflators) likely to be around the OECD average and below that in France, Italy and Canada.

8. Prospects for US economy?

[Commerce Department's index of leading indicators rose in April for first time in a year, but industrial production is falling and seasonally adjusted unemployment is 9.5 per cent. M1 significantly above target range half way through year. Year on year rate of consumer price inflation down for the 7th consecutive month to 6.6 per cent in April.]

Seventh consecutive month of falling US inflation rate very good news - stabilising influence for the world economy. Helped by realistic and flexible wage settlements in which unions have given job security priority over wage increases. Reasonable prospect US economy should pick up later this year.

9. US Budget?

[House of Representatives passed budget plan with projected deficit for FY83 of $99 billion; Senate approved plan has deficit of $116 billion. House and Senate meet this week in conference to work out compromise. The two chambers largely agree on total revenue to be raised next year but Senate wants smaller cut in social programme.]

Hope two Houses of Congress will soon reach agreement on budget for Fiscal year '83; must reach agreement on details as well as total expenditure and federal deficit.

10. US interest rate developments

[One major US bank cut its prime rate to 16 per cent - others so far stayed at 16½ per cent.]

Prime rate well below peak of 21½ per cent last summer. Settlement of Budget for fiscal 83 would improve prospects for lower interest rates, especially given recent rate of inflation in US.

11. Prospects for international interest rates?

Always difficult to forecast interest rates with certainty, but firm and balanced policies should over a period bring lasting reduction in both inflation and interest rates.

12. OECD see bleak prospects for UK economy?

[Report in The Times 24 May]

Latest OECD forecast ('Economic Outlook') published in December; next not due to be published until July.

U FALKLANDS CRISIS EFFECTS

1. UK economy affected by Falklands crisis?

Possible economic consequences cannot of course be ignored. But UK is basically in a strong financial position: inflation is coming down; interest rates were falling before crisis; balance of payments remains healthy; output is higher than a year ago. Disturbance due to Falklands dispute small in relation to overall macro-economic picture. No question of requiring any change in basic economic strategy.

2. Effect of Falklands dispute on markets?

[Markets have recovered some of the confidence lost in early days of dispute, and equity, gilt and money markets now stronger. Exchange rate holding up, and domestic interest rates now ¾ per cent lower than before crisis began]

Only natural that markets unsettled. But markets aware that underlying position of UK economy is strong. Shock seems to have been absorbed so far without significant ill-effect, reflecting confidence in government handling of crisis, and in economic policies. Too early to say what long term effects will be, but Government determined not to be deflected from its path.

3. Will dispute affect UK trade figures?

Volume of UK-Argentine trade negligible (£20 million a month on either side).

4. Will freeze on Argentine assets affect standing of City?

We have not confiscated Argentine's assets, merely frozen them. This action was taken under extraordinary provocation; we believe international financial community will understand this.

5. Effect of restrictions on Argentinia?

The crisis and our action will greatly reduce Argentina's capacity to raise loans on the international markets. A number of Argentine public foreign borrowing operations amounting to many hundreds of $million have been suspended since crisis began.

6. Argentina's debts

[NOT FOR USE: Argentine foreign debt at end 1981 estimated at $34 billion - about half size of Mexico's or Brazil's.]

Sign of times that Argentine military aggression should create instability in global capital markets. All more important to negotiate settlement quickly and to discourage similar acts in future. [IF PRESSED on debt default possibility: Banks have taken fairly relaxed atttude because ultimately overseas debt must be repaid by exports; Argentina's export sector is agriculture, which, according to most experts, is fundamentally healthy.]

7. Falkland Islands: Cost/Financing of operation?

No cash ceiling on cost of operation; needs of task force must and will come first. Obviously too early to assess cost - duration and nature of operation still unknown. When cost is known we shall decide how to deal with it. But cost can and will be met in ways consistent with Government's economic strategy. [IF PRESSED: Not all of cost will be additional. At this stage, extra cost represents very small proportion of (over £14 billion) Defence Budget. No cash or budgetary problem immediately in prospect but economic strategy will not be relaxed, even if this involves higher taxes.]

8. Cuts in defence spending have weakened our ability to respond to Falklands crisis?

No. We have not cut defence spending since 1978-79. We have increased it by over 85 per cent in cash terms - a real increase of about 11 per cent - to over £14 billion. We are spending more on conventional naval forces in real terms than was spent in year before we came to office. When expenditure on modernising strategic deterrent is at its peak we will still be spending more on conventional Navy than in 1978-79.

AIDE MEMOIRE ON THE UK ECONOMY

14 June 1982

RECENT DEVELOPMENTS AND INDICATORS

(i) Activity. GDP fell by 6 per cent between 1979 H2 (last cyclical peak) and 1981 Q2 (trough of current recession), rose about 1 per cent during 1981 H2 then declined by ¼ per cent in 1982 Q1. Recent decline largely reflects impact of severe weather and strikes at turn of year. Despite weakening, underlying level of output remains above levels of last spring. Most independent assessments expect continued recovery during 1982 and 1983.

Volume of new engineering and construction orders in 1981 up 15 and 11 per cent on 2H 1980. Private housing starts up over one third in same period. Reflecting strong rise in private and public sectors, total housing starts in 4 months to April 1982 up one quarter on 1981 average.

Recovery in 1981 largely reflected sharp fall in rate of destocking. Q1 figures suggest period of rapid destocking now over. Consumers' expenditure and Government consumption broadly flat. Fixed investment broadly flat in 1981, but latter beginning to pick up in manufacturers, distributors and services (MDS) investment rose 5 per cent in certain areas in 1982 Q1; DOI investment intentions survey suggests rise of 2 per cent in MDS fixed investment in 1982.

(ii) Lack of complete trade figures for 1981 and changed documentation procedures make recent figures difficult to interpret. Exports have held up better than many had feared. In 7 months to March non-oil exports no lower than in 1980. Non oil imports have risen - up 11 per cent in same period - reflecting reduced rate of destocking and higher output. Current account estimated to be in surplus of £½ billion in 1Q 1982 following £7 billion surplus in 1981.

(iii) Employment and unemployment. UK employment fell 2.1 million (9 per cent) between mid 1979 and 4Q 1981 (about two-thirds concentrated in manufacturing), though rate of decline has slowed down. UK adult unemployment risen by 1.6 million (less than fall in employment) and stood at 2.87 million (12 per cent) in May. Total unemployment (including school leavers) was 2.97 million (12.4 per cent). Underlying rate of increase in unemployment slowed sharply during 1981 (105,000 per month in 4Q 1980 cf 22,000 per month so far in 1982). Other labour market indicators improving; eg short-time working down by ¾ during 1981, overtime up by over 10 per cent during 1981, and vacancies - despite slight weakening since February - up by 1/5 in 3 months to May on 2Q 1981, and with more rapid turnover.

(iv) Wages and prices. Increase in earnings in 1980-81 pay round 11 per cent (settlements averaged about 9 per cent), half that of previous pay round. Settlements well inside single figures are now widespread (CBI average for manufacturing 7 per cent) suggesting further moderation in current pay round. 12-monthly increase in RPI for first time in over 3 years well inside single figures; 9.4 per cent, in April. Recent progress suggests outturn to November this year could well be in Budget time forecast of 9 per cent. Manufacturers' input prices now no higher than last August; in 12 months to May they rose just 4¾ per cent. Corresponding rise in manufacturers output prices 8¾ per cent -lowest figure for over three years.

(v) Productivity and Competitiveness (manufacturing). Output per man risen 12 per cent since end-1980. Output per man and output per man hour 5 and 8 per cent respectively higher than previous cyclical peak (1H 1979). Together with pay moderation, resulted in little increase in unit wage and salary costs during 1981 - rise of less than 3 per cent in year to 1Q 1982 - a rate below average of our competitors and comparable to Germany and Japan. Competitiveness (relative normalised unit labour costs) improved by at least 10 per cent during 1981, but remains about 1/3 worse than in 1975.

(vi) Company finances. Gross trading profits of ICCs (excluding North Sea) rose by over one quarter between 1H and 2H 1981, but real pre tax rate of return just 2½ per cent in 1981. Despite rise in company borrowing and deterioration in liquidity in 4Q 1982 (largely reflecting reduced sale of destocking and unwinding of civil service dispute which delayed companies' tax payments), company finances healthier in 1981 as a whole than in 1979 and 1980. Company liquidity improved in 1Q 1982.

(vii) Monetary aggregates. £M3 grew at an annual rate of 13 per cent in 1981-82 target period (from mid-February 1981 to mid-April 1982) compared with target range of 6-10 per cent. At least part of excess reflected increased market share of banks in mortgage lending. Over the same period, M1 and PSL2 grew at rates of 7 and 12 per cent per annum respectively. In recent months monetary aggregates have grown more slowly; in first 3 months of 1982-83 target period developing favourably in relation to 8-12 per cent target range.

(viii) Interest rate/exchange rates. Interest rates have fallen since turn of year; process temporarily interrupted by Falklands crisis, but now resumed. 3 month inter-bank rate fell from 16 per cent in December to 12¾ per cent early June. After falling over 10 per cent during spring and summer 1981, effective exchange rate broadly constant at around 90 since last August.

(ix) Government borrowing. Provisional estimate suggests PSBR £8.9 billion in 1981-82 (3½ per cent of GDP, compared with 5 3/4 per cent in 1980-81) about £2 billion lower than estimated at Budget time. Precise reasons for 1981-82 shortfall not yet known; balance of implications, if any for 1982-83 PSBR unknown. FSBR forecast of £9½ billion (3½ per cent of GDP) remains best central estimate.

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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 BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 24 May, are sidelined.

B A Collins
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RA

R I G ALLEN

8 June 1982

EB Division
H M Treasury
01-233-3364

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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. Versailles summit achievements?

Agreed to maintain prudent monetary policies and achieve greater control of budgetary deficits in order to reduce real interest rates. We also agreed to intensify our economic and monetary co-operation, to resist protectionate measures, not to use our exchange rates to gain unfair competitive advantages and we agreed on a cautious approach to financial and trade relations with the Eastern bloc.

3. Versailles summit: international monetary undertaking

[Comminique stresses "joint responsibility to work for greater stability in world monetary system".] Major countries explicitly accept responsibility for international monetary system. This could be start of gradual move towards greater stability in the system.

4. Contribution made by 9 March Budget to economic strategy?

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 particularly to help business but also individuals, within responsible fiscal framework.

5. Lower than forecast 1981-82 PSBR means fiscal policy tighter than intended?

[Estimated PSBR outturn 1981-82 now about £8½ billion cf £10½ billion at time of Budget March 1981 and still predicted in 1982 FSBR.]

Not possible to answer this question until more known about why PSBR was lower in 1981-82. Need also to consider the wider context. Lower borrowing by public sector in first quarter of 1982 was factor in sharp fall in our interest rates relative to overseas rates in those months. Cannot assume 1981-82 short fall will necessarily feed across to 1982-83; far less that Budget judgement needs revision.

6. Government's impact on inflation disappointing?

12-monthly RPI inflation rate in April 9½ per cent - down from 10½ per cent in March. Lowest figure for over three years. Then, inflation was accelerating. Now, trend is firmly downwards. Indeed, we may do rather better than FSBR forecast of 9 per cent by end-1982. [But NB credence should not be given to DOI press release reporting Mr Jenkin as claiming inflation would fall to 7½ per cent this year.]

7. Economic recovery in doubt?

Profile of recovery likely to be uneven and jerky particularly when affected by such factors as very severe weather and industrial disputes. It remains the case that activity is above levels of last spring. Prospect is for resumed and continued recovery. This is supported by almost all independent assessments, CSO's cyclical indicators and latest CBI assessment. Most encouraging pointer for sustainable recovery is progress being made against inflation. (See ~~also Section~~ B.)

8. Trade figures disappointing?

No. Current answer remains in healthy surplus (£½ billion) in 1982 Q1. Exports recovered in March and in last six months have held up better than many feared, given earlier loss in competitiveness. Imports up sharply since 1981 H1, reflecting in part higher activity and end of destocking. (See also Section L.)

9. Investment remains depressed?

[1982 Q1 figures for capital expenditure in manufacturing, distribution and services sector published 20 May; new DOI Investment Intentions Survey published 27 May.]

Some encouraging signs. Manufacturing fixed investment stabilised in H2 1981 and has retained level into Q1 of this year following sharp falls from Q4 1979; intentions surveys point to some recovery in course of 1982. Strong growth in distributive and service industries' ~~investment~~ - up 12½ per cent since Q1 1981.

10. Do FSBR forecasts still hold?

No reason to question broad shape of forecasts but in certain areas, eg inflation, progress is faster than foreseen at Budget time. [NB: Not the practice to issue revisions between twice-yearly publication of forecasts under Industry Act ie Budget-time and autumn.)]

11. Do FSBR forecasts still hold?

No reason seriously to question broad shape of forecasts but in certain areas, eg inflation, we could well make faster progress than foreseen at Budget time. (Not the practice to issue revisions between twice-yearly publication of forecasts under Industry Act ie Budget-time and autumn.)

12. Outlook for unemployment?

Not the practice to publish estimates of the overall effects of the Budget, or its individual measures, on employment. But current policies to tackle inflation provide only basis for sustained recovery and more jobs. (See also Section C)

13. Armstrong/unified Budget?

[Report due to be published 17 June. Leak in FT, 7 June refers to the Committee proposing "major overhaul of the way public expenditure and tax decisions are taken, in direct rejection of his views of Sir Geoffrey Howe . . . ."]

Await TCSC report with interest. Proposals will need careful consideration. But Government does already take account of tax and expenditure when taking decisions on each.

14. Treasury model of economy 'rigged' to produce discouraging results from alternative policy packages?

See Section P.

15. Implications of latest fall in interest rates?

[Short-term rate down over ½ percentage point on week ago; Midlands and National Westminster announce ½ point cut in base rates 8 June.]

Continues welcome decline in interest rates seen earlier in year; the Falklands crisis disguised underlying downwards trend. Market perceived that conditions were right for a fall in rates and Bank acquiesed in this: monetary aggregates growing more moderately; inflation coming down and the exchange rate strong. Sign of confidence in Government policies; and welcome assistance for business.

BULL POINTS

As at 7.6.82

(i) Activity. Slight decline in GDP (output) in 1Q 1982 in part reflects effects of very severe weather and industrial disputes at turn of year. Most recent major independent forecasts, latest CBI assessment and cyclical indicators see prospect of further recovery in 1982-83.

(ii) Investment. Private sector investment, particularly in plant and machinery, held up well relative to output investment in plant and machinery in 1981 only slightly (1½ per cent) lower than 1980, 5 per cent higher than 1979. DoI investment intentions survey suggests 2 per cent rise in manufacturer's distributor's and services' investment in 1982. Manufacturer's investment (including leasing) expected to recover during course of 1982, rise 5 per cent in 1983.

(iii) 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.]

(iv) Manufacturing productvity. Output per head rose 12 per cent since end 1980. Output per head and output per hour 5 and 8 per cent higher than previous peak in 1H 1979.

(v) Unit labour costs: Pay moderation and higher productivity has meant dramatically low increase in manufacturers unit wage costs over last year - about 3 per cent in Q1 1982 on a year earlier. Recent rate of increase below the average of our major competitors and comparable to that of Germany and Japan.

(vi) Competitiveness. Cost competitiveness improved by at least 10 per cent during 1981, reflecting pay moderation combined with exchange rate fall.

(vii) Profits: Industrial and commercial companies gross trading profits (excluding N.Sea and net of stock appreciation) rose strongly during 1981, up over 25 per cent between 1H and 2H 1981.

(viii) Exports have held up better than many feared following earlier loss of competitiveness. Recent months figures suggest non-oil exports (exluding erratics) running at about same level as in 1980. Engineering export orders up 17 per cent in 1981 on 2H 1980 to reach their highest level.

(ix) Unemployment. Rate of increase in unemployment has slowed further this year to just 1/4 that of a year earlier. Vacancies improved since mid 1981. Short-time working in manufacturing reduced by over ¾'s since January 1981 and overtime working has increased.

(x) 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.

(xi) 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 1983 represents major step towards comprehensive provision for young people.

(xii) 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.

(xiii) Inflation. 12 monthly RPI increase in single figures in April (9.4 per cent); lowest since January 1979. Trend now clearly downwards, not upwards as then. Increase in RPI more than halved since peak (21.9 per cent) in Spring 1980. CBI April survey shows lowest degree of unit cost pressure for 15 years.

(xiv) Examples of export successes reported in the Press include: design supply and installation over 300 miles of railway of carrier and audio telecommunications cable for Zimbabwe's railway electrification programme (BICC Telecommunications, Merseyside); contract for converting to leadfree petrol consumption of first 1000 BL Minis destined for Japan (Carbodies Ltd, Coventry).

(xv) Overseas investment in UK: US direct investment in Britain amounted to stock of over $14 billion in 1980. Nearly 60 per cent of all US outward non-oil direct investment now takes place in EC - over half of that in UK. Half of all Japanese investment in the EC also comes to Britain.

(xvi) Overseas debt repayments. Official external debt reduced from over $22 billion in May 1979 to around $1372 billion at end-May 1982.

(xvii) Innovation. Total of industrial robots in use in UK reached 713 last year; expected to pass 1000 this summer, UK is fifth in World league table of robot users.

Economic Briefing Division, HM Treasury, 01-233 3819/5809

B ECONOMIC ACTIVITY AND PROSPECTS

1. Recent figures not encouraging?

[GDP(O) is provisionally estimated to have fallen slightly (about ¼ per cent) in Q1 1982, but remains ½ per cent up on Q2 1981. Some stockbuilding in manufacturing and distributive industries in Q1 1982 following sharp slow down in rate of destocking in H2 1981. (First stockbuilding for two years). Volume of investment in manufacturing, distributive and service industries some 5 per cent higher in Q1 1982 than average for 1981].

Latest figures not uniformly unencouraging. While disappointing that rise in activity did not continue for third consecutive quarter, not unexpected that profile of recovery be uneven and jerky, particularly when affected by such factors as very severe weather and industrial disputes. Remains case that activity is above levels of last spring. Latest (20 May) figures also show rise in investment and also some stockbuilding during first quarter.

The prospect is for resumed and continued recovery. This is supported by almost all independent assessments, CSO's cyclical indicators, and business opinion survey indicators. Most encouraging pointer to sustainable recovery is the continued progress against inflation.

2. Investment intentions survey?

[DOI's investment intentions survey for May suggests rise in fixed investment in manufacturing distributive and service industries (MDS) of 2 per cent in 1982 and more substantial increase in 1983. Manufacturers ivestment (including leasing) expected to recover during course of 1982, showing the volume for 1982 as a whole much the same as 1981 and to rise about 8 per cent in 1983.]

Survey encouraging taken with rise in first quarter (see labour). Suggests trough in MDS investment passed in 1981, revovery gaining momentum during 1982 and 1983.

3. May CBI Trends Enquiry/Forecast Gloomy?

[In reviewing latest CBI situation report, FT (Monday 7 June) quotes CBI as claiming "Economy to remain in doldrums" Monthly Trends Enquiry suggests little change in order books in recent month and continuing approximate zero net balance of firms expected to raise output in next 4 months. The latest forecast suggests recovery to resume this year both 1 per cent growth in 1982, 2 per cent in 1983. Inflation forecast to fal to 9 per cent by end 1982, 7½ per cent 1983. CBI expect continued improvement in company profits and financial position.]

Taken together monthly enquiry and forecast point to continuation of recovery during course of 1982 and 1983, lower inflation and improved profitability and financial position of companies. Forecast closely in line with Budget forecast and bulk of outside forecasts.

4. Other evidence of improvement in economy?

See Bull Points (following Section A).

5. Government assessment of prospects

[FSBR forecast (9 March) assesses recovery to have begun. Main points are:

	per cent increase on year earlier	
	1982	1983 H1
GDP	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 major post-Budget assessments:

	NIESR (May)	LBS (Apr)	St James (Apr)	Phillips &Drew (June)	CEPG (April)	CBI (May)	FSBR (March)
Per cent change 1982 on 1981	+1	+1½	+1½	+1½	-½	+1	+1½]

Nearly all see prospect of continued recovery in 1982 in line with FSBR, (as always, a range, with Cambridge forecast (CEPG) being the more pessimistic) and see inflation at 8-9½ per cent by Q4 1982 - also in line with FSBR. [See also C3 (unemployment), K3 (inflation) and L6 (balance of payments).]

7. Latest National Institute (NIESR) forecast gloomy?

[End May review suggests current recovery "weakest for past 25 years" and suggests "some doubt as to whether period since last Spring should be considered genuine recovery at all". Forecast suggests output to rise 1 per cent pa in 1982 and 1983 unemployment (UK adult sa) to rise to 3 1/8 million by end 1983, inflation to fall to 8¾ per cent in 1983, strong current account surplus (over £6 billion) in 1982 and 1983.]

Forecast for activity and inflation for 1982 broadly in line with FSBR and most major outside assessments (see 6 above). Expected that recovery be uneven particularly when affected by very severe weather and industrial disputes. Government never suggested initially rocovery would be very rapid - NIESR forecast, broadly in line with FSBR and majority of outside forecast suggests continuing recovery and single figure inflation in 1982.

C LABOUR MARKET

1. Recent unemployment figures?

[In May, unemployment (UK adult seasonally adjusted) rose by 22,000 to 2,872,000 (12 per cent). Total unemployment fell by 38,000 to 2,969,000 (12.4 per cent). Average monthly underlying increase in adult unemployment (after allowing for men over 60 transferring to long term Supplementary Benefit) are:

1980	1981				
Q4	Q1	Q2	Q3	Q4	First 5 months 1982
105	77	62	51	33	22]

May's rise (much the same as average monthly increase in Jan-April) confirms that unemployment has been rising more slowly this year than last.

2. Vacancy figures disappointing?

In May, vacancies (UK seasonally adjusted) fell slightly for third consecutive month to 107,000 compared with 113,000 in February. Vacancy flow data for April (latest month available) show inflow and outflow much improved - about 165,000 per month this year compared with about 145,000 per month in 2Q 1981.]

Despite recent falls vacancies still ½ higher than at low point in Q2 1981 and turnover is also higher.

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, some broadly flat (LBS, St James) others (P&D, S & Coats) expect slight (roughly 50-100,000) fall in 1983. Liverpool foresee fall of 400,000.]

Unemployment forecasts uncertain; independent forecasters encompass differing views for 1983 - several projecting stabilisation, some [a slight] decline. Rise in unemployment drastically reduced since end 1980. 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; depends on so many factors. Following well-established precedent of previous administrations in not publishing. Public Expenditure White Paper figures are planning assumptions not forecasts.

IF PRESSED that PEWP figures show Government planning sustained higher level of unemployment: No. Maintaining constant figure for the Survey period is conventional assumption adopted by previous Administration. Greater the progress that can be made in reducing inflation and maintaining moderation in pay settlements, the better the prospects for unemployment.

5. Employment continuing to fall?

[Total employment declined 1.9 million or 8 per cent in 2 years to Sept 1981. Provisional Q4 figures indicate decline of about 200,000 compared with 150,000 in Q3 and 300,000 per quarter in H1 1981.]

Decline in H2 1981 almost half that in H1. Other labour market indicators improving (see C1-3 above).

6. Unemployment higher than in other countries?

[On standardised definitions in Q3 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. High Exchequer costs of unemployment? Recent Treasury estimates suppressed?

Possible to produce wide range of estimates depending on assumptions made and concepts followed. No single figure of this kind can purport to show how changes in unemployment alter the public finances. [IF PRESSED on cost of benefit payments, rebates and administration only in current year: It is estimated that the 1982-83 cost of benefit payments, rent or rate rebates, and administration per extra 10,000 unemployed is around £18 million. [Answer given to PQ 13 May col W314.] IF PRESSED on total Exchequer cost: Estimates have been made of Exchequer cost of additional registered unemployment (eg for 1980-81 in February 1981 EPR). There has been continued work on the various elements included in that calculation. Treasury at present considering basis on which estimates of Exchequer cost prepared.]

8. What is Government doing to provide more jobs?

Government pursuing sensible fiscal and monetary policies to curb inflation and creating conditions for enterprise - only measures that will ensure sustainable increase in employment. Nevertheless Government expanding schemes to meet special difficulties and improve training - eg plan to spend £1½ billion in cash on 1982-83 (40 per cent more than in 1981-82) on special employment and training measures; new Youth Training Scheme costing £1 billion a year from 1983-84; and MSC working on proposed new non-profit-making scheme announced in Budget Speech.

9. <u>Government reaction to MSC Task Group report on future of training for young people</u>?

Task Group's proposals are of considerable significance for future shape of training arrangements for young school leavers, both employed and unemployed. Government will consider recommendations carefully with a view to reaching a decision as soon as possible this summer.

D TAXATION

1. Burden of taxation

[Total taxation (i.e including for example income tax, indirect taxes, corporation tax, rates and NIC) in 1978-79 was 34½ per cent of GDP (at market prices), 36 per cent in 1979-80, 37½ per cent 1980-81. It is forecast to be 40 per cent in 1981-82 and 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 total burden in 1982-83 compared with 1981-82. [NB: Not true of burden on persons.]

2. Burden of tax has risen for most households since 1978-79?

[Comparisons given in Parliamentary Answers to Mr Straw 3 December, 17 February and 18 March col W199.]

Slow growth of output and difficulty of restraining public expenditure have inevitably meant higher tax burden. But real personal income after direct taxes still higher than under last Government. And more honest to raise taxes to finance necessary higher expenditure than to increase borrowing, with the increased interest rates and inflation that would bring.

3. Burden has fallen for the rich?

Abolition of absurdly high marginal rates and raising of thresholds in 1979 essential to remove disincentives. Reimposition of an 83 per cent top rate of income tax would finance a reduction of less than one quarter of 1p in the basic rate.

4. Burden has risen most for the poor?

Proportion of income paid in income tax and NICs will fall in 1982-83 for lowest paid taxpayers. And low paid with children entitled to benefits such as FIS.

5. Scope for tax cuts because of lower than expected PSBR in 1981-82?

No reason to believe that PSBR in 1982-83 will be lower than forecast (see A7). Government want to cut taxes further, when economic circumstances permit, but more tax cuts too soon could jeopardise recovery.

6. Personal tax burden increased by recent Budget - when NICs taken into account?

[Full explanation given in Parliamentary Answer 11 March OA col 955].

The real increase in personal allowances and tax thresholds will reduce income tax as a percentage of income at all levels of incomes. Those over pension age who are taxpayers will benefit from income tax changes and will be unaffected by NIC rise, and, of course, State pensions are being uprated from November. [IF PRESSED: In immediate cash terms, increases in personal allowances etc will compensate for NIC increase for majority of taxpayers. Taking into account increased earnings in 1982-83 (for example using the Government Actuary's 7½ per cent assumption) percentage of income paid in income tax plus NIC will rise for most people, but will fall for the lowest paid (below about ½ average earnings (married) and below about 1/3 average earnings (single).]

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. Poverty trap/unemployment trap getting worse?

[Joint (Treasury/DHSS/Inland Revenue) memorandum submitted to TCSC Sub-Committee.]

The poverty and unemployment traps are a matter for concern. Must be remembered that result from attempts to relieve poverty over a period of years when the economy has shown little growth. The answer is to get sustained growth going again - this is the objective of our economic policies.

9. Budget reduction in NIS not enough for industry?

Cut welcomed by CBI and industry generally. Provides substantial help on business costs. 1 per cent reduction maximum possible without risks for PSBR: outright abolition too costly. And other measures to help business directly - energy, construction, innovation and enterprise packages plus helpful - and welcomed - improvements in capital tax regime (see also Section P).

10. Excise duties increases inflationary/harmful to industries

Increases in excise duties as a whole slightly less than broadly compensate for past year's inflation. Variations between duties take account of industrial considerations e.g supplementary increase last July on tobacco/Scotch whisky industry/help for industry by smaller increases on e.g derv - mainly used by industry.

11. Government take from North Sea oil too high?

See S1.

12. Merger of tax and social security planned?

See G5.

E PUBLIC EXPENDITURE AND FINANCE

[Public Expenditure White Paper (Cmnd 8494) published 9 March. Gives planning totals of £115.2 billion in 1982-83, £121.1 in 1983-84 and £128.4 in 1984-85. About £5 billion higher than last White Paper in 1982-83 and £7 billion in 1983-84. Net effect of changes announced in Budget is to reduce totals to £114.9 billion, £120.4 billion and £127.6 billion].

1. Public expenditure too high?

Spending in 1982-83 planned to be about £5 billion (4½ per cent) lower than intended by last Government even if higher than planned when this Government first took office. Decisions to increase spending represent flexible but prudent response to changed circumstances e.g additional spending to help young unemployed. Drive to improve management in public sector and reduce administration expenses continues.

2. Ratio of public spending to GDP is getting back to peak levels of mid 1970's?

Ratios in 1980-81 (43½ per cent) and 1981-82 (45 per cent forecast) remain below level of 1974-75 and 1975-76 (46 per cent in both years). [NB 1981-82 ratio could be nearer 44½ per cent. See H5.] Rise in ratio in 1981-82 mainly reflects higher expenditure on social security at a time when real GDP falling. Ratio expected to fall in next few years: assumptions in MTFS would mean figures of 44½ per cent in 1982-83, 42½ per cent in 1983-84 and 41 per cent in 1984-85. Reflects assumed GDP growth and curbing of public expenditure.

3. Increase spending in recession?

No good trying to spend way out of recession. Any benefits would be short-term. If increased spending not financed responsibly, would soon lead to more inflation. If financed prudently, would lead to higher interest rates and/or higher taxes. We are responding, within limits of prudence, to needs of current circumstances.

4. Real terms comparisons

No volume equivalents of cash plans. But cash increase in plans between years is 9 per cent in 1982-83, 5 per cent in 1983-84 and 6 per cent in 1984-85 (and projection of GDP deflator in MTFS is rather lower than this in 1982-83, rather higher in 1983-84 and about same in 1984-85). So in cost terms [i.e cash inflated/deflated by general movement in prices] there is an increase in 1982-83, a decrease in 1983-84 and a small decrease in 1984-85.

5. 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).

6. 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.

7. 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.

8. Cash figures should be accompanied by constant price figures to give some idea of levels of service?

Constant price figures of limited value in new situation. Cash programmes intended to have primacy. Necessary to get away from old system of volume planning and destroy idea that programme managers automatically entitled to be compensated for effects of inflation by revaluing their programmes. In any case old 'volume' figures not a measure of level of service. Simply measured resources put into programmes - inputs. The level of service provided - output - takes account not only of resource inputs, but efficiency and effectiveness of their use. We are continuing to review and develop use of output measures in planning and management of public expenditure.

9. End-year flexibility?

Possibility of end year flexibility is being looked at again. There could be some managerial advantages in such a scheme. But we also have to consider question of cost.

10. Revised cash limits 1982-82 announced 27 May

[In his Budget statement, after allowing NIS surcharge cut to help industry, the Chancellor announced that, in order to leave them where they would have been without the change, appropriate reductions would be made in relevant cash limits and votes of central government, in rate support grant to LAs and in EFLs of NIs and other public corporations. Revised EFLs for nationalised industries and for three other public corporations were given in answer to a written PQ on 7 April. (The revised figures included also certain other changes.) Further revisions to central government cash limits - published in written PQ 27 May.]

Revisions implement 'clawback' consequent on reductions in national insurance surcharge - a move intended to reduce business costs in the private sector. But as public sector employment also liable to the surcharge, appropriate reductions have been made to leave public bodies where they would have been without the change.

11. Cash limits 1982-83 and public sector pay?

(See Sections F and K.)

12. Cut public sector pay bill/administrative costs of central government?

Only one third of current expenditure is on wages and salaries and much of that is for nurses, teachers, members of armed forces, police and so on. Provision for public service pay increases 1982-83 limited to 4 per cent. Administrative costs ae not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain drive for more efficient management throughout public sector.

LOCAL GOVERNMENT

13. Overspending in 1982-83? Government response?

Local authorities are budgeting to spend some £1½ billion above Government's plans (£1¼ billion in England, £200 million in Scotland, £60 million in Wales). Government cannot ignore this large planned overspend.

Action in ENGLAND: Secretary of State for the Environment intends to implement scheme for grant abatement announced last year and is considering further across-the-board grant cut.

Action in SCOTLAND: Secretary of State for Scotland is seeking to reduce grants of Lothian Regional Council (by £45 million) and Stirling District Council (by £1½ million).

Action in WALES: Secretary of State for Wales has announced his intention to withhold grant. He also asked Welsh local authorities to submit revised budgets. Amount of grant to be withheld will be determined in light of these.

Local authorities have only themselves to blame for these grant penalties.

14. Large rate increases this year are Government's fault?

Not at all. If local authorities had sought to spend in line with Government's plans, rate increases should be very low. Where they are high, it is because local authorities have chosen to overspend.

15. Effect of NIS reduction on local authorities?

As Chancellor announced in Budget, we intend that local authorities overall will be neither worse nor better off as a result of decrease in NIS. We are aware of the difficulties involved in offsetting the reduction by a decrease in grant, and are looking constructively at possibility of postponing the reductions for local authorities until April 1983.

16. Green Paper on Domestic Rating System: Government response?

Government is considering carefully all representations received. We wish to produce proposals for a scheme that will remedy shortcomings of present system while commanding wide support.

F CIVIL SERVICE STAFFING AND PAY

1. Civil Service too big/does too much/is over staffed?

Since Government came to office, Civil Service has been reduced by 9 per cent to 666,400. This is smallest since 1966. Results from reduction in functions, privatisation and improvements in efficiency. On course to achieve aim of having Civil Service of 630,000 by April 1984. This is 102,000 fewer staff in post than in April 1979, and will mean the smallest Civil Service since the end of the Second World war.

2. Civil service pay: non-industrial civil servants

[Settlement date 1 April 1982.]

Civil Service Arbitration Tribunal awarded pay increases ranging from 4.75 per cent to 6.25 per cent - worth 5.9 per cent overall - and increases in annual leave. Government announced on 6 May its decision to accept the award. Increases (announced 12 May) for the higher civil service (under-secretary and above) are larger; they have been decided in the light of the recommendations of the Top Salaries Review Body. Cash limits and manpower targets are not being adjusted. (See also Section K)

3. Civil Service pay: industrials

[Settlement date 1 July 1982]

Claim for increase in pay in line with inflation, shorter working week and longer holidays, is under consideration.

4. Scott Report/Public sector pensions?

See K 21.

G SOCIAL SECURITY

1. Now that unemployment benefit is to be brought into tax why not restore November 1980 5 per cent abatement ?

Decision to abate UB not simply taken as proxy for tax but to reduce public expenditure and improve incentives to find and keep work. (Chancellor's Budget statement in March 1980 made that perfectly clear.) Those reasons remain valid. Any improvement on rates announced would seriously worsen incentives. Cost too would be high - £60 million in full year [net of reduced claims for supplementary benefit, but gross of tax].

2. Why cut child dependency additions to unemployment benefit?

[In line with practice in recent years, uprated level of child dependency additions to unemployment benefit (not Supplementary Benefit) abated by amount of increase in Child Benefit. In consequence, CDAs will drop from current level (80p) to 30p next November.]

Child dependency additions to unemployment benefit are being phased out, and will eventually be replaced entirely by Child Benefit. In this we are following practice adopted by last Labour Government.

3. Death grant - increase to realistic level?

[Consultative document about death grant published 3 March, comments asked for by 30 July.]

Social Services Secretary would welcome comments on recently published consultative document on death grant. As have made clear, aim is to redistribute in more sensible fashion resources now devoted to death grant - cannot afford to add to those resources.

4. Merger of income tax and national insurance planned?

Government's written evidence to TCSC did not suggest such a merger. Committee asked about feasibility of merging the two systems, and the evidence gave an illustration of what a joint system would look like.

H PUBLIC SECTOR BORROWING

[NB CGBR for May to be published 9 June.]

1. Reasons for PSBR undershoot in 1981-82?

Reasons not yet fully understood, since information on borrowing comes earlier than information on the flows of expenditure and revenue that give rise to that borrowing. Budget forecast based on best estimates at time of 1982-83 FSBR. Always considerable uncertainties at time of Budget. Spending, and some forms of borrowing, often high and variable in March. We shall certainly study reasons for shortfall and see what lessons they hold.

2. Why treat PSBR as a crucial statistic when forecasting errors of this size can occur?

Importance of balance between government's spending and income recognised by all governments, whatever the difficulties of forecasting.

3. Implications for fiscal policy and MTFS?

See A5-7.

4. If PSBR higher in 1982-83 than in 1981-82 won't interest rates have to rise?

As percentage of GDP, outturn for 1981-82 is more or less equal to the forecast for 1982-83 ie around 3½ per cent. The 1982-83 forecast is still a low figure both by comparison with deficits abroad and in relation to size of deficits over past decade.

5. Implications for public expenditure in 1981-82 and 1982-83?

Not known exactly what 1981-82 outturn will be nor the implications for 1982-83, as will be some time before information on 1981-82 outturn will emerge. [IF PRESSED: It is estimated, on very incomplete information, that the planning total will fall from £105.2 billion in the FSBR to around £104.5 billion (around £104 billion was provisional estimate given in other briefing) and that ratio of public expenditure to GDP will fall from 45 per cent to 44½ per cent].

6. Implications of CGBR outturn in April for year 1982-83?

[CGBR for April published last week £0.8 billion, compared with £2.4 billion in April 1981.]

Too soon to make any change in forecast for year on basis of only one month's figures. Last year's figures distorted by Civil Service dispute.

7. Effect of Civil Service dispute on PSBR?

PSBR in both 1981-82 and 1982-83 affected by Civil Service dispute. In 1981-82 some £$\frac{3}{4}$ billion of receipts delayed from March 1981 were collected, but some £1$\frac{1}{2}$ billion of receipts due in 1981-82 will now be collected in 1982-83. Debt interest cost of the strike some £$\frac{1}{2}$ billion in 1981-82.

8. 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.

MONETARY AND FINANCIAL POLICY

1. Monetary growth in 1982-83

[In banking April (second month of target period) £M3 and PSL2 increased by ½ per cent and 1¼ per cent respectively; M1 was flat (all seasonally adjusted). Target range is for annual rates of growth of 8-12 per cent. Provisional banking May figures to be published 8 June.]

Too early to judge outturn with any greater precision than at Budget time. But recent figures encouraging.

2. 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 P4)

3. Bank lending

[Speculation in markets that recent rapid growth has slowed. Provisional banking May money figures (and lending by London clearing banks) to be published 8 Junel.]

Too early to say whether growth slowing. Part at least of recent rapid growth is substitution for lending by building societies and other forms of consumer credit. To extent that it is additional, adds to inflationary pressures, so must proceed cautiously on interest rates.

4. Prospects for 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. Markets seem to have absorbed impact of Falklands crisis without significant ill-effect.]

Of course we want to see lower rates. Have seen significant reductions over past 6 months. But we must proceed cautiously if we are not to let up in the fight against inflation.

5. Will high and unstable US rates affect UK rates?

[US rates eased slightly over past month, but still high.]

US rates not sole determinant of UK rates, but high US rates certainly an adverse development and in September were a key factor in driving our rates up. Recently, however, sterling has remained reasonably firm, probably helped by improved prospects for wage round, and good trade figures. UK interest rates have eased this year against US trend; but we cannot insulate ourselves from difficult international background. (See also T10.)

6. Falls in interest rates since New Year incompatible with strategy?

Taking account of all evidence, present levels of interest rates are consistent with policy of continuing downward pressure on inflation.

7. MTFS being quietly shelved?

[3rd MTFS states Government's objectives 'to reduce inflation and to create conditions for sustainable growth in output and employment', by 'steady but not excessive downward pressure on monetary conditions'. Key financial indicators are the monetary aggregates and exchange rate. Target range for growth of M1, £M3, PSL2 in period February 1982 - April 1983 of 8-12 per cent. Illustrative path of 7-11, 6-10 per cent in 1983-84, 1984-85. Targets for later years to be set nearer the time.]

No. Updated MTFS is realistic and flexible, describes how monetary policy operated in practice. MTFS serves useful purpose. Right to retain and adjust in light of experience.

8. 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.

9. Overshoot of 1981-82 monetary target

[£M3 grew by 13.0 per cent per annum in 1981-82 target period compared with target range of 6-10 per cent; M1 grew by 7.2 per cent per annum, and PSL 2 by 12.1 per cent per annum over same period.]

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 market share of banks in mortgage 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.

10. Implications of latest fall in interest rates?

[Short-term rate down over ½ percentage point on week ago; Midlands and National Westminster announce ½ point cut in base rates 8 June.]

Continues welcome decline in interest rates seen earlier in year; the Falklands crisis disguised underlying downwards trend. Market perceived that conditions were right for a fall in rates and Bank acquiesed in this: monetary aggregates growing more moderately; inflation coming down and the exchange rate strong. Sign of confidence in Government policies; and welcome assistance for business.

K PRICES AND EARNINGS

PRICES

1. Inflation lower than forecast in Budget statement?

[12 monthly rate of inflation 9.4 per cent in April, compared with 10.4 per cent in March and 21.9 per cent in May 1980. Budget forecast: 9 per cent by Q4 1982, falling to 7½ per cent by mid-1983].

Inflation is now in single figures and is continuing to fall. We could well make rather faster progress in reducing inflation than we anticipated at the time of the Budget.

2. What reason is there to expect a further decline in inflation?

Over next year or so, moderation in unit labour costs should continue to exert downward pressure on rate of inflation, as should weak commodity prices. Competitive pressures on firms to limit price rises are also likely to remain strong.

3. FSBR inflation forecast more optimistic than major outside forecasts?

All assessments released since Budget contain an improved inflation prospect. April CBI quarterly survey shows substantial decline in net balance of firms expecting higher prices and costs in next four months. Balance of firms expecting higher costs now lowest for 15 years. (See also 1 above and A.11).

4. Chance of 7½ per cent inflation by end of year?

[Industry Secretary Speech to CBI 24 May.]

Fall to 7½ per cent by end of year not impossible - it is within the margins of error attached to the Budget forecast of 9 per cent. Recent figures have been encouraging and an outturn somewhat better than 9 per cnt is quite possible.

5. Inflation still not down to 7.4 per cent reached under previous Government?

[Average year-on-year rate of inflation between February 1974 and May 1979 was 15.4 per cent; average level of inflation since May 1979 has been 14.4 per cent.]

Year-on-year rate of inflation had risen to 10.3 per cent when previous Government left office. And on present forecasts average level of inflation will be lower under this Government than under its predecessor - first time this has happened in over 30 years.

6. Inflation still not as low of competitors

[UK inflation 9.4 per cent in April, compared with 6.6 per cent in US, 5 per cent in West Germany, and (March figure) 2.8 per cent in Japan.]

UK inflation now lower than Western European (OECD) average, and well below many countries - such as France and Italy. Still some way to go to match US, West Germany and Japan, but good progress being made in right direction.

7. Effect of 1982 Budget on RPI?

Compared with full indexation of excise duties, direct effect of Budget is RPI reduction of 0.1 per cent (or an increase of 0.1 per cent including also the direct effect of the 2 December measures). [IF PRESSED on non-indexed basis: direct effect is 0.8 per cent increase in the RPI (or 1.4 per cent including also 2 December measures).]

8. Movement in tax and prices index?

[Increase over 12 months to April 9.7 per cent, compared with increase of 9.4 per cent in RPI].

Fact that TPI has been increasing faster than RPI reflects measures taken to restrain Government borrowing, which is essential if inflation is to be controlled. But following recent Budget, difference is now small.

9. Effect of 1982 Budget on TPI?

Compared with full indexation of excise duties, direct effect of Budget is TPI reduction of 0.4 per cent (or increase of 1.1 per cent including also direct effect of 2 December measures). [IF PRESSED on non-indexed basis: direct effect is 1.6 per cent reduction (or a 0.3 per cent increase including also 2 December measures).]

10. Nationalised industry prices

[Increase over 12 months to April 14.1 per cent, compared with an increase of 9.4 per cent in the RPI (see also R8)].

Gap between nationalised industry price increases and RPI due in large measure to cumulative effect of years of artifical price restraint. World oil price rises of 1979 and 1980 have also played important part. Increases regrettable, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so, but sustained improvement only possible if industries succeed in holding down current costs, particularly pay.

11. Effect on retail prices of EC farm price settlement?

[EC Agriculture Ministers agreed on 18 May, by majority decision, to raise level of farm support prices under CAP by average of just over 10 per cent].

Estimates of effect of the CAP price settlement on retail prices can only be made in general terms, and will depend on such factors as the type of support operated and the prevailing market conditions in the sectors concerned. Agriculture Minister (in statement to House 19 May) estimated that total package would add in full year about ¼ per cent to retail prices index and 1¼ per cent to retail food price index. [NB Treasury believes this may be under-estimate because assumes constant absolute profit margins.]

PAY

12. Current level of pay settlements

The recent decisions on public service pay which the Government has announced confirm the downward trend of settlements since the last pay round, when they generally averaged 8-9 per cent. Settlements are also well below rate of inflation for second year running.

13. 4 per cent pay factor abandoned?

The 4 per cent factor is not a pay norm, but a broad measure of what Government thinks reasonable and can be afforded in fixing provision from which public service wage bill has to be met. Government has decided to accommodate cost of Civil Service arbitration award within the relevant provision. Only if expectional difficulties arose later in the year would limited calls on the contingency reserve be considered.

14. Government norm now 6 per cent?

There is no norm, nor has there been. The 4 per cent factor remains the basis on which provision for public service pay has been set. Where extra provision has been needed to help finance proposed higher increases, as with nurses, doctors and dentists, it has been found partly from other savings on programmes concerned and partly from contingency reserve.

14. Government satisfied with 6 per cent?

Increases of 6 per cent are higher than provision which the Government made for pay within programmes. They will have implications for level of non-pay expenditure.

15. Why only 4 per cent for NHS ancillaries and white collar grades?

Cost of the Civil Service arbitration award will be accommodated within 4 per cent pay provison. Moreover, within the range of pay increases announced both for the Civil Service and the Armed Forces, many civil servants and Servicemen will get only a little above the 4 per cent being offered to some NHS groups.

16. Top Salaries Review Board increases too large compared with for example 6.4 per cent for nurses

[Government announced on 12 May increases of 14.3 per cent for senior civil servants and senior members of the Armed Forces, and 18.6 per cent for the judiciary.]

Government believes these increases are fully justified. Essential to ensure adequate supply of candidates of sufficient calibre for the Bench, and to provide adequate career structure and differentials in higher levels of Civil Service and Armed Forces. TSRB are only group whose present salaries are below those recommended for April 1980.

17. Why only 4 per cent for MPs (also announced 12 May)?

Problems of recruitment, career structure and differentials do not apply to MPs. Government therefore felt is appropriate to propose increases no higher than the pay factor included in Estimates.

18. Average earnings index

[Year on year growth 11.0 per cent in March compared with 11.4 per cent in February, though (unpublished) underlying increase slightly lower than in recent months at around 10½ per cent.]

Encouraging that underlying rate of growth continues to fall. But must remember change over the 12 months to March straddles two pay rounds - not entirely indicative of recent trends. Also, earnings index inflated recently by some increase in hours worked.

19. Government aiming to cut living standards?

[Although RPDI was 1 per cent higher in 1981 Q4 than in 1979 Q1, it is likely to fall below the 1979 Q1 level during 1982]

No. Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

20. Index-linked pensions and the Scott Report?

The Government is considering whole question in light of Scott Report. Our aim is to ensure that public servants' pensions are fair to taxpayers, as well as to current employees and pensioners and their dependants.

L BALANCE OF PAYMENTS

1. March trade figures?

[Figures published 7 June show current account in estimated £330 million surplus during March. Non-oil trade back in surplus for first time since October. Invisible surplus of £110 million lower than earlier projected in part reflects change in statistical treatment of EC Budget refunds (see 4 below). Current account surplus of about £½ billion in 1Q 1982 compares with £2½ billion in 1Q 1981 and about £1½ billion in 1Q 1981. For 1981 as a whole, estimated current amount surplus (still partial data) now £7 billion cf Budget estimate of £8 billion.]

Figures still incomplete for 1981, and difficult to interpret. But current account remains in substantial surplus and exports holding up well.

2. Export prices gloomy?

[Figures remain extremely difficult to interpret, following last years Civil Service dispute and changed documentation procedures. Latest figures show apparent weakening in non-oil volumes in Jan-Feb reversed in Feb-March. Volume of non-oil exports (excluding erratics) in September 1981 - March 1982 much the same as 1980 average.]

Exports help up better than many feared following earlier fall in competitiveness. Present months figures suggest non-oil exports running at about same levels as in 1980.

3. Imports?

[Figures remain difficult to interpret (see 2 above). Non-oil import volumes between September 1981 and March 1981 substantially higher than in low levels of 1Q 1981, and about 10 per cent higher than 1980 average.]

Sharp revovery in imports ie part reflects end to destocking and rise in activity.

4. Although trade figures are good, fall in invisibles surplus is bad news [£0.3 billion against the £1.4 billion projection published with February Trade figures].

It would be wrong to read too much into these figures, which need careful interpretation. About half the fall from the earlier projection results from a new seasonal adjustment to the figure for EC refunds. This will add the same amount to the figures over the rest of the year. Most of the rest reflects a substantial [around £500 million] change to the CSO's estimate of net interest profit and dividend payments from and to countries abroad. This is a very erratic item, subject to revision. Trade in services remains in large and growing surplus (£1043 million in Q1, up from £1006 million in Q4 1981).

[NB. If the comparison is with the revised figures for Q4 1981 our net payments to the EC increased in Q1, and there was a fall in net interest and dividend receipts. But in that comparison the seasonal adjustment point does not apply since the revised 1981 figures are also seasonally adjusted.]

5. <u>Why are interest and dividend receipts down when we have been investing so much abroad</u>?

This is a very erratic series, subject to revision, and reflecting interest and profits on overseas investment in the UK as well as our investment abroad. Since 1979 we have achieved a substantial improvement in the UK's external balance sheet, and there is no doubt that in the longer run this will give us a valuable return in overseas earnings. [For the time being our overseas earnings may have been temporarily hit by the US recession; or may initially be taking the form of capital gains rather than income.]

M EXCHANGE RATE AND THE RESERVES

1. Policy towards the exchange rate

[Since last autumn sterling has remained broadly stable. The average £ effective rate in Q1 1982 was over 10 per cent lower than in Q1 1981. Recent lows were $1.7470 on 6 April, DM 4.098 on 21 May. Highs were $1.97 on 30 November, DM 4.407 on 9 February. Rates at noon on 4 June were $1.7965, DM 4.236 and an effective of 90.69. Reserves at end April stood at $18.159 billion, compared with $19.0 billion at end March.]

The Government has no target for the exchange rate. The rate is taken into account in interpreting domestic monetary conditions and taking decisions on policy.

2. Bank of England intervening to support the rate?

Policy is unchanged. The Bank do intervene to smooth excessive fluctuations and preserve orderly markets particularly when conditions are unsettled. But as the Chancellor has already stated we have no target - undisclosed, secret or otherwise - for the exchange rate. Most recent reserves figures confirm that policy is unchanged.

3. Concerted intervention to reduce the value of the dollar?

All the experience in recent years is that exchange rates for major currencies cannot be manipulated by intervention alone. Intervention can help to steady markets, but not counter major exchange rate trends. That takes changes in real policies, affecting interest rates, monetary conditions and fiscal policies. Lower US inflation is in everyone's interest: the matter for real concern is the US fiscal/interest rate mix, a problem all countries are familiar with.

4. Lower the exchange rate to help UK competitiveness?

Effective exchange rate is now about same as when Government came to office. So any loss of competitiveness since then is entirely due to our paying ourselves more than we can afford. Only way to achieve lasting gains in competitiveness is by cutting inflation and bringing costs under control.

5. Debt repayments

We have made excellent progress with our plans to reduce the burden of external debt substantially during this Parliament. We aimed to reduce official external debt to $14 billion by end of 1981. This has been more than achieved - external debt is now around $13 billion, compared with over $22 billion when the Government took office.

N EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. UK budget settlement

Foreign Ministers agreed on 25 May to a settlement for the UK budget contribution for 1982. The settlement provides for a basic refund of £490 million ~~ecus~~ in respect of 1982, with provision for changes to this figure if our unadjusted net contribution varies from the Commission estimate of £880 million. It was also agreed that the problem for the longer term would be settled by the end of November.

2. Remainder of Commission 'Mandate' report

The other member states broke the link between the different parts of the mandate report when they voted through the agricultural prices. But we are prepared to continue to work on the basis of previous agreements where applicable.

3. CAP prices 1982-83 and the Luxembourg Compromise

As Agriculture Minister made clear in his statement on 19 May, we consider the adoption of the 1982-83 CAP prices to have been wholly contrary to the Luxembourg Accords, which were in existence before we joined the Community and which have been observed for 16 years. This action raises serious constitutional issues. Foreign Ministers are to consider the implications on 20 June.

4. UK objectives for longer-term negotiations?

Government has made it clear that, in spite of our relative economic position, UK is prepared to remain a net contributor - but only on a very modest scale.

5. UK refunds in respect of 1981

Commission paid us before 31 March £813 million for supplementary measures as first instalment of our refunds in respect of 1981. This represents 81 per cent of our entitlement for that year. Our net contribution for 1981-82 is now put at some £200 million - very substantially less than it would have been without the 30 May 1980 budget agreement.

6. UK a net recipient in 1981?

In fact we remained a small net contributor to the allocated Community budget. We also, of course, contribute to aid etc. which is part of the unallocated budget. Very satisfactory that the outturn was better than expected: for we remain one of the less prosperous member states.

7. Will UK have to repay or forego refunds if net contribution less than originally estimated?

No. The UK is clear that minimum net refunds payable under 30 May agreement are 1175 million ecus (European Currency Units) for 1980 and 1410 million ecus for 1981.

8. 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.

9. Policy for CAP reform

Key measures are price restraint, curbs on surplus production and strict control of the growth of guarantee expenditure.

10. 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

11. 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.

12. Join the EMS for exchange rate stability?

There is no reason to suppose that by the simple act of joining the EMS exchange rate mechanism we would guarantee exchange rate stability. This has not been the experience of the current participants. Genuine stability requires a return to low inflation rates throughout the Community.

P INDUSTRY

1. Treasury simulations for April meeting of NEDC: TUC accusation that Treasury 'rigged' results, on Chancellor's orders.

No truth whatsoever in this charge. Treasury model is designed, operated and, where necessary, modified, purely on basis of professional judgement of economists within Treasury. Treasury Ministers in no way involved in its design or operation. (TUC charges were fully answered in a detailed statement issued by the Treasury on May 14.)

2. Will technical discussions between Treasury and TUC (and other NEDC partners) now take place?

We hope so (but no date has been fixed).

3. Prospects for industry-recovery?

Fall in output has now come to an end. Underlying level and manufacturing output now (ie February/March) about 2 per cent above level last spring. Budget forecast suggests there may be 3 per cent increase in manufacturing output in 1982 as a whole. Latest CBI survey encouraging (see B2).

4. Company financial position?

[Non-oil industrial and commercial companies (ICC's) gross trading profits (net of stock appreciation) rose by over a quarter between 1H and 2H 1981, but from a very low base - ICC's real rate of return just 2½ per cent in 1981. ICC's finances showed some weakening in 4Q reflecting slowdown in destocking and unwinding of civil service dispute, but finances better in 1981 as a whole -

£bn

	1979	1980	1981 Year	H1	H2
Net borrowing requirement (+)/repayments (-)	+6.1	+5.7	+4.4	-1.2	+5.6
Financial surplus (+)/deficit (-)	-2.7	- 1½	+1.2	+1.5	-0.3

]

Increase in profits (albeit from low level) encouraging. Some apparent deterioration in financial position reflects slowdown in rate of destocking, and effects of unwinding of civil service dispute (which delayed companies' tax payments), but companies' finances much healthier in 1981 than in two previous years. Company liquidity improved considerably in first three months of 1982 [new DOI Survey figures published 4 June].

5. Births and deaths of firms

[Report in FT 11 May of Henley Management College Paper showing 'more firms now dying than being born'?]

No really satisfactory statistics to measure this. Henley used lists of firms registered under Companies Acts - not same thing as list of actively trading companies (eg sole traders and partnerships excluded, firms sold in liquidation to other companies counted as 'deaths'). A better guide might be the list of 1.3 million firms registered for VAT: latest available figures (1980) show births and deaths roughly in balance.

6. Rate of return still too low?

[Real pre-tax rate of return of ICCs was 2½ per cent in 1981 - half the previous lowest figure in 1975.]

Yes, but Government can only help in limited ways. Fundamental improvement in ICC's profits and real rates of return depend on improved performance by companies, both management and employees. Much encouraged by recent productivity gains and trend towards moderate pay settlements.

7. High interest rates damaging for industry and investment?

[Each 1 per cent in interest rates raises interest payments on industry's borrowing by around £250 million.]

Budget measures have eased pressure on interest rates, and the recent ½ per cent fall in the banks' base rates is encouraging. But Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking. Continuing relatively high level of interest rates must be seen in context of priority attached to reducing inflation and need to control growth in money supply underlying the MTFS. (See brief J).

8. Government help for small firms

Budget provided further help for small businesses, increasing the number of measures taken so far to over ninety. Enterprise package included further reduction in weight of corporation tax; further increases in VAT registration limits; increase in global amount available for loans under Loan Guarantee Scheme 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.

9. Response to Loan Guarantee Scheme?

Scheme operating successfully. We have already issued more than 3,900 guarantees - about half to new businesses. Total lending under scheme is just under £132 million. Budget provided for the lending ceiling - in year to May 1982 - to be raised from £100 million to £150 million. Further £150 million available in year just commencing. Three more banks admitted to scheme in April making total of thirty financial institutions now participating.

10 Government thinking again about Loan Guarantee Scheme?

[Article in FT 24 May]

Scheme under continuous review.

11. High failure rate under Loan Guarantee Scheme expensive for Government?

Too early to assess overall cost of scheme. After first year of the 4000 guarantees issued, 45 have been 'called'. Cost has been more than covered by the premium income received over the period.

12. Enterprise zones: response from private sector?

All eleven zones now in operation. Response has been very encouraging. Many new firms are setting up in the zones, existing firms are expanding their activities and vacant land has been brought into use. Too early to assess success of zones.

R NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83 and future years?

Nationalised industries' total external finance increased by £1.3 billion in 1982-83 (£1.2 billion after allowing for NIS cut and other changes), £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.

INVESTMENT

2. How robust are the forecasts of nationalised industry demand/contributions to public expenditure, given the recent track record?

Plans published in PEWP at Budget time considerably less optimistic than those published last year.In particular, in increasing substantially the external finance available to the industries in each year of the Survey, Government recognised effect of lower demand on the industries' internal resources - 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 still expected to decline over Survey period, but from higher base and at more gradual rate than forecast last year.

3. 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 their internal resource forecasts. But perfectly possible that plans might need to be revised, for example if the industries fail to restrain their current costs, including pay.

4. But shortfall in capital spending 1981-82?

[Figures in FSBR imply shortfall of £¾ billion, latest estimates suggest that this may be nearer £1 billion.]

Not easy to establish firm reasons after the event. Such evidence as we have suggests a mixture of reasons. Most important has been cut in investment in response to changed circumstances such as lower market demand. These cuts have been extraneous and have not borne any direct relationship to EFL pressures. Other cuts have been for wholly beneficial reasons, such as lower than expected inflation and cost savings.

5. 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.

6. Private finance for NI investment?

We have indicated our willingness to consider new financing proposals, provided they can be structured so as to induce improvements in efficiency at least sufficient to offset the extra cost, and provided the finance is raised in fair competition with the private sector. The NEDC will shortly be considering a report on the progress that has been made in devising schemes which meet these criteria.

7. Finance more nationalised industry investment by cutting current spending?

Yes. As in private sector, moderate pay settlements and control of other costs are essential. Ability to finance new investment in nationalised industries bound to diminish if excessive pay settlements agreed. Each 1 per cent off wages saves about £140 million this year; and each 1 per cent off total costs saves £330 million this year.

NATIONALISED INDUSTRY PAY AND PRICES

8. Nationalised industries' prices

[Having risen approximately in line with retail prices for several months, the April figures again showed nationalised industry domestic prices increasing more rapidly than the RPI, by 14.1 per cent for NI against 9.4 per cent for all items RPI over the 12 months to mid-April. The restoration of this differential was expected, and reflects March increase in London Transport fares and ending of electricity industry's rebates to consumers. The removal of these temporary distortions confirms that nationalised industry prices are still increasing somewhat faster than the RPI, largely because of increases in the energy sector.]

Gap between nationalised industry price increases and RPI has been due in large measure to cumulative effect of years of artifical price restraint. World oil price rises of 1979 and 1980 have also played an important part. We greatly regret the need for these increases, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so, but sustained improvement will only be possible if the industries succeed in holding down their current costs, particularly pay.

PRIVATISATION

9. What further sales expected?

Special sales of assets in 1982-83 forecast at around £700 million and around £600 million in each of the later years. These figures well above those in last White Paper. This reflects primarily very large sales of energy assets - Britoil and the British Gas Corporation's major

offshore oil assets - to be made possible by Oil and Gas (Enterprise) Bill currently before the House.

10. Special asset sales in 1981-82

Gross sales in 1981-82 totalled £481 million, so target published in 1981 Public Expenditure White Paper of £500 million nearly met. Pleasing result - included two large sales - Cable and Wireless (£182 million) and Amersham International (£64 million).

11. But what about net figure?

Delivery of BNOC oil in 1981-82 paid for in 1980-81 and taken into account in special disposals figure for that year reduced 1981-82 receipts by £573 million to total of -£92 million. But it is the gross figure which is the true measure of success of Government's privatisation programme.

12. Government has sold assets too cheap?

[Heavy oversubscription for British Aerospace, Cable and Wireless, Amersham International, followed by large increases in prices when shares first traded.]

Not in Government's interest to see shares underpriced, given the loss to the PSBR, but also risks in pitching price too high. Getting balance right not easy - especially when company's shares have not previously been traded. Government will continue to consider alternative forms of sale eg tender, but critics should note that sale by tender could make it harder for small investor to buy shares.

S NORTH SEA AND UK ECONOMY

1. Impact of $2.50/barrel rise in North Sea oil price on Government revenues?

[$2.50/barrel rise is a figure quoted in the press for negotia tons involving BNOC and oil companies.]

Treasury estimate that a sustained $1/barrel rise in the North Sea oil price, all other thing being equal, would directly raise Government North Sea revenues by about £350 million in a full financial year.

2. In view of falls in price of oil earlier this year, 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.

3. Onerous tax system damaging future field developments?

[Shell/ESSO announcement plans for Tern shelved partly because of tax system; reports that Phillips are postponing T-block complex and BP their Andrew field].

Other adverse factors - falling oil prices; high development costs - much more important. No evidence that tax system is the determining factor inhibiting future development.

4. Government should do more to stimulate UK Continental Shelf oil production in 1990's?

[Select Committee on Energy's Report on depletion policy published 18 May: recommends reserve powers to impose production cuts but main emphasis on promoting development of fields to come into production in 1990s - increase pace of licensing rounds and overhaul fiscal regime].

Government's considered reply will be given in due course. Accept need to prolong high levels of UKCS production until end of century at least. Energy Secretary announced 17 May Government's plans for Eighth Round of licensing. Do not accept that fiscal regime makes North Sea development unattractive. On Committee's general proposal for overhaul of regime, would point out that industry does not want a structural upheaval: it would create serious uncertainty and major transitional problems.

5. Benefits of North Sea should be used to strengthen the economy?

[FSBR projections (in money of the day) of Government revenues from North Sea: £6.4 billion in 1981-82, £6.2 billion in 1982-83, £6.1 billion in 1983-84, and £8.0 billion in 1984-85. Lower than last year's projections, principally because of downward revision to oil price expectations. Projections incorporate March fall to $31 a barrel for Forties oil. Contribution of North Sea to GNP estimated at 4 per cent of GNP in 1981. Not projected to rise before 1985.]

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve a lower level of interest rates to the benefit of industry and the economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Less than 6 per cent of total General Government receipts in 1981-82.

6. 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.

8. Are we really any better off for our North Sea oil?

We are better off with oil - at current oil prices - than we would have been without it. We have been spared the fall in real national income that other industrial countries have suffered following oil price rises. But North Sea oil is costly to produce, so we are not necessarily any better off than we would have been had oil prices not risen. No need therefore for the possession of oil to require a contraction in our industrial base.

T WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Versailles summit achievements?

Agreed to maintain prudent monetary policies and achieve greater control of budgetary deficits in order to reduce real interest rates. We also agreed to intensify our economic and monetary co-operation, to resist protectionist measures, not to use our exchange rates to gain unfair competitive advantages and we agreed on a cautious approach to financial and trade relations with the Eastern block.

2. Versailles summit: international monetary undertaking

[Comminique stresses "joint responsibility to work for greater stability in world monetary system".] Major countries explicitly accept responsibility for international monetary system. This could be slant of gradual move towards greater stability in the system.

3. Results of OECD Ministerial and IMF Interim Committee meetings?

At both meetings Finance Ministers reaffirmed that successful policies to reduce inflation were essential to create sustained recovery. They stressed urgent need for budgetary discipline, smaller fiscal deficits, monetary restraint, promotion of productive efficiency and reduction of rigidities in markets for labour and goods. Clearly both communiques accorded closely with HMG's strategy.

4. 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 the War.]

Not a question of U-turns. OECD Ministers meeting earlier this month agreed reduction of unemployment 'cannot be achieved on a sustainable basis' unless inflation reduced. But not just industrial countries' view: 2 days later Interim Committee of International Monetary Fund - on which developing countries sit - agreed 'combating inflation is a necessary step for resumption of sustainable growth at a satisfactory pace . . . . . reduction in inflation and inflationary expectations, in nominal and real interest rates and in existing rigidities is essential for steady expansion of output and reduction of unemployment'.

5. Anti-inflation policies are working

[Inflation down from a year ago in 6 of major 7 economies - significantly down in US (from 10 to 6½ per cent), Japan (6½ to 3), Italy (20 to 15½) and UK (12 to 9½). Small reductions in Germany (to 5 per cent) and Canada (to 11½), but increase in France (from 12½ to 14).]

Yes. Firm fiscal and monetary responses to 1979-80 vindicated by events. UK still some way to go to match US, Germany or Japan in bringing down inflation, but moving in right direction and ahead of some other European countries.

6. Governments' policies have failed or worsened situation?

No. Adjustment to second oil shock better than to first. Investment has performed better, impact on wages better contained and dependence on oil reduced. But these gains must be reinforced by continued firm policies.

7. UK policies out of line with other countries?

UK far from alone as made plain again in communiques from recent IMF and OECD meetings where Ministers reaffirmed commitment to reducing inflation and improving productive efficiency. Most countries have already begun taking necessary medicine. German budget deficit cut almost 30 per cent this year. President Mitterand has declared next year's budget deficit must not exceed 3 per cent of GDP. Italy, Netherlands, Belgium, Australia and Sweden have also announced measures to cut planned public spending. Irish Government also acting to reduce deficits. And most countries have set non-accommodating monetary targets.

8. 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.

9. Prospects for US economy?

[Commerce Department's index of leading indicators rose in April for first time in a year, but industrial production is falling and seasonally adjusted unemployment is 9.4 per cent. M1 significantly above target range half way through year. Year on year rate of consumer price inflation down for the 7th consecutive month to 6.6 per cent in April.]

Seventh consecutive month of falling US inflation rate very good news - stabilising influence for the world economy. Helped by realistic and flexible wage settlements in which unions have given job security priority over wage increases. Reasonable prospect US economy should pick up later this year.

10. US Budget compromise?

[Senate agreed a fiscal plan with a deficit of nearly $116 billion; House of Representatives is considering 3 main plans this week; eventual differences between House and Senate plans will have to be ironed out in joint House-Senate Committee.]

Important for many countries that agreement on US budget should be reached soon. Senate's plan would entail Federal deficit of about 3½ per cent of GNP.

11. US interest rate developments

[One major US bank cut its prime rate to 16 per cent - others so far stayed at 16½ per cent.]

Prime rate well below peak of 21½ per cent last summer. Settlement of Budget for fiscal 83 would improve prospects for lower interest rates, especially given recent rate of inflation in US.

12. 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.

13. OECD see bleak prospects for UK economy?

[Report in The Times 24 May]

Latest OECD forecast ('Economic Outlook') published in December; next not due to be published until July.

U FALKLANDS CRISIS EFFECTS

1. UK economy affected by Falklands crisis?

Possible economic consequences cannot of course be ignored. But UK is basically in a strong financial position: inflation is coming down; interest rates were falling before crisis; balance of payments remains healthy; output is higher than a year ago. Disturbance due to Falklands dispute small in relation to overall macro-economic picture. No question of requiring any change in basic economic strategy.

2. Effect of Falklands dispute on markets?

[After rising initially, interest rates have recovered to levels a little below those obtaining before crisis. Exchange rates also holding up well.]

Shock seems to have been absorbed so far without significant ill-effect, reflecting confidence in government handling of crisis, and in economic policies. Too early to say what long term effects will be, but Government determined not to be deflected from its path.

3. Effects of Falkland Islands dispute on sterling?

Only natural that markets unsettled. But markets are aware that underlying position of the UK is strong, with inflation falling, growth picking up and a healthy balance of payments surplus. Falklands dispute is small in relation to this overall macroeconomic picture; no question of it requiring any change in our basic economic strategy.

4. Will dispute with Argentine affect UK trade figures?

Volume of UK-Argentine trade negligible (£20 million a month on either side).

5. Will freeze on Argentine assets affect standing of City?

We have not confiscated Argentine's assets, merely frozen them. This action was taken under extraordinary provocation; we believe international financial community will understand this.

6. Effect of restrictions on Argentinia?

The crisis and our action will greatly reduce Argentina's capacity to raise loans on the international markets. A number of Argentine public foreign borrowing operations amounting to many hundreds of $million have been suspended since crisis began.

7. Argentina's debts

[NOT FOR USE: Argentine foreign debt at end 1981 estimated at $34 billion - about half size of Mexico's or Brazil's.]

Sign of times that Argentine military aggression should create instability in global capital markets. All more important to negotiate settlement quickly and to discourage similar acts in future. [IF PRESSED on debt default possibility: Banks have taken fairly relaxed atttude because ultimately overseas debt must be repaid by exports; Argentina's export sector is agriculture, which, according to most experts, is fundamentally healthy.]

8. Falkland Islands: Cost/Financing of operation?

No cash ceiling on cost of operation; needs of task force must and will come first. Obviously too early to assess cost - duration and nature of operation still unknown. When cost is known we shall decide how to deal with it. But cost can and will be met in ways consistent with Government's economic strategy. [IF PRESSED: Not all of cost will be additional. At this stage, extra cost represents very small proportion of (over £14 billion) Defence Budget. No cash or budgetary problem immediately in prospect.]

9. Cuts in defence spending have weakened our ability to respond to Falklands crisis?

No. We have not cut defence spending since 1978-79. We have increased it by over 85 per cent in cash terms - a real increase of about 11 per cent - to over £14 billion. We are spending more on conventional naval forces in real terms than was spent in year before we came to office. When expenditure on modernising strategic deterrent is at its peak we will still be spending more on conventional Navy than in 1978-79.

1/2

AIDE MEMOIRE ON THE UK ECONOMY

7 June 1982

RECENT DEVELOPMENTS AND INDICATORS

(i) Activity. GDP fell by 6 per cent between 1979 H2 (last cyclical peak) and 1981 Q2 (trough of current recession). After rising 1 per cent in 1982 Q1, GDP declined by approaching ¼ per cent in 1982 Q1, but remains above levels of last spring. Recent decline largely reflects weakening in industrial production which, though showing some recovery in February and March from weather and strike affected levels at turn of year, nearly ½ per cent lower in 1Q 1982 than in 4Q 1981. Despite weakening, underlying level of manufacturing production remains some 2 per cent up on 2Q. New engineering and construction orders in 1981 up 15 and 11 per cent in volume respectively on 2H 1980. Private housing starts up over one third in same period.

Recovery in 1981 largely reflected sharp fall in rate of destocking. Q1 figures suggest period of rapid destocking now over. Consumers' expenditure, Government consumption and fixed investment broadly flat in 1981. But latter beginning to pick up in certain areas in 1982 Q1; DOI investment intentions survey suggests rise of 2 per cent in manufacturers', distributors' and service industries' fixed investment in 1982.

(ii) Lack of complete trade figures for 1981 and changed documentation procedures make recent figures difficult to interpret. Exports have held up better than many had feared. In 7 months to February non-oil exports no lower (up ½ per cent) than in 1980. Non oil imports have risen - up 11 per cent in same period - reflecting reduced rate of destocking and higher output. Current account estimated to be in surplus of some £7 billion in 1981.

(iii) Employment and unemployment. UK employment fell 2.1 million (9 per cent) between mid 1979 and 4Q 1981 (with about two-thirds concentrated in manufacturing), though rate of decline has slowed down. Unemployment risen by less than fall in employment. UK adult unemployment stood at 2.87 million (12 per cent) in May. Total unemployment (including school leavers) was 2.97 million (12.4 per cent). Underlying rate of increase in unemployment slowed sharply during 1981 (105,000 per month in 4Q 1980 cf 22,000 per month so far in 1982). Other labour market indicators; eg short-time working (down by ¾ during 1981) overtime (improved by over 10 per cent during 1981) and vacancies - despite slight weakening since February - up by 1/5 in 3 months to May on 2Q 1981 and with more rapid turnover.

(iv) Wages and prices. Increase in earnings in 1980-81 pay round 11 per cent (settlements averaged about 9 per cent), half that of previous pay round. Settlements well inside single figures are now widespread (CBI average for manufacturing 7 per cent) - suggesting a further moderation in current pay round. 12-monthly increase in RPI for first time in over 3 years well inside single figures, 9.4 per cent, in April. Recent progress suggests outturn to November this year could well be in Budget time forecast of 9 per cent. Manufacturers' input prices no higher in April than last August. Manufacturers' output prices rose 8¾ per cent in year to April -lowest figure for over three years.

(v) Productivity and Competitiveness (manufacturing). Output per man rose 12 per cent since end-1980. Output per man and output per man hour 5 and 8 per cent respectively higher than previous cyclical peak in 1H 1979. Together with pay moderation, resulted in little increase in unit wage and salary costs during 1981 - rise of less than 3 per cent in year to 1Q 1982 - a rate below average of our competitors and comparable to Germany and Japan. Competitiveness (relative normalised unit labour costs) improved by at least 10 per cent during 1981.

(vi) Company finances. Gross trading profits of ICCs (excluding North Sea) rose by over one quarter between 1H and 2H 1981, but real pre tax rate of return just 2½ per cent in 1981. Company borrowing fell and liquidity improved, but latest 4Q figures suggest some deterioration as destocking slowed and effects of civil service dispute (which delayed companies tax payments) unwind.

(vii) Monetary aggregates. £M3 grew at an annual rate of 13 per cent in 1981-82 target period (from mid-February 1981 to mid-April 1982) compared with target range of 6-10 per cent. At least part of excess reflected increased market share of banks in mortgage lending. Over the same period, M1 and PSL2 grew at rates of 7 and 12 per cent per annum respectively. In recent months monetary aggregates have grown more slowly, reflecting lower than expected government borrowing in 1981-82 and (temporary) effects of recovery from civil service dispute.

(viii) Interest rate/exchange rates. 3 month inter bank rate fell from 16 per cent last October to 13½ per cent in mid March. After falling over 10 per cent during spring and summer 1981, effective exchange rate broadly constant at around 90 since last August. While Falklands Islands' dispute continues to unsettle markets exchange rates and interest rates little changed overall since dispute began.

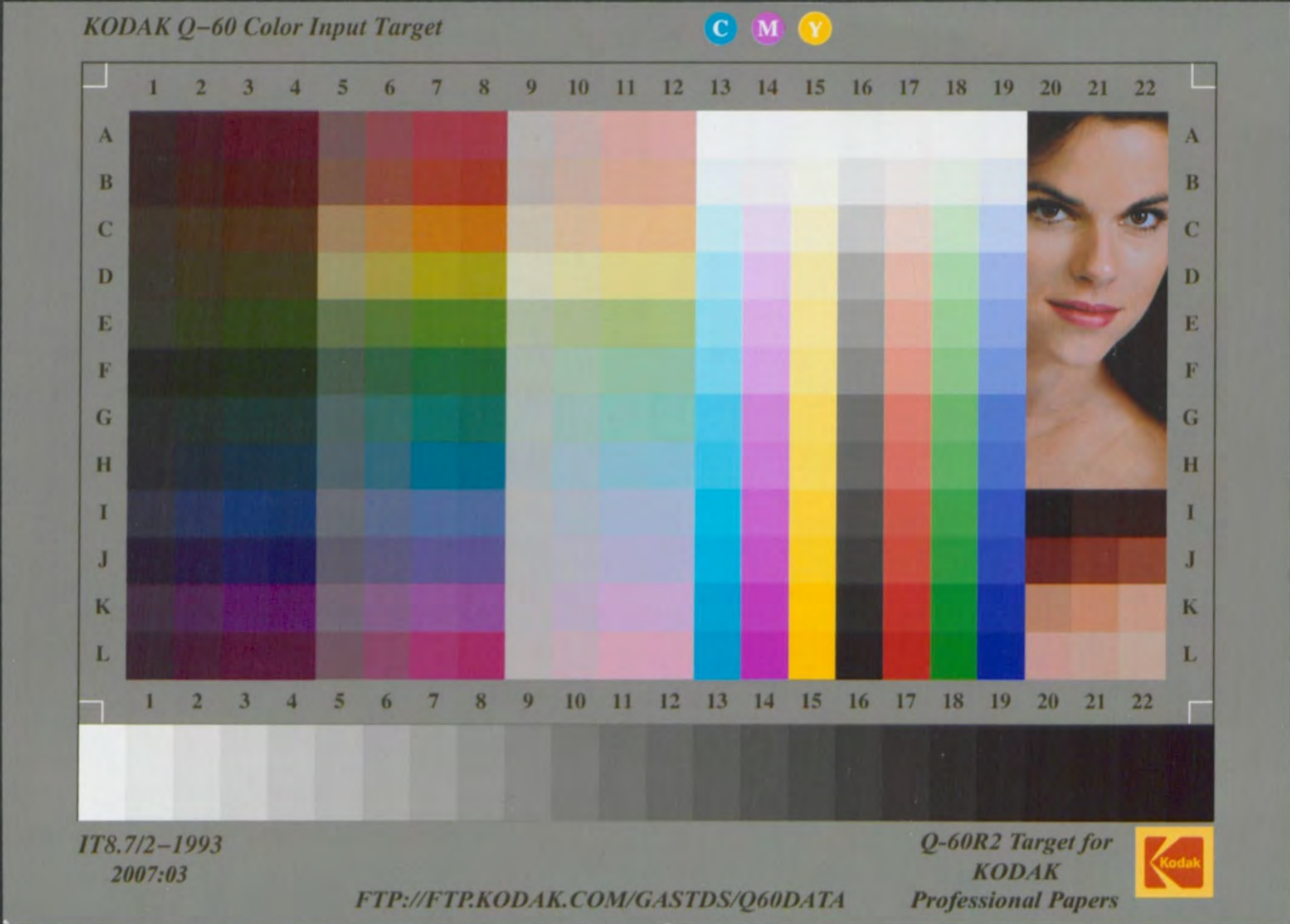
(ix) Government borrowing. Provisional estimate suggests PSBR £8.6 billion in 1981-82 (3½ per cent of GDP, compared with 5 3/4 per cent in 1980-81) about £2 billion lower than estimated at Budget time. Largely reflects lower payments and higher underlying level of receipts than expected by central government, and lower borrowing by local authorities. Precise reasons for 1981-82 shortfall not yet known; balance of implications, if any for 1982-83 PSBR unknown. FSBR forecast of £9½ billion (3½ per cent of GDP) remains best central estimate.

PART 16 ends:-

1.6.82

PART 17 begins:-

8.6.82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