CONFIDENTIAL

PO -CH /GH/0019

PART A

CHEVENING 1981-82

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PO -CH /GH/0019
PART A

From: Douglas Wass
7 January 1981

X

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (L)
Minister of State (C)
Sir A Rawlinson
Sir K Couzens
Mr Ryrie
Mr Burns
Mr Middleton
Mr Barratt
Mr Kemp
Mr Kerr
Mr Ridley
Mr Cropper
Mr Harris

CHEVENING

We are to hold our informal conference at Chevening this weekend. The attached bundle of papers from the FCO sets out starting, finishing and meal times during the conference, as well as various other pieces of information about accommodation and travel arrangements etc.

The work programme which I would suggest we follow is:-

<u>Saturday afternoon: (2.30-6.30)</u>

Economic Strategy

<u>Papers</u> (i) "Operational Decisions on Interest Rates", paper by Mr Middleton.

(ii) "Approach to the Budget", paper by Mr Burns (to be circulated).

<u>Saturday evening: (9.00-10.30)</u>

General discussion

No Papers

<u>Topics</u> (i) Pay and Industrial Scene

(ii) Bank taxes

(iii) Reducing our vulnerability to shocks.

Sunday morning (9.00-12.00)

Public Expenditure

Papers (i) "Public Expenditure Timetable and the Budget", paper by Sir Anthony Rawlinson.

(ii) "Public Expenditure: Problems Ahead", papers by the Public Services Sector.

(iii) "Longer Term Trends in Public Expenditure", paper by Mr Byatt.

I shall be letting you and other participants have a list of possible points for discussion.

On another, more domestic matter, I suggest that dress for the conference could suitably reflect its informal nature, although lounge suits (short dresses for the ladies) might be the tenue for dinner on Saturday. I gather that, in one or two cases, bathrooms will be shared, and so I would advise all conference members to take dressing gowns.

As you know, I am asking those who are taking their wives to Chevening to contribute towards the cost of meals and accommodation. The charge is £20, and I should be grateful if cheques for this amount, payable to HM Treasury, could be sent to my office in due course. There is no charge for wives who will be joining us for Sunday lunch only.

Any further enquiries about this weekend should be addressed to my office.

DW

DOUGLAS WASS

From: Sir D Wass
Date: 17 November 1981

Diary OK? file

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
MST (L)
Sir A Rawlinson
Sir K Couzens
Mr Ryrie
Mr Burns
Mr Middleton
Mr Kemp
Mr Cropper
Mr Ridley
Mr Harris
Mr F E R Butler

SUNNINGDALE II

You asked me to consider further the location of the discussion weekend in January. We have spoken with the Ministry of Defence, No 10, the Foreign Office and the then Civil Service Department.

All of the MOD houses which might have been suitable are in use or closed for the holidays on the weekend of 9-10 January, except for the Royal Naval College at Greenwich. Pleasant though the Painted Hall there is, our party would be swallowed up in so large a place.

No 10 do not think the Prime Minister would wish to make Chequers available for other Ministers' meetings.

Most Foreign Office houses can be ruled out for one reason or another. Chevening is probably the most comfortable place available from anyone and relatively cheap. On the other hand, since it only has 13 bedrooms some of our party would have to lodge in the village, which would be inconvenient and not conducive to the kind of occasion we want to have.

Sunningdale is available, if we move quickly. I know that you are not overfond of it, but it can accommodate us all fairly comfortably and we know that it can organise conferences of this sort efficiently.



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On balance, I think Sunningdale would be the best venue. If you agree, I will arrange for it to be booked.

I will minute separately about the agenda and papers.

DW

DOUGLAS WASS
17 November 1981

FINANCIAL SECRETARY TO THE TREASURY

CHANCELLOR

cc Chief Secretary
Economic Secretary
Minister of State (L)
Sir D Wass
Sir A Rawlinson
Sir K Couzens
Mr Ryrie
Mr Burns
Mr Middleton
Mr F E R Butler
Mr Kemp
Mr Cropper
Mr Ridley
Mr Harris

SUNNINGDALE II

The Financial Secretary has seen Sir Douglas Wass' minute of 17 November. He can't help thinking that if 13 bedrooms is not enough the party must be very large - too large. He has commented surely we can all fit into Chevening.

M C Felstead

M C FELSTEAD
23 November 1981

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H. M. TREASURY

Parliament Street, London SW1P 3AG, Press Office: 01-233-3415
Telex 262405

2 December 1981

# ECONOMIC PROSPECTS FOR 1982

The Industry Act (1975) requires the Government to publish economic forecasts twice a year. This press notice reviews economic developments so far this year and outlines the prospects for 1982.

## Summary

2. In the world economy, attempts to contain the inflationary impulses from the second major oil shock of the decade are restraining activity in many industrialised countries. The United Kingdom, with particularly deep-seated problems of high inflation and low productivity growth, is making painful adjustments - through lower wage settlements and higher unemployment - in a highly competitive environment.

3. The rise in sterling was one of the causes of the rapid fall in inflation which began in mid-1980. The fall in the exchange rate earlier this year has interrupted progress but slower increases in pay together with productivity improvements point to further falls in cost and price inflation in the course of 1982.

4. After the fall in output in 1980 and the first half of 1981, there are signs that recovery began in the summer of this year. Further growth of output is forecast for 1982.

## RECENT ECONOMIC DEVELOPMENTS

5. A year ago, and at the time of the 1981 budget, government forecasts showed UK output levelling out and then recovering slowly by the end of 1981; while inflation was expected to fall substantially from its 1980 level. These expectations have been broadly fulfilled.

### The world economy

6. 1980 was a year of very slow growth in the world economy, with unemployment rising and inflation high. This year has seen the maintenance of generally tight monetary and fiscal policies including very high nominal and real interest rates, and while inflation (the rise of consumer prices in the major economies) has come down from 12 per cent in 1980 to about 10 per cent in 1981, this has been accompanied by depressed output in many countries, and by substantial increases in unemployment. As usual at this stage of the economic cycle, commodity prices have weakened relative to prices of manufactures, and contributed to the increasing deficits of many developing countries. The volume of world trade may now be rising slowly. The table below shows how recent years compared to earlier periods in world economic development.

| | Annual percentage changes | | | |
|---|---|---|---|---|
| | 1964-1973 | 1973-1979 | 1980 | 1981 (partly forecast) |
| GNP in major 7 countries | 5 | 3 | 1 | 1 |
| Consumer prices | 4½ | 9½ | 12 | 10 |
| World trade in manufacturing (weighted by the pattern of UK markets) | 10 | 5½ | 5 | 2 |

## The UK economy

7. The exchange rate in September/October was 13 per cent below the average for the first quarter of 1981 and at about the same level as in mid-1979. Import prices, measured by average values in sterling terms, rose 7 per cent between the first quarter of 1981 and the September/October level - a modest rise in relation to exchange rate and overseas price movements, reflecting both weak commodity prices and a reduction in margins on imported manufactured goods. Higher import prices have three main effects: directly on prices in the UK; indirectly through the higher costs of UK producers; and through the lessening of the downward pressures on the prices of all goods and services sold in the UK in competition with imports. Partly in consequence, there has been no further fall in the rate of inflation in recent months.

8. Companies' inability to pass on higher costs into prices together with the fall in activity contributed to a large fall in the level of wage settlements. The underlying increase in average earnings in the year to September, at about 11 per cent, was broadly comparable to the average of other countries, after years in which the increase had been well above that of most other countries. These movements, together with the changes in the exchange rate, imply that competitiveness, as measured by relative unit labour costs, has improved over 10 per cent this year; but remains 35-40 per cent worse than in 1975, a deterioration mainly attributable to the higher rate of increase in UK unit labour costs relative to the UK's competitors.

9. There has been a modest recovery in company profits, which are estimated to have risen in aggregate 8 per cent between the second half of 1980 and the first half of 1981. Non-North Sea profits of industrial and commercial companies have however remained broadly flat since mid-1980; and the rate of return on capital remains very low, having fallen from 9 per cent in 1970 to 3 per cent in 1980. With companies cutting their expenditure, above all

on stocks (destocking by industrial and commercial companies in 1980 and the first half of 1981 amounted to £6bn), they succeeded im moving from a position of heavy overall borrowing in 1979 and early 1980 to a net repayment of debt in early 1981. Over the three years to 1980, the personal sector's real disposable income increased by 17 per cent. But by mid-1981 the shift of real income towards consumers and away from companies was being reversed.

10. After the rapid fall in activity during 1980, especially in manufacturing, there was a much smaller fall in the early part of 1981. Preliminary estimates for the third quarter suggest a 2 per cent increase in manufacturing output (stock adjusted) with a particularly strong rise in chemical production, and a rise in the total output of the economy. A recovery in activity has been suggested over the past year by the responses to the output question in the regular surveys undertaken by the Confederation of British Industry:

Balance of ups over downs, percentages

| | Trend in Output Volume over next four months | Present Stocks of finished goods too high | Volume of new orders over next four months | New export orders over next few months |
|---|---|---|---|---|
| 1980 July | -41 | 36 | -47 | -35 |
| October | -31 | 33 | -32 | -17 |
| 1981 January | -16 | 31 | -17 | -10 |
| April | - 4 | 26 | - 2 | 1 |
| July | 1 | 20 | + 4 | 9 |
| October | 0 | 17 | + 2 | 11 |

11. The second column suggests that, as the level of stocks has been substantially reduced and expectations of output recovery strengthened, the desire to reduce stocks has steadily declined. The third quarter estimates of stockbuilding are consistent with this. The last column indicates an improvement in export orders,

a trend also evident in the Department of Industry's series for export orders in engineering. But the rises in interest rates in September and October, reflected in a lower level of business optimism in some recent surveys, suggest a cautious interpretation.

12. The early stages of a recovery in industrial output have been accompanied, as usual, by a sharp fall in short-time, and a recovery in overtime, with average hours worked increasing by about 3 per cent in manufacturing between the end of 1980 and the summer of 1981 - and by a continuing, though much slower, rise in unemployment. In manufacturing, there has been little change in total hours worked since the beginning of this year - the rise in average hours offsetting the fall in employment. Productivity has been better than would have been expected on the basis of past experience: output per man hour in manufacturing rose 7 per cent between the fourth quarter of 1980 and the third quarter of 1981.

13. Over the twelve months to banking October, M1 grew by a little under 10 per cent, the wide measure of private sector liquidity, PSL2, by 13 per cent, and £M3 by over 15 per cent. The Civil Service dispute has served to raise the growth of most, if not all, monetary aggregates this year, with probably the greatest impact on £M3. The PSBR for the year as a whole appears to be in line with the Budget forecast of £10½ billion. The growth in bank lending, especially to the personal sector, has been very rapid so far this year: to some extent this reflects a move by the banks into the housing market. Other factors influencing the demand for money in 1981-82 include the rise in nominal incomes, at around 10 per cent. The recorded figures for the February 1981 to April 1982 target period, which will be raised by the strike and by the banks' gain in market share, may be somewhat above the top of the target range, though interpretation of recent movements has been made very difficult by the distortions arising from the effects of the Civil Service dispute.

## ECONOMIC PROSPECTS

### Assumptions

14. This forecast takes full account of the decisions on public expenditure and on employees' National Insurance contribution rates announced by the Chancellor on December 2. A conventional assumption is made that income tax thresholds and allowances and the rates of specific duties will be raised by 12 per cent in the 1982 Budget, in line with the expected rate of increase in the RPI over the year to the fourth quarter of 1981.

15. Interest rates are, in practice, determined by a number of factors, set out in the 1981 Budget Statement. These include all the monetary aggregates and the exchange rate. This forecast is constructed on the assumption that the growth of £M3 in 1982-83 will be at the top end of the 5-9 per cent range set out in the MTFS last March, and that the exchange rate will remain constant, against a weighted average of other currencies, at the level in November 1981.

### The world economy and UK trade

16. Output in the main industrial countries may recover over the next year. But the upswing is likely to be no more than moderate by past standards - perhaps 1½-2 per cent - and unemployment is liable to increase further in many countries. The nature of the forecast recovery reflects the slow progress in reducing inflation against a background of firm policies.

17. There has been little, if any, rise in overall world trade in 1981. In 1982, the modest recovery in output, the growth in OPEC markets and the usual tendency for trade in manufactures to rise faster than trade in total, suggest that world trade in

manufactures (weighted by the UK share of markets) could expand by 4-5 per cent.

18. Judgments about the course of UK trade in 1981 have been obscured by the Civil Service dispute and the September and October trade figures are extremely difficult to interpret. Export volumes have held up well since the early part of the year, in difficult circumstances. The rise in import volumes in September/October is consistent with a much reduced rate of destocking, and with a rise in output, in the second half of 1981.

19. Over the next year, the volume of exports can be expected to rise, as foreshadowed in recent surveys. As output rises next year, with stocks no longer being reduced, further rises in import volumes are in prospect. The current account of the balance of payments should continue to run a sizeable surplus into 1982 though at a lower rate than in late 1980 and early 1981 when the import level was exceptionally low.

Inflation

20. The rate of inflation is inevitably being affected by the turnaround in sterling that took place earlier this year, though there is tentative evidence from the latest trade figures that some of the impact is falling on importers' margins. Once this has finished feeding through into final prices, however, and provided there is a continued slowdown in the rise in domestic unit costs, a further fall in the inflation rate is in prospect: over the year to the fourth quarter of 1982, the RPI is forecast to rise 10 per cent.

21. Profit margins - as measured by the movement of prices over actual costs - should continue to improve over the next year. With the exchange rate lower than at the start of 1981 and firms continuing to make productivity gains they should be able to

retain higher profits. Nonetheless, an exchange rate still high in real terms by comparison with the period before 1980 will continue to limit firms' ability both to raise prices, and to incur higher costs. The competitive pressures in the private sector, and the influence of cash constraints in the public services, should combine to bring about another substantial fall in the level of wage settlements and earnings growth, over the next year. The share of company profits, net of North Sea oil, in total domestic incomes should show a considerable recovery in 1982.

## Domestic demand and activity

22. After an increase of 17 per cent between 1977 and 1980, the personal sector's real income after tax is now lower, by over 3 per cent in the second half of 1981, than a year earlier, as a result of the fall in wage settlements relative to prices, and the rises earlier this year in taxation and National Insurance Contribution rates. A further fall in after tax real income is forecast, but the level of personal consumption may remain steady with a continuing fall in the saving ratio influenced partly by the further decline in inflation.

23. The company sector's real income after tax should show some recovery over the next year, after the sharp fall during 1980, as a result of some improvement in profit margins from the low levels reached in 1980 and early 1981. This recovery in income, together with a better prospect for demand, should ease the financial pressures on companies to reduce stocks. Indeed, there could be a small increase in stocks next year (see Table 2).

24. In the second half of 1980 and the first half of 1981 companies' sales were being met, in part, from running down stocks as well as from current production. By 1982, on this forecast, all sales will be met from current production, and none - in aggregate -

retain higher profits. Nevertheless, the exchange rate still high in real terms in comparison with the period before 1980 will continue to limit firms' ability both to raise output, and to earn higher income. The competitive pressures in the private sector, and the influence of cash limitations in the public services, should continue to bring about further substantial fall in the level of wage settlements and earnings growth, over the next year. The share of company profits, net of North Sea oil, in total domestic income should show a considerable recovery in 1982.

Domestic demand and activity

22. After an increase of 1% per year between 1977 and 1980, the personal sector's real income after tax is now lower, by over 2 per cent in the second half of 1981, than a year earlier, as a result of the fall in wage settlements relative to prices, and the sharp rise this year in taxes and National Insurance contribution rates. A further fall in after tax real income is forecast, but the level of personal consumption may remain steady with a considerable fall in the saving ratio (attributed partly to the further decline in inflation).

23. The company sector's real income after tax should show some recovery over the next year, after the sharp fall during 1980, as a result of some improvement in profit margins from the low levels reached in 1980 and early 1981. This recovery in income, together with a better prospect for demand, should ease the financial constraints on companies to reduce stocks. Indeed, there could be a small increase in stocks next year (see Table 3).

24. In the second half of 1981 and the first half of 1982 companies' sales were being met, in part, from running down stocks as well as from current production. By 1982, as this reduces, all sales will be met from current production, and even - in aggregate -

from destocking. The stock/output ratio in manufacturing had fallen back sharply by the third quarter of 1981: this forecast implies a stock/output ratio in 1982 close to the average for the period 1975-79.

25. Fixed investment, outside general government, should also see some recovery in 1982 after a fall up to the first half of 1981. In industry, a moderate recovery was suggested for both manufacturing and distribution by the Department of Industry's May survey of investment intentions. Private housing starts are higher than a year ago, and there may be some rise in investment - which is measured by sales - over the next year.

26. In total, domestic demand is forecast to recover by over 1½ per cent between the second halves of 1981 and 1982. With imports again tending to rise faster than exports, the prospect for domestic output, consistent with the rise predicted for profitability, is one of moderate recovery which will help to limit the rise in unemployment. Manufacturing output, which fell particularly sharply in relation to total output up to the end of 1980, may now recover rather more sharply than total output. The table below sets out half yearly paths for total output, and for manufacturing output:

1975 = 100

| | 1980 | | 1981 | | 1982 | |
|---|---|---|---|---|---|---|
| | I | II | I | II | I | II |
| GDP | 109 | 106 | 105 | 105½ | 106 | 106½ |
| Manufacturing output (stock-adjusted) | 99 | 90½ | 87½ | 90½ | 92 | 93 |
| Money GDP | 209.6 | 221.3 | 230.7 | 244.0 | 258.7 | 270.1 |

These forecasts are close to those published in November 1980 and in March 1981.

Government borrowing

27. In the first half of 1981-82 the PSBR was £9½ billion, seasonally adjusted. The best estimate is that, in the absence of the Civil Service dispute, it would have been about half this figure; and much smaller than in the first half of the previous financial year. The trends in revenue and the PSBR this year are being obscured by the effects of the dispute, but it seems that the PSBR for the year as a whole may turn out near to the budget estimate of £10½ billion, or 4 per cent of GDP at current market prices. This represents a substantial fall from nearly 6 per cent in 1980-81.

28. Next financial year, 1982-83, the public expenditure planning
But on current view of [illegible]
total is expected to be about £115 billion. On the basis of the conventional assumptions that thresholds, allowances and specific duties are raised in line with inflation, general government receipts should rise faster than expenditure next year, against the background of money GDP forecast to rise 11 per cent. On this basis, and on the assumptions already stated, decisions on public expenditure point to a PSBR next year broadly in line with the projections published at the time of the last Budget. But experience shows that estimates of the PSBR are liable to substantial margins of error.

Risks and uncertainties

29. The summary table includes averages of past errors from internal Treasury forecasts over the last ten to fifteen years. The particular average shown in the table is the average absolute error. An analysis of errors in the first six Industry Act Forecasts was published in the Economic Progress Report for June 1981.

30. On this occasion, and because of the absence of trade statistics for much of 1981 because of the Civil Service dispute, the forecast of the balance of payments is subject to a larger

margin of error than usual. The current account balance is the difference between inflows and outflows each of which approach £100 billion. The distortions of recent borrowing and money supply figures also make interpretation more hazardous than usual.

PRESS OFFICE
HM TREASURY
PARLIAMENT STREET
LONDON SW1P 3AG

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months of worse than usual. The current account reflects the difference between inflows and outflows each of which approach $[illegible] million. The discrepancies of recent balance of payments and money supply figures make interpretation more ambiguous than usual.

PRESS OFFICE
HM TREASURY
PARLIAMENT STREET
LONDON SW1P 3AG

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## TABLE 1: ECONOMIC PROSPECTS FOR 1982

| | Percentage changes 1980 to 1981 | Percentage changes 1981 to 1982 | Average errors from forecasts, relevant for 1982 per cent |
|---|---|---|---|
| **A Output and expenditure at constant 1975 prices** | | | |
| Gross domestic product (at factor cost) | -2 | 1 | $1\frac{1}{2}$ |
| Consumers' expenditure | 0 | 0 | $1\frac{1}{2}$ |
| General government expenditure on consumption and investment | -2 | 0 | $1\frac{1}{2}$ |
| Other fixed investment | $-2\frac{1}{2}$ | $2\frac{1}{2}$ | 3 |
| Export of goods and services | $-5\frac{1}{2}^{+}$ | $2\frac{1}{2}^{+}$ | $3^{+}$ |
| Change in rate of stock-building as a percentage of level of GDP | $-\frac{1}{2}$ | $2\frac{1}{2}$ | 1 |
| Imports of goods and services | $-4^{+}$ | $8\frac{1}{2}^{+}$ | $2\frac{1}{2}^{+}$ |
| | 1981 £ billion | 1982 £ billion | £ billion |
| **B Balance of payments on current account** | $6^{+}$ | $3^{+}$ | $2\frac{1}{2}^{+}$ |
| | Percentage changes 4th quarter 1980 to 4th quarter 1981 | Percentage changes 4th quarter 1981 to 4th quarter 1982 | per cent |
| **C Retail prices index** | 12 | 10 | 3 |

\+ The uncertainties caused by the absence of trade statistics for part of 1981 imply that the estimates and forecasts of trade and the current account are particularly uncertain in this forecast.

TECHNICAL FOOTNOTE TO TABLE 1

The errors relate to the average differences (on either side of the central figure) between forecast and outturn. The method of calculating these errors has been explained in earlier publications on Government forecasts, notably in November 1978 (see Economic Progress Report Supplement, or Economic Trends No 301, November 1978, and Economic Progress Report, June 1981). The calculations for the constant price variables are now derived from internal forecasts made during the period June 1965 to October 1979. For the current balance and the retail prices index, forecasts made between June 1970 and October 1979 are used. The errors are after adjustment for the effects of major changes in fiscal policy, where excluded from the forecast. Quarterly forecasts are grouped so as to be comparable with changes between calendar years as shown. Thus for forecasts of constant price variables and the current account made in quarter 0 the errors relate to the forecast period (quarters 1 to 4) compared with the base year (quarters -3 to 0). For the retail prices index the margin relates to the percentage change between quarter 0 and quarter 4.

TABLE 2: CONSTANT PRICE FORECASTS OF EXPENDITURE, IMPORTS AND GROSS DOMESTIC PRODUCT

£ million at 1975 prices, seasonally adjusted

| | Consumers' expenditure | General government expenditure on goods and services | | | Other Fixed Investment | Exports of goods and services | Change in stocks | Total final expenditure | Less imports of goods and services | Less adjustment to factor cost | Plus statistical adjustment | GDP at factor cost | GDP index 1975 = 100 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Final consumption | Fixed investment | Total | | | | | | | | | |
| 1979 | 71,400 | 23,850 | 3,350 | 27,200 | 17,550 | 33,050 | 1,500 | 150,700 | 35,300 | 12,400 | 650 | 103,650 | 109.9 |
| 1980 | 71,450 | 24,450 | 2,950 | 27,400 | 17,850 | 33,300 | -2,000 | 148,000 | 34,150 | 12,450 | - 50 | 101,350 | 107.5 |
| 1981 | 71,650 | 24,450 | 2,300 | 26,750 | 17,400 | 31,450 | -2,300 | 144,950 | 32,750 | 12,100 | -950 | 99,150 | 105.2 |
| 1982 | 71,700 | 24,550 | 2,200 | 26,750 | 17,850 | 32,200 | 300 | 148,800 | 35,600 | 12,400 | -600 | 100,200 | 106.4 |
| 1980 First half | 35,800 | 12,150 | 1,550 | 13,700 | 9,050 | 16,950 | - 500 | 75,000 | 17,800 | 6,200 | 300 | 51,300 | 108.8 |
| Second half | 35,650 | 12,300 | 1,400 | 13,700 | 8,800 | 16,350 | -1,500 | 73,000 | 16,350 | 6,250 | -350 | 50,050 | 106.2 |
| 1981 First half | 35,900 | 12,200 | 1,200 | 13,400 | 8,550 | 15,700 | -1,800 | 71,750 | 15,700 | 6,100 | -500 | 49,450 | 105.0 |
| Second half | 35,750 | 12,250 | 1,100 | 13,350 | 8,850 | 15,750 | - 500 | 73,200 | 17,050 | 6,000 | -450 | 49,700 | 105.5 |
| 1982 First half | 35,850 | 12,250 | 1,100 | 13,350 | 8,900 | 15,950 | 100 | 74,150 | 17,650 | 6,200 | -350 | 49,950 | 106.1 |
| Second half | 35,850 | 12,300 | 1,100 | 13,400 | 8,950 | 16,250 | 200 | 74,650 | 17,950 | 6,200 | -250 | 50,250 | 106.7 |
| **Annual percentage changes** | | | | | | | | | | | | | |
| 1979 to 1980 | 0 | 2½ | -12 | ½ | 1½ | 1 | | -2 | -3½ | ½ | | -2 | |
| 1980 to 1981 | 0 | 0 | -21½ | -2 | -2½ | -5½ | | -2 | -4 | -3 | | -2 | |
| 1981 to 1982 | 0 | ½ | - 5 | 0 | 2½ | 2½ | | 2½ | 8½ | 2½ | | 1 | |

Notes:- 1. GDP figures in the table are based on 'compromise' estimates of gross domestic product.

2. Figures in £ million are rounded to £50 million. Percentage changes are calculated from unrounded levels and then rounded to ½ per cent. The GDP index in the final column is calculated from unrounded numbers.

3. Data on exports and imports for the first half of 1981 are based on very partial information.

Chevening p.p.

SIR ANTHONY RAWLINSON

cc Mr Burns
Sir K Couzens
Mr Ryrie
Mr Kemp (without attachment)

CHEVENING

As requested at this morning's Second Secretaries' meeting, I attach a copy of Sir Douglas Wass's minute to the Chancellor about the proposed conference at Chevening on 9-10 January.

Although the minute does not mention it, the proposal is that Mr Middleton should be invited to the Saturday session; and that either Mr Barratt or Mr Littler should be invited to the Sunday session. (You agreed to consider which of the two to propose.) We shall issue the invitations from this office.

J. G. C.

J G COLMAN
4 December 1981

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CHANCELLOR OF THE EXCHEQUER

CHEVENING CONFERENCE

I should like to take your mind on a number of matters connected with the conference we are to have at Chevening on 9 and 10 January.

We have now made a booking and I should like to obtain your agreement to the cast list, subjects for discussion and one or two other matters of administration.

On cast, you clearly want to have all the Ministers of the 'old' Treasury. Do you wish to include Mr Hayhoe as well? As you know I think that there are advantages in exposing him to the culture of the Treasury. But his experience of macro-economic and financial matters does not appear to be very substantial, and you may feel that his contribution might not be very significant. I have not taking any soundings of his office, and to the best of my knowledge he is not aware that the conference is to take place. If he is not invited, you will want to treat the whole matter with great delicacy.

So far as officials are concerned, I suggest we have the four Second Permanent Secretaries, Mr Middleton, Mr Kemp and myself. You will want your Principal Private Secretary and I imagine the three special advisers. This produces a total of 16 which I would have thought was the absolute limit if a reasonably intimate and closely-knit discussion is to be achieved.

I think we need two specific subjects to focus discussion, and I suggest we have one on the Saturday afternoon and one on the Sunday morning. The dinner and after dinner discussion on Saturday evening could be either a continuation of the afternoon discussion or get on to some topic which any of the participants felt to be worth ventilating. The two specific subjects I suggest are:-

(i) the economic outlook and the prospects for the Budget.

(ii) The control of public expenditure. Lessons from the 1980 exercise.

I would ask Terry Burns to write a short paper on item (i) and to introduce it; Anthony Rawlinson would be glad to do something on (ii) and also to introduce it.

On timing, I suggest that we assemble just before lunch on Saturday and aim to leave immediately after lunch on Sunday. I think that it is your wish that wives be invited to the lunch. Unfortunately the dining table at Chevening seats only 24. Perhaps the best solution would be to go for a buffet lunch, but to have a short drinks interval with wives before lunch so that we could all meet each other.

DW

DOUGLAS WASS
2 December 1981

Chevening

RESTRICTED

PERM. SEC'S. OFF

Sir K Couzens
Sir A Rawlinson
Mr Burns
Mr Kyrle
Mr Kemp

Kevin Pl keep Chevening papers together.
Pl copy to Sec Gen + Mr Kemp.. (to whom I will speak)

SIR DOUGLAS WASS

You spoke to the Chancellor this morning about the case for getting away from "Autumn Budgets", and ensuring that announcements come out in a trickle, rather than a flash-flood ~~or in~~ when the dam breaks in late November/early December.

2. It was agreed this morning that this issue, and the wider one of the Armstrong proposals, should be discussed at the Chevening Conference in January.

3. As a coda to this morning's discussion, and in case it may be helpful in preparing papers for Chevening, I should record that the Chancellor last night minuted to me as follows:-

> "The wider questions - embracing the whole of the Armstrong proposals - do now deserve fuller consideration, since I have some sympathy with the Prime Minister's view that we are now moving towards the worst of both worlds. So far from finance determining expenditure, the coach is still moving well ahead of the horses. And the "simultaneous publication" of PEWP and FSBR is a relatively fictional affair. For we have to defend and present one side only at this time of year.
>
> Possible approaches, not mutually exclusive, include:-
>
> (a) uncoupling and spreading out the three components in yesterday's announcements, e.g. by preparing, and publishing, the Industry Act forecast early, on the basis of conventional assumptions (e.g. spending to be in line with the previous PEWP); publishing the Government Actuary's report late; abandoning publication of more than a few major public expenditure decisions before Budget time

/or publishing the

722

or publishing the full PEWP (or a skeletal one) by Christmas; or

(b) publishing both sides of a provisional budget at an early (i.e. late autumn/early winter) stage in an effort to oblige people to look at both sides of the account."

4. The Chancellor has emphasised to me that these suggestions were no more than provisional and preliminary thoughts, designed to stimulate constructive discussion.

JOK.

J O KERR
4 December 1981

From: Sir Douglas Wass
Date: 22 December 1981

MR BURNS — Yes ✓ phned D.W.'s office 23/12 to say yes J.
SIR K COUZENS )
SIR A RAWLINSON) Copy to each
MR RYRIE )
MR KEMP )

CHEVENING

As you know the Chancellor is anxious that any participant of the Chevening seminar who wishes to be accompanied by his wife should be able to do so. The wives would join the participants at meals, but would otherwise "amuse themselves". Five of the Ministers/Special Advisers have said that they would like to take advantage of this offer.

Would you please let me know, before the Christmas break if possible, whether you would like to be accompanied? For your information my own wife will join me. I fear that I am having to make a charge for wives, based on (short-term) marginal costs. I have provisionally put this at £20, but will give a more exact estimate next week when I have seen the costings.

DW.

DOUGLAS WASS

→ ~~Mr Spackman~~ [initials]

A34

This 'correction' table on p 3 cannot be correct - can it?

B

MR BYATT O/R

cc Mr Burns
Miss Brown
Mr Kemp
Mr Stannard
A 3

THE LONGER TERM

We discussed some revisions for the Chevening paper. Mr Kemp has also raised some points. We have these in hand.

2. There are though one or two jottings which I made at PCC which it may be helpful to record. I am copying to Terry Burns for information, as some touch on points which he raised.

i) The New Zealand Planning Council: Mrs Holmans and I had an informal meeting earlier this year with some ex New Zealand Treasury staff now at their High Commission (mainly to discuss Health expenditure). One outcome was our learning about their Planning Council. I enclose (top copy only) a careful appraisal of the Council, and for copy addresses some extracts. A similar Council for the UK would not be feasible. But the functions listed in "Appendix 1" so closely echo some of the thoughts expressed by Sir Douglas Wass that I think you should know about it.

ii) Publication and public debate: Two related points. First, I doubt that the present exercise is suitable for publication, because it is tied to only one political stance. Second, any exercise which looks at a wide range of political priorities must I think be done by a non-official body. Political realities would not allow the development, consideration and publication of such work officially, even if we had the resources to do it. We could of course, provided Ministers did not object, help the non-official body. The end product would be more useful if we did.

iii) The resource implications of privatising services: I was mildly concerned that PCC seemed to assume that services were



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funded centrally mainly for reasons of equity, so that charging, although politically difficult, at least should be in economic terms efficient. If people wanted more health care they would buy it - more resources would then move into supplying it. For some services this may be true. For the biggest programme, Health, it is not. There is an overwhelming case on resource grounds for tight central control on the supply of health services. Free markets,(the main examples being the USA, and Canada until they outlawed medical insurance) lead to serious overprovision: essentially because patients still do not pay-as-they-use (they are insured, often by their employers) and the amount of care supplied and it price is determined largely by the doctors themselves. This is not to say there are no sensible alternatives to the NHS, nor that market disciplines, and consumer choice, cannot be increased: this is now being studied. But there is much more to the method of funding than equity. This general concern was also voiced after the meeting by Mr Kemp, spontaneously, from his experience as head of SS group.

iv) A social security sector: Many European countries, I believe, have a private sector, a public sector, and a social security sector. The last of these, funded largely by employer and employee contributions to a central fund or funds, covers the "DHSS" areas, including health. This may be one of the strategic issues which an outside study might consider: would this be a polically more acceptable way of funding? Or would it, like NIC, be seen just as another tax. The social insurance option for health is one that DHSS are now looking into. For now we have decided not even to mention the idea of a "third sector", for fear that DHSS would make too much of it. But worth a thought perhaps for the future.

v) GDP growth assumptions: This is our first experience of the word processor and I am afraid it played a trick on us with Table A3. We will keep an eye on it in future. The figures for the first three years in the PCC version were correct, but the whole table should read:

GDP (1979 - 80 = 100)

| | Low GDP growth | Intermediate | High GDP growth |
|---|---|---|---|
| 1979 - 80 | 100 | 100 | 100 |
| 1980 - 81 | 95.96 | 95.96 | 95.96 |
| 1981 - 82 | 95.6 | 95.6 | 95.6 |
| 1985 - 86 | 97.6 | 103.5 | 106.0 |
| ? 1990 - 91 | 100.0 | 111.5 | 110.0 |

Mr Burns referred to the table, but I do not think it misled him. The figures mean that the income effect on demand for services should be small for the "low growth" scenario over this period. But I agree that this effect should be mentioned for the high growth case and for the still longer term, as it already is in your Chevening draft.

vi) <u>Uprating of social security payments</u>: Mr Burns asked about this, and may like a more detailed reply. In the low growth scenario benefits are assumed to be maintained in line with prices. In the high growth scenario most benefits (77% of the total), are assumed to increase in real terms by about 1 per cent per year from 1982 - 83.

MS

M J SPACKMAN

23 December 1981

SUMMARY RECORD OF A DISCUSSION BETWEEN THE CHANCELLOR AND THE GOVERNOR AT NOON ON 23 DECEMBER, 1981 IN THE TREASURY

Present:

| | |
|---|---|
| Chancellor of the Exchequer | Governor |
| Sir D Wass | Mr George |
| Mr Ryrie | |
| Mr Kerr | |

---

The Chancellor explained that he had thought it worthwhile to have a short discussion before the Christmas break on:-

a. likely market developments, and how to respond to them, over the Christmas period; and

b. preparations for the Seminar which the Prime Minister had convened for 7 January (Mr Scholar's letters of 21 December.)

2. The Governor and Mr George described the current situation in the markets. Sterling had in the last few days risen, as the dollar rose; though over the last month there had been a fall of 1 per cent on the effective rate. The gilts market was now very quiet. In the money markets, rates at the longer end were rising, while at the shorter end they were being held down by bank dealings. The bank was in fact leaning against a rising trend in rates. The Chancellor enquired whether there was any prospect of interest rates easing over the holiday period: the Governor thought not. The bank had clearly signalled to the markets that it was trying to hold rates down, but its ability to do so was necessarily limited. Mr George added that there was unlikely to be any downward movement in US rates before the New Year, though some might occur in January. The Governor added that the exchange rate, and money supply, arguments had pointed, and still pointed, to rates higher than those which now obtained: in working to hold rates down, the authorities were deliberately disregarding the

/evidence of the growth

evidence of the growth of £M3 and, to a lesser extent, the other aggregates. Other desiderata were regarded as more important in present circumstances.

3. Mr Ryrie and Sir Douglas Wass wondered whether a rise in the exchange rate, occasioned perhaps by the trade figures, or the Polish situation, might justify a small downward movement in the rates. The Governor did not exclude this, if the rise were substantial, but he and the Chancellor agreed that there was no case in present circumstances for immediate action further to lower interest rates.

4. The Chancellor however suggested that it might conceivably be sensible to move the unpublished band down a little. With dealing taking place at the bottom end of the band, the impression might be conveyed - to those aware of the position of the band - that the authorities were expecting rates to rise. The Governor thought that moving the band down, if it were a signal at all, would be a perverse signal in current circumstances. It was however agreed that the Bank and the Treasury should separately discuss whether it was right that movements of the band should take place only when rates were at either end of it, and it was intended that they should move outside the area covered by its present position.

5. Turning to preparations for the Seminar on 7 January, the Chancellor agreed that a preparatory meeting of Treasury and Bank participants would be appropriate. He did not envisage sending No.10 many new papers in advance: most of the ground likely to be explored had already been covered in the note on "Monetary Policy and the Exchange Rate" which was sent to No.10 on 14 December. He had considered submitting the Economic Secretary's paper on Indexed Gilts, but was on reflection inclined to think that this would be unnecessary. On EMS, the Prime Minister had his own autumn paper, which Lord Carrington had also seen: the Governor's November letter would however be a useful addition. (The Governor agreed to its submission.) An annotated agenda was in preparation in the Treasury. The Governor said that the Bank would

/prepare a note on the

prepare a note on the market situation, and developments over the Christmas period. He suggested that the Chancellor might lunch with him shortly before the Seminar (and a lunch on 5 January has subsequently been arranged.)

6. The meeting ended at 12.45 pm.

JOK.

J O KERR
24 December 1981

Distribution:

PS/Economic Secretary
Sir D Wass
Sir K Couzens
Mr Burns
Mr Ryrie
Mr Middleton
Mr Monck

PS/Governor

Collect papers.



SIR ANTHONY RAWLINSON

c Sir D Wass
Mr Burns —
Sir K Couzens
Mr Ryrie
Mr Barratt
Mr Littler
Miss M P Brown
Mr Kemp
Mr Mountfield
Mr Spackman o.r.
Mr Stannard

CHEVENING: LONGER TERM TRENDS IN PUBLIC EXPENDITURE

I attach a final version of the paper, amended in the light of the PCC discussion and your own comments.

2. I presume that all the Chevening papers will go to Ministers at the same time and that the Central Unit will let Mr Stannard know how many copies they will need.

IB

I C R BYATT
4 January 1982

**LONGER TERM TRENDS IN PUBLIC EXPENDITURE**

The emerging picture

In preparation for the next public expenditure survey, Ministers will want to look at the longer term evolution of public expenditure in the light of their decisions in the first 2½ years of this Parliament. This paper begins to set the stage for this by looking at public expenditure against the background of the prospects for the economy. It is inevitably broad brush, but gives advance warning of problems lying ahead.

2. The projections in this paper assess the consequences of present policy. Figure 1 shows that total public expenditure, when built up from an analysis of what is happening within each programme, is still on an upward trend, although at a much slower rate than before 1979. It is unlikely to fall relative to GDP. Because of this the tax burden is likely to remain at its present high level and could even increase.

3. The projections for the individual programmes are shown in figures 2 and 3. Important features include some check to the growth of social security expenditure compared with the past two decades, and strongly rising expenditures on defence and on health.

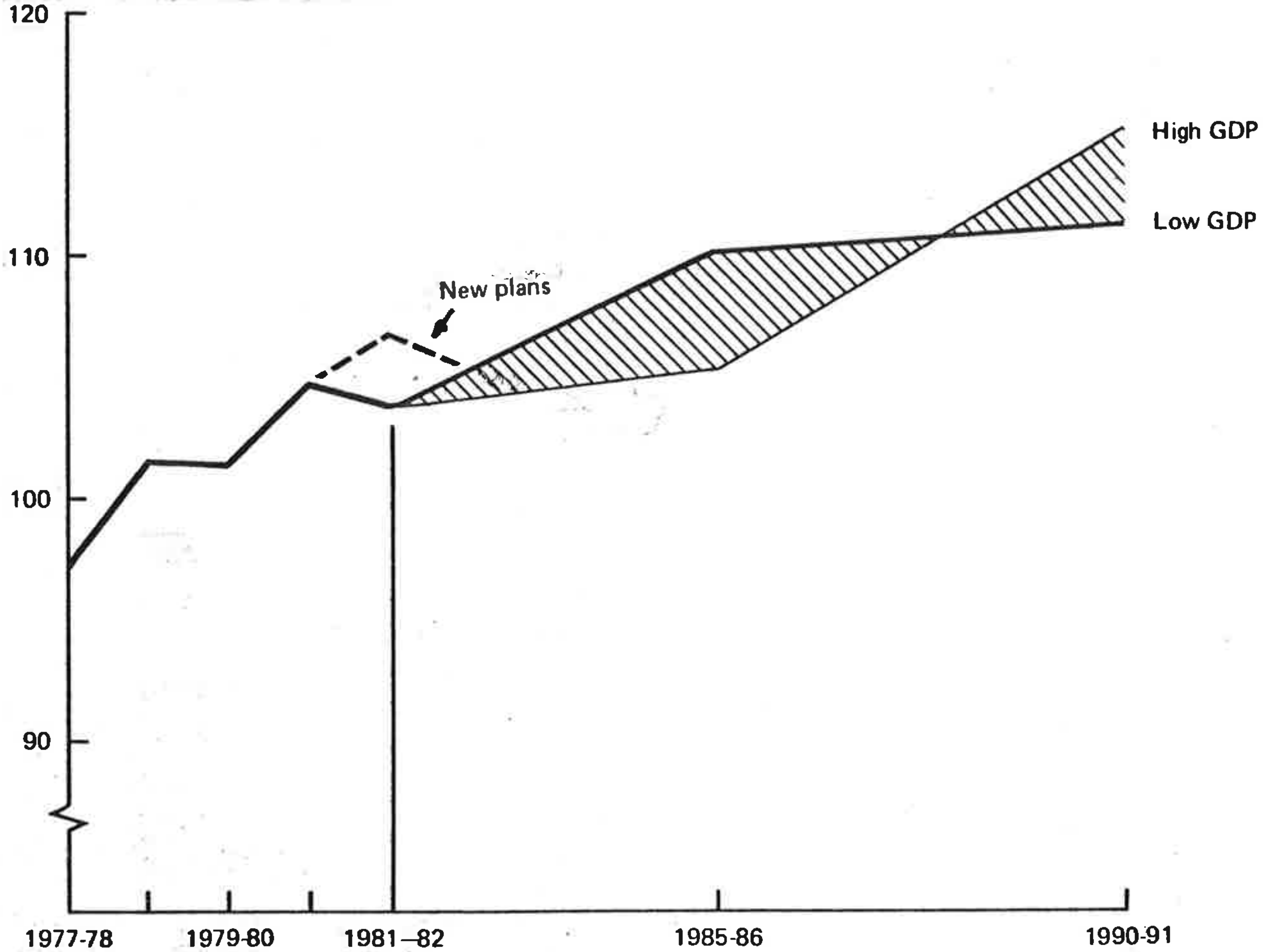
Basis of the public expenditure projections

4. The projections take account of recent decisions. We have not presumed on future actions but projected trends which broadly reflect decisions taken so far. Thus, for example, the NATO defence target is maintained indefinitely.

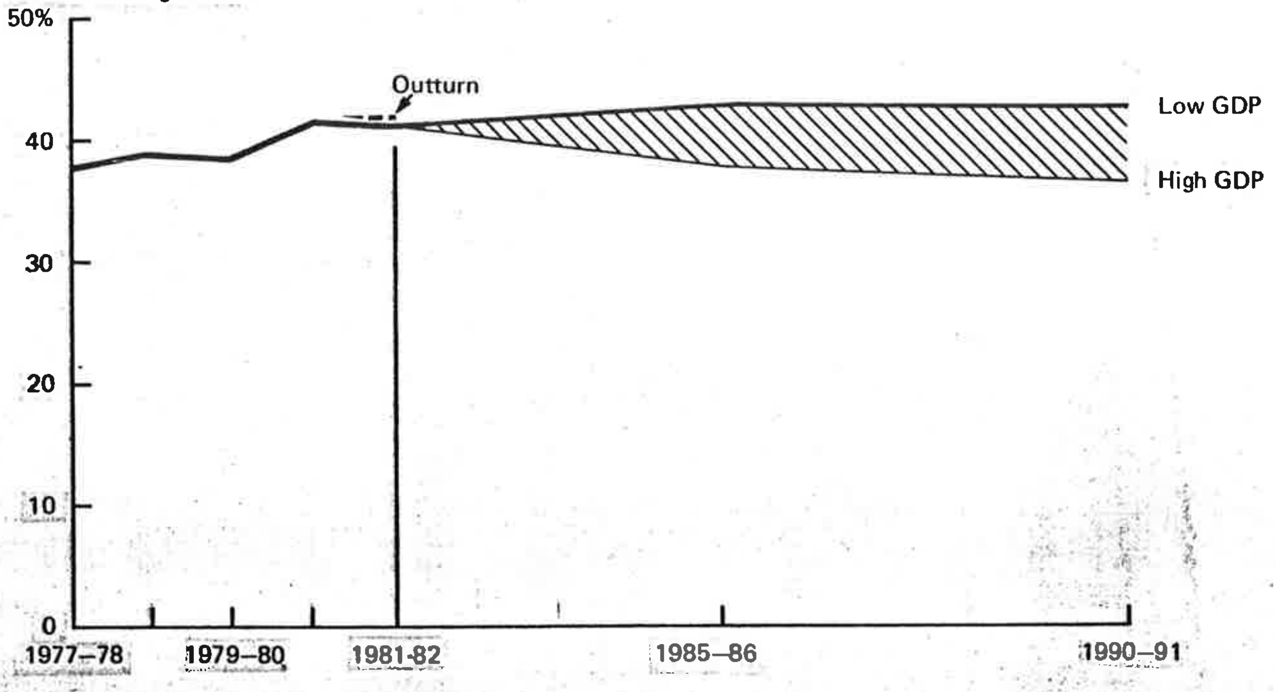
5. The projections are at 1981-82 prices, but include relative price changes, rather than in cash, because of the difficulty of foreseeing the path of inflation many years ahead. This is reasonably satisfactory for the programmes and the planning total. The projections include estimates of the likely changes in relative prices of inputs such as labour and more sophisticated equipment. Account has also been taken of other "determinants", such as demographic trends and (for social security) unemployment. The projections are inevitably subject to a fairly wide margin of error and should be seen as thick lines on a graph rather than precise figures. The years 1985-86 and 1990-91 represent the mid-eighties and the end of the decade rather than precise dates.

FIGURE 1 — Planning total

(a) £ billion (1981-82 cost terms)




(b) Percentage GDP




Note: Pre 81-82 figures are based on Cmnd 8175 unless stated otherwise

FIGURE 2

**Public expenditure by programme, cost terms**

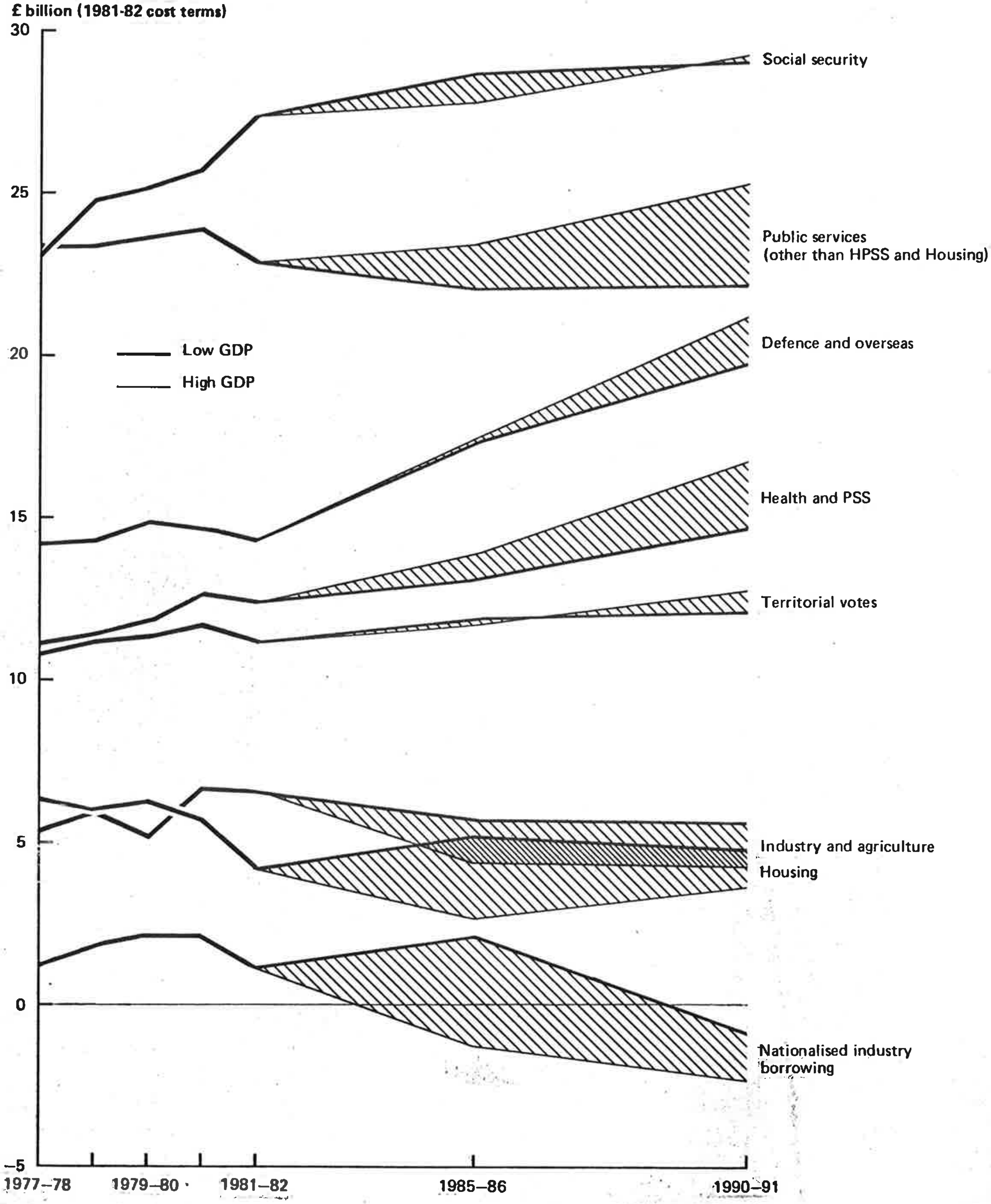
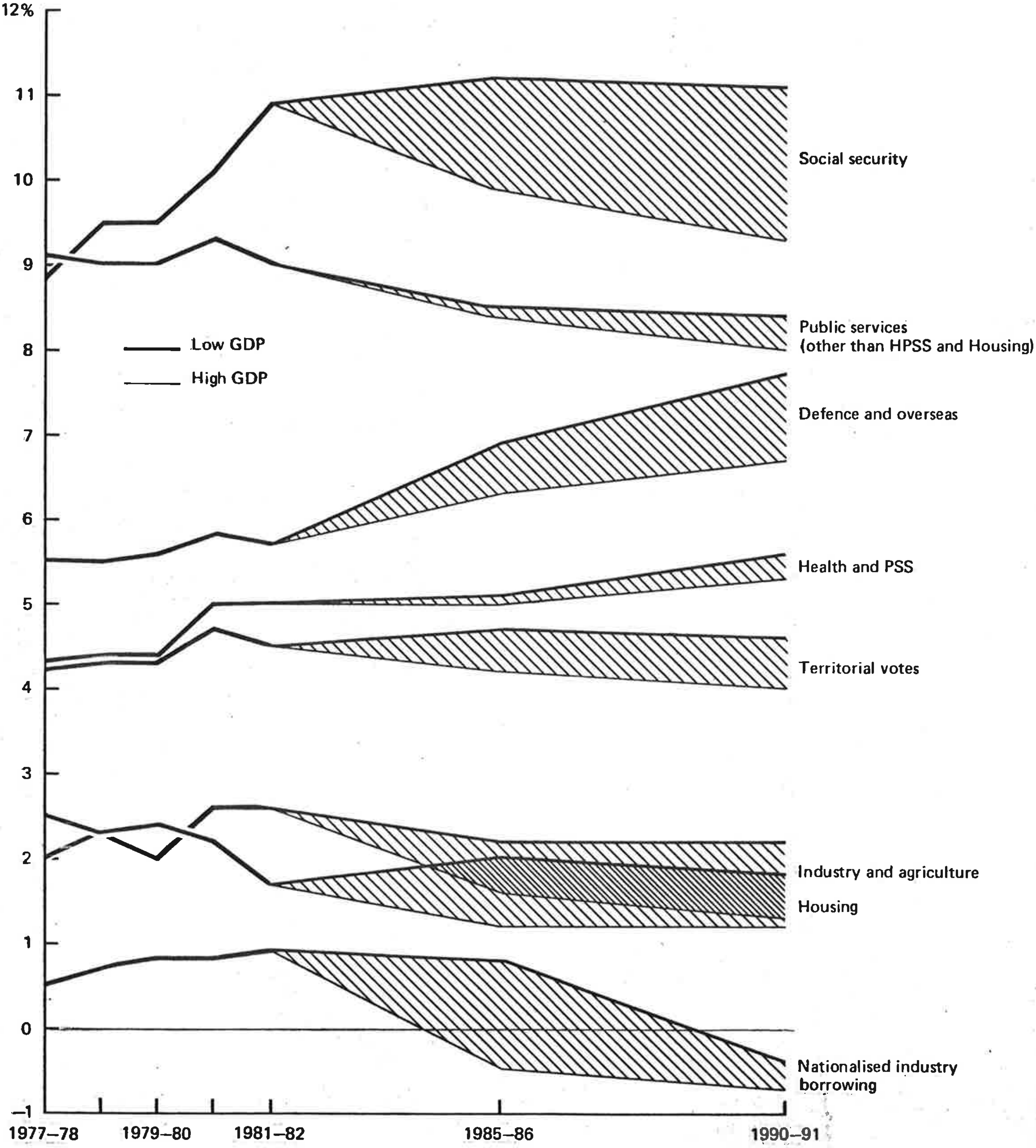


FIGURE 3 **Public expenditure by programme relative to GDP (Percentage)**



## The economic scenarios

6. Two broad scenarios are used, drawn from earlier work.* They show GDP growth rates of ½ per cent and 2½ per cent a year. The low projection illustrates a continuation of the poor growth performance since 1973, the high one a gradual return to a growth picture which by the nineties is broadly similar to that achieved in the fifties and sixties. The recent Industry Act forecast is close to the low growth scenario. For this reason, and because of the tendency in the past to over-predict economic growth and under-predict public expenditure, the figures for public expenditure on the low growth scenario deserve more attention.

7. Economic growth has several effects on the public expenditure totals. The higher the rate of productivity growth the higher will be average real earnings in the private sector. This will pull up public sector earnings and so raise the real costs of public service programmes. The public's demand for some services is related to income levels; as people get richer they want more health and education and a better environment. But this effect is largely suppressed in the projections. For the high GDP scenario, especially, this may be optimistic. Social security expenditure is also affected by the level of activity; in the low growth scenario it is assumed that unemployment will remain high.

## The position in more detail

8. (a) Planning total

Figure 1 shows the public expenditure planning total in 1981-82 prices and as a share of GDP, in the mid-1980s and the end of the decade. It also sets out the expected outturn in 1981-82 and recently agreed total for 1982-83. If economic growth were buoyant, the impact of high productivity on public sector costs could push the total sharply upwards later in the decade. But despite the higher total in cost terms, public expenditure declines as a share of GDP in the high GDP scenario. Growth brings its own rewards. The low GDP scenario implies that public expenditure may remain nearly constant as a proportion of GDP throughout the decade.

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* These two scenarios were approved by the then Financial Secretary earlier this year and seen by the Chancellor in July in the course of correspondence with the Trade Secretary. They became public knowledge in the course of Department of Trade evidence to the Stansted Inquiry.

(b) Defence and overseas services

The defence expenditure projections show what would be the effect if the NATO 3 per cent real growth target were continued throughout the decade. In the low GDP scenario defence expenditure rises from 5 per cent of GDP now to nearly 7 per cent by the end of the decade. Expenditure on overseas aid and other overseas services is especially subject to political developments but is assumed not to change substantially.

(c) Industry and employment

Expenditure in support of agriculture is related to the working of the CAP, the funding of which is uncertain in the longer term. In deference to present policy nationalised industry net borrowing is projected to turn around dramatically by 1990-91 in the low GDP scenario and by 1985-86 in the high case. These changes arise not from any major assumed change in investment, but from much higher assumed levels of internal financing as a result of higher prices and greater efficiency. As noted earlier this would be difficult to achieve. The energy and industry programmes are dominated by subsidy payments, which in practice are affected strongly by the trading performance of individual firms and industries. Projections in this area are particularly uncertain. Expenditure on employment measures is dependent on policy responses to the level of employment. It is assumed in the low GDP scenario that it continues at its 1981-82 level, and in the high GDP scenario that it declines to the levels of the mid 1970's.

(d) Public services

Expenditure on the public services (such as health, education and environmental services) is projected to increase in cost terms in both scenarios, although in the high GDP case this is due largely to relative price increases. As will be seen from the graphs, the main reason for this is the rise in expenditure on health and personal social services. This rise is due largely to the increase in the most expensive client groups for these services (the over-75s and women of child-bearing age). The fall in the number of children of school age lies behind the fall in education expenditure although, as this programme shows, there are difficulties in adjusting expenditure downward when the size of the client group declines. Substantial reductions over the past two years have been made in public service investment, especially in housing. In the low GDP case, some subsequent recovery is assumed, possibly as a concession to pressures for employment creation.

(e) Social security

The level of social security expenditure is as high or higher in the low as in the high growth case. (With low GDP growth there is more unemployment pay: with high GDP growth some growth is assumed in the real value of benefits.) Social security is therefore a much higher proportion of GDP in the low growth scenario. The projected rate of growth of social security is much less than that of the past two decades. This is because of specially favourable demography: birth rates were low in the interwar years and there is no significant increase in the number of pensioners. In later years, and especially beyond 2000, demography, combined with the build up of Better Pensions, will, under present legislation, lead to large increases in the cost of pensions.

Implications

9. The projections both of the economy and of public expenditure are uncertain, and the further ahead one tries to look the more uncertain they become. But we feel that the general picture they portray is sufficiently clear. Figure 4 illustrates some of the expenditure trends in a low growth world. Figure 1 shows the broad implications for the tax burden. These gloomy prognostications are some way distant from the Government's objectives in 1979. To some extent this is because the economy has been slow in responding to policy changes. But the strength of the upward pressures on public expenditure have also been responsible. These pressures could well continue to push expenditure upwards despite the unpopular actions which the Government has taken.

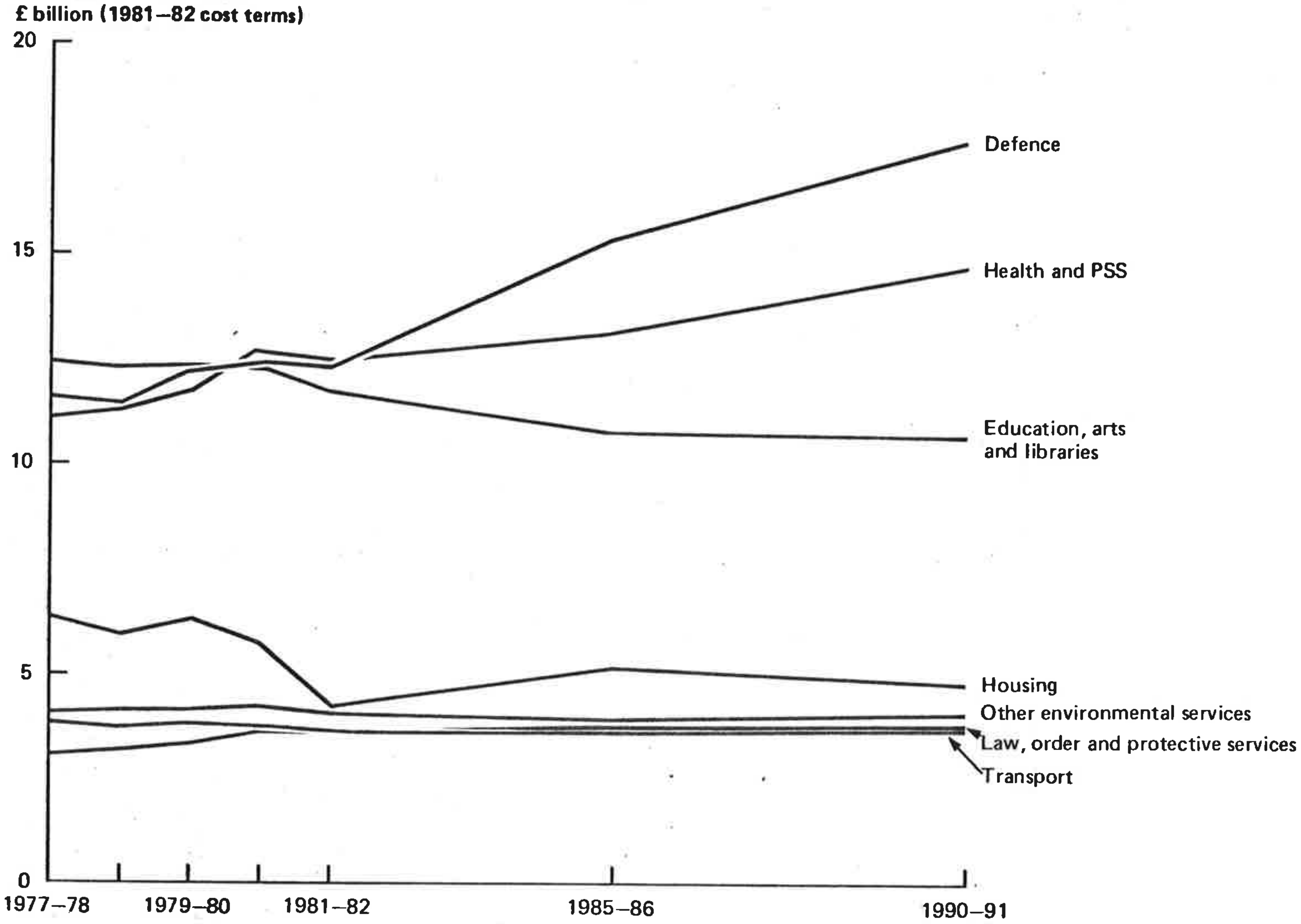
10. If we were to return to a relatively high rate of economic growth, the picture would be more encouraging, although, as this paper has indicated, this could bring about some additional problems. But although growth would help, it is necessary first to achieve it.

11. These considerations suggest an approach on several fronts:-

(a) First, what can be achieved by an even tougher stance on public expenditure. The need to persist with increasing defence expenditure at 3 per cent a year in real terms regardless of the growth of GDP has to be questioned. The pledge to maintain pensions in real terms may become unrealistic if the living standards of the working population do not revive. It may be necessary to be more vigorous in reducing expenditure in programmes such as education where client groups are falling despite local opposition to reducing the numbers of schools.

CONFIDENTIAL

FIGURE 4 **Expenditure on public services and defence, low GDP scenario**




CONFIDENTIAL

(b) Second, can more money be raised from charges for public sector activities, or other new arrangements, on the grounds that levying money in this way might have less disincentive effect than conventional taxes? The Institute of Economic Affairs has suggested a number of areas where this could be done, although there are some obvious difficulties. The study of new ways of financing health care is exploring this type of approach, although as that study is showing there can be reasons of economy and efficiency for central funding of public services.

(c) Third, assuming that, whatever may be done on public expenditure, it will remain necessary to levy taxes on much the present scale, should ways of changing the structure of taxation be examined with the objective of reducing its harmful economic effects? Increasing the coverage of VAT (eg to energy), despite manifesto commitments, is relevant here. There is also a strong case for achieving as much tax as possible in ways which have low disincentive effects, such as the present regime for taxing North Sea oil production.

(d) Finally, what could be done to develop public awareness of the limits to public expenditure; to encourage a political climate which eschews pledges which then tie Ministers' hands; and to create a climate where it might be possible to question major longer term commitments, such as Better Pensions? It might be helpful to encourage (or even commission) work by non-official bodies on longer term public expenditure trends and their implications.

Public Sector Group Economists
4 January 1982

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CONFIDENTIAL

## PAPERS FOR CHEVENING: PUBLIC EXPENDITURE

### Note by Sir Anthony Rawlinson

Attached are three papers on public expenditure matters, for discussion at Chevening.

A The first is about the public expenditure timetable and the budget, covering questions which the Chancellor indicated he would like to discuss about the timing and nature of public expenditure decisions and announcements.

B The second consists of notes on four major matters which will require attention during the coming months.

C The third is a paper by Mr Byatt and others about longer term trends in public expenditure.

AKR

A K RAWLINSON
5 January 1982

CONFIDENTIAL

PUBLIC EXPENDITURE TIMETABLE AND THE BUDGET

Should we continue to announce in the autumn the public expenditure programmes for the year next ahead and publish the full White Paper at Budget time? Does there have to be a comprehensive public expenditure announcement in the autumn? Can, should it be de-emphasised, to avoid the label mini-budget? Or made a more balanced and comprehensive trailer for the main budget, ie a preliminary "green" budget, as advocated by the Armstrong group?

2. This note argues that the answer to the first two questions is yes, and that the choice is between continuing much as in the last two years, or moving in the direction of a "green" budget in the late autumn, so as not only to consider but also to present publicly both sides of the budget together.

## A common conflict

3. As to timing of public expenditure announcements there is a common conflict. Good management of individual programmes is aided by early decisions, promptly communicated to those concerned, which in practice means announced, provided always that the decisions are not later reopened. Economic and budgetary policy usually prefers to keep options open as late as possible, including the option of further adjustments in the public expenditure programmes.

4. The main tax decisions can mostly be delayed until the spring budget. The desire to link expenditure more closely to them therefore becomes an argument for delaying the expenditure decisions. But some compromising is necessary.

## The expenditure decisions for the year next ahead

5. The main decisions on the expenditure Survey for the financial year next ahead should be taken by the end of November at latest.

Reasons:

(i) It is a basic principle of the public expenditure survey that the main decisions should be taken together, so that they can be considered in relation to each other, and to the totals. This is sensible, and helpful to policies of restraint.

(ii) For operational reasons some of the main expenditure decisions must be taken, and communicated to those who have to act on them, well in advance of the beginning of the financial year, especially for programmes administered through subordinate authorities: the local authorities, the national health service, Arts Council, etc.

(iii) Decisions requiring legislation need adequate lead time. For example, if national insurance contributions are to be increased to an extent which needs legislation and this is to be effective for the whole of the next financial year, decision is needed in November. Such a decision should have regard to the needs of the NI Fund and be so explained to Parliament and publicly. So the decision on the following year's uprating of benefits ought also to be taken at the same time.

(iv) More generally the Parliamentary Estimates timetable requires decisions by end November on the main programme figures for the next year, so that the detailed Estimates can be derived from them.

6. There are some arguments for an earlier date. The points just mentioned are about what is operationally necessary. But if it is desired to reduce spending, it helps to make this known to the bodies concerned earlier rather than later. Thus, for local authorities and nationalised industries final decisions can be delayed until about November, but downward pressure on their plans will be more effective if some guidance is given not later than early August.

7. It used to be stated as the aim to reach conclusions in July. But -

- in practice decisions commonly slipped into the autumn.

- even if decisions are recorded in July, the risk is high that they will then get reopened.

- cash planning now implies that the decisions involve a view about pay and prices. Future surveys will start from cash plans. It may not be necessary to specify pay and price factors as precisely as in 1981, but some assumptions about inflation, especially as to pay, will have to be adopted, and will have to be made public. It will often be desirable to leave these decisions as late as practicable.

- discussion in the autumn can take account of the autumn economic forecasts and of thinking about tax measures in the next budget partly related to that.

8. The conclusion is that the right timetable for decisions is broadly what has been aimed at in recent years, that is to conclude the Survey in November. In the event the 1981 Survey ran a little late, leaving the time for Estimates and the White Paper uncomfortably compressed.

9. There will be advantage in giving some preliminary guidance to local authorities and nationalised industries in July/August. It can be provisional but implies taking some view in the summer about the broad prospects and the direction in which policy should go.

<u>Form of announcement</u>

10. Operationally it would be conceivable to announce the expenditure decisions in a trickle, as required for the various programmes. (The later the decisions, the more compressed the trickle.) But the arguments are strong for a comprehensive announcement of the programmes for the year next ahead:

- it will be known that the decisions have been taken, which leads to strong pressure to publish them.

- there will be leaks, probably garbled.

- it is better for Treasury Ministers to present the decisions in the way they wish in relation to the emerging total and the macro-economic context.

Expenditure decisions for the later years

11. There is not the same operational need to take by a particular time the decisions for the later years, but it is obviously convenient, and sensible, to deal with them in the same operation; and if they are to be published in a full White Paper at budget time, November is not too early for the main decisions.

12. One feature of recent Surveys has been the tendency to concentrate on the year next ahead and pay little attention to the later years. This loses some of the benefit of looking at expenditure over a period of years. Closer linking with tax policy may in practice tend to emphasise the year next ahead. But some of the recurrent problems over excessive expenditure can be linked with neglect of the realistic consequences in later years of the policies adopted.

Industry Act Forecast

13. There is no operational need to couple the public expenditure announcement with that of the Industry Act forecast.

14. If the forecast precedes the announcement, it will have to use public expenditure figures from the last White Paper, known to be different from those about to be decided. This may attract criticism as futile and pressure for a fresh, updated forecast. It can be published later than the public expenditure announcement, but if this is not until late November, it is a question whether anything is gained by delaying the Industry Act forecast for a further week or two. To publish it after Christmas would bring it oddly close to the Budget, and raise questions about consistency with the Act.

## The White Paper

15. It takes at least 10 working weeks (ie excluding the Christmas/New Year holiday) to produce the full White Paper after the programme decisions have been taken, and work on any immediate announcement concluded. If decisions are taken in November, it might be practicable to publish the White Paper slightly before the Budget (but not in 1982). This would move away from the conjunction with the budget. This has no operational significance but has been thought symbolically appropriate.

16. It would be possible to publish in the autumn, as in 1979, a short White Paper confined to the year next ahead, to be followed by the full White Paper later. This would be little different from the type of announcement of the last two years. It makes it slightly more difficult to defer decision on the few elements which otherwise need not be settled in the autumn, notably the Contingency Reserve and thus the final total. Some merit in keeping these open until nearer the Budget. It would also require more time between decisions and publication.

## Budgetary character of autumn announcement: mini or green?

17. How far a public expenditure announcement in November/December has the character of a mini budget depends to some extent on its content. It is not certain that in every year there will be new charges, or increases in national insurance contributions, which attracted the main public attention this year, and enhanced the resemblance to a budget. But there will quite often be such elements.

18. A more balanced picture might be presented by saying not less but more about the tax side. A comprehensive announcement covering tax as well as expenditure would be a move towards the Armstrong "Green Budget".

## A late autumn Green Budget

19. Variations would be possible as to the degree of provisionality and degree of detail, but a comprehensive Green Budget in the late

autumn could come to rival as an occasion the "ordinary" (or "White") Budget of March. This would confirm or modify the broad decisions announced in the Green Budget, and fill out details not settled or not announced then. But the presumption would have to be that broadly decisions announced in the Green Budget would stand.

20. This procedure would imply considering and discussing in Cabinet at the time when decisions on public expenditure are being taken, that is, in October/November, firmer views than hitherto about the next year's tax and borrowing. It might not be necessary to go into great detail, but the Chancellor would have to take and express a view broadly whether to increase or reduce the fiscal burden, how the increase or reduction would affect individuals and companies, and what sort of instruments would be used.

21. This would have the advantage of enabling tax objectives to be ranked alongside public spending objectives, rather than left to become the residual. It could have advantages in negotiations with spending Ministers.

22. But there are some risks and disadvantages:

a) It would overtly bring Cabinet colleagues into the Budget-making process, both as to fiscal stance and as to relatively detailed tax measures. But this may be the direction in which we are moving anyway, if the public expenditure discussions are to be more closely linked with their implications for tax and with tax objectives.

b) By adding to the range of matters for consideration by Treasury Ministers and for discussion in Cabinet in the autumn it would make it more difficult to put through the essential expenditure business punctually. (Problems of absences, party conferences etc).

c) If the Green Budget tax changes do not come into effect until 1 April, there could be a problem of forestalling.

Judgment would be needed whether this is acceptable, or whether changes have to take effect from the date of announcement, ie November or December.

d) The Green Budget decisions would be based on conditions and forecasts likely to be superseded by the time of the White Budget. There would be a special problem if the Green Budget were other than roughly neutral. If the judgment in November is that tax increases will be necessary in March, the Chancellor will be under pressure to change his mind between November and March. If the Green Budget is "generous", there will be disappointment if the White Budget is not. Generally, significant change between the two will be difficult, and defeat much of the object of the Green Budget.

e) Similar arguments of uncertainty and risk of change apply to the fiscal stance, its relationship to a Medium Term Financial Strategy and to the PSBR, and the effects on markets of announcing in late autumn, a fiscal stance for the forthcoming financial year.

f) Criticism would probably increase that the autumn expenditure announcement contains too little of the additional detail which can only be elaborated in the full White Paper. Thus pressure would increase to bring this forward which would require still earlier decisions.

23. These difficulties are quite strong. In so far as they cause the Green Budget to be more tentative and provisional, this loses some of the benefits too. But there is merit in bringing tax more into the discussion of public expenditure decisions, and if this is done, it may not be all that great a further step to bring it more into their announcement.

24. The Treasury Committee are planning hearings on the Armstrong proposals in which it will be necessary to go over all this ground in public in the next few weeks.

HM Treasury
4 January 1983

CONFIDENTIAL

## PUBLIC EXPENDITURE: PROBLEMS AHEAD

Attached are four notes, based on material by Mr Barratt, Mr Littler, Mr Kitcatt and others, about certain major matters concerning public expenditure which will require attention during the coming months.

2. The first note points to certain problems concerning the further development of cash planning.

3. The second and third notes are about what are today the two greatest obstacles to the reduction in public expenditure at which Treasury Ministers have aimed: the protected programmes (defence, health, social security, law and order) and the lack of control over local authorities' current expenditure.

4. The fourth note refers briefly to the current work on financial management. This may not lend itself to discussion at Chevening, but for the longer term it is an important and we believe useful development.

AKR

A K RAWLINSON
5 January 1982

CONFIDENTIAL

## I. PROBLEMS OF CASH PLANNING

The move to cash planning of public expenditure has gone well in this first transitional year. Much of the argument during the Survey was about implicit volume or levels of services. That was right: sensible planning of expenditure requires attention not only to the cash amounts but to what they are intended or expected to buy; and this is especially the concern of the Ministers responsible for programmes. But the new cash system has been accepted, and its discipline in general respected, save in defence. Most demands for "restoration of volume" or "compensation" have been successfully resisted, at least in form. The use of up to date values has given the discussion the desired sense of actuality and an easier and more direct relationship to revenue and PSBR calculations.

2. In 1982-83 holding to the cash provision agreed will encounter renewed problems concerning local authorities (see separate note), possibly concerning nationalised industries, probably again concerning defence. In general cash limits will be tight, reflecting the carry forward under cash planning of squeezes from the current year, the deliberately tight 9% and 4% cash factors, the 2% or larger cuts in cash-limited programmes. A final decision on the amount of the Contingency Reserve can wait until the end of January. It should be the minimum that is realistic, but it must be enough to make holding it a realistic task. Once fixed, it <u>must</u> be held.

3. The Treasury Committee may be expected to renew their pressure for more volume information in the Estimates and the White Paper. Pressure for "volume" figures at constant prices should be resisted, but it will be unavoidable that frequent reference be made or implied to expectations of the pay and price movements relevant to individual programmes.

4. Cash planning should in principle simplify the transition to the next Survey. The cash provision for future years as determined in 1981 provides a starting point with no automatic need for revaluation. But some problems lie ahead.

5. The forecasters are guessing that inflation may be higher by perhaps 2% than the 6% and 5% assumed in the cash programmes for 1983-84 and 1984-85. The difference may have to be displayed in the budget publications. In any event decision will be required at the beginning of the next Survey whether (a) to stick to the present cash figures as the starting point, leaving the discrepancy to emerge as additional bids by spending Ministers for all or most programmes, or (b) to seek to pre-empt most of these bids by a general percentage increase in cash programmes at the start, not necessarily of the full amount of the discrepancy. In either case Treasury Ministers will have to give general guidance as to the rate of inflation to be assumed.

6. Some general adjustment of cash programmes at the start may be the best way forward. This would be a move away from the purest concept of cash planning, but it was foreseen that pure cash planning might not be sensible for the later years if inflation were to move differently by a large amount from expectation. Piecemeal adjustment of individual programmes would be too apt to concede additional provision for relative price changes, and allow the proper consideration by spending Ministers of the real content of their programmes to emerge as renewed claims to entitlement to certain volumes. If after the general adjustment the aggregate looks too high, the remedy is to make policy changes in the Survey, not to mask the need for them by unrealistic provision for inflation.

7. Part of the answer to this problem may be a Contingency Reserve for later years larger than in the past. An apparently over-large Reserve is more difficult to hold, but the Reserve for later years is more an estimating provision than a control limit, and we should not lose sight of the aim of more stable expenditure programmes and totals which ideally stand through several Surveys and provide a realistic element in medium term economic assessments.

## II THE PROTECTED PROGRAMMES

A major obstacle to bringing down the total of public expenditure in the central Government sector is the policy of protection of certain programmes. These protections will become an even more important influence on the total in future years, as further cuts in other programmes become more and more difficult.

2. The protection of these programmes reflects deliberate policy choices. But the pledges which embody them perpetuate these choices in a way which may no longer accord with the choices which would be made today, or in the future.

3. If the practical range of options for public expenditure is to be widened, it must be an objective to avoid fresh repetition or extension of pledges in these areas, especially in the run-up to the next election.

4. But the pledges are a symptom as well as a cause of the political climate. There is therefore the wider polical question what can be done to change this political climate.

5. The rest of this note discusses in more detail the significance of these protected programmes.

6. Four large programmes have been the subject of specific pledges, or other commitments, by the Government. These programmes have accordingly been given specially favourable treatment in successive public expenditure exercises, including the 1981 PES round. They are:

| Programme | Nature of pledge | 1981 Decision |
|---|---|---|
| Defence | To meet NATO target of 3% p.a. real growth to 1985/86; to make provision in 1985/86 that will be 21% higher in real terms than actual expenditure in 1978/79; and to keep Servicemen's pay in line with that of "their counterparts". | 1981/82 cash limit increased to ensure expenditure at least 8% higher in real terms than in 1978/79; addition in 1982/83 to meet the 3% target; additions offered, and still not fully accepted by Mr Nott, for 1983/84 and 1984/85, intention being broadly to meet 3% target in those years. |
| Health | To maintain spending levels at those planned by the previous administration. | Health programme to increase in 1982/83 by 1.7% net over likely outturn for 1981/82 (and say 1% over 1981/82 planned provision). For 1983/84 and 1984/85, real growth at ½% p.a. |
| Social Security | Pledges vary in their explicitness. Full pledge to compensate for price increases in respect of retirement pensions and similar benefits (list in Mrs Chalker's letter of 8 April 1981). Less explicit pledges for other benefits. | Full uprating in November 1982 for all benefits plus 2% catching up for fully pledged benefits. |

| Programme | Nature of pledge | 1981 Decision |
|---|---|---|
| Law and order | Specific commitment to index police pay, and general commitment to support law and order. | Maintain commitment on police pay, and additional expenditure on police and probation services, magistrates courts and prisons. |

7. The protection given to these programmes has very significantly increased their share of public expenditure. Thus in 1978/79 the four programmes (including their territorial counterparts) accounted for about 55% of total public expenditure. By 1984/85 they will, on present plans, account for nearly 62%. It has also seriously inhibited the Government's room for manoeuvre in the tax field. Thus if a decision had been taken to hold spending on defence and on the cash-limited element in the health/programme constant in real terms at its 1978/79 level, the cash saving in 1984/85 would have been around £3-3½ billion.

8. As an illustration of what could still be achieved if it were decided during the 1982 PES to cease to give these programmes as much protection as hitherto (while still giving them relatively favourable treatment), decisions to

- freeze defence, health (gross expenditure on HCHS only), and law and order at their 1982/83 levels in real terms;

- uprate all social security benefits in November 1983 and November 1984 by 2% less than would be required for full price-protection

would save in 1984/85

| | £m | |
|---|---|---|
| Defence | 740 | |
| Health (including territorials) | 110 | |
| Law and order (" ") | 70 | |
| Social Security | 815 | |
| | 1735 | (say £1¾ billion) |

## III LOCAL AUTHORITIES' CURRENT EXPENDITURE

In 1980-81 and in 1981-82 local authorities' actual current expenditure, which represents about 21% of the planning total, has been much higher than intended in the Government's published plans; by about £1bn (6%) in 1980-81 and perhaps as much as £1.7bn (9%) in 1981-82. The weakness of the Government's control over local authority current expenditure is not a new phenomenon, but with the Government's policies of tighter restraint of public spending has emerged as of much greater practical significance and intractability.

2. The problem is partly presentational - of avoiding publishing expenditure plans, including totals, with their implications for economic management, which are not going to be fulfilled - but more importantly of substance, how to bring about an amount and distribution of local authority spending which accords with the Government's economic and other policies, including tax policies.

### Survey procedure

3. Changes are needed in the Survey procedure, to focus attention on the realities of the problem. In the next few weeks LG Group will be working up proposals in consultation with the departments most concerned.

4. Previous practice has been to build up the Survey plans by function, looking at the plans for each service as a whole, with little regard for the spending authorities involved, and with spending Ministers generally free to redistribute Survey provision within their programmes. This procedure was slightly modified in 1980, and in the 1981 Survey, because the paramount need was to compress total local authority current expenditure, in the end the totals were settled first, their distribution being treated as secondary.

5. This is in many ways more realistic, and consistent with the block grant, which operates on aggregate spend for each

ocal authority. But in 1981 it was done in a scrambled way, and the final distribution of the revised plans was still out of line with what local authorities are in practice likely to spend. There is a risk that they will continue to overspend on services (notably school meals, transport and personal social services) where the planned provision is unrealistically low, while cutting less than they might on others (chiefly education) where the provision has been set higher than is necessary or will in the event be spent. The total may look realistic, but the way in which it has been distributed makes it more likely to be exceeded. In future Surveys this problem is likely to worsen. The present plans for the later years are notional distributions of totals implying 2% cuts a year in real terms. The risk is considerable of departing even further from reality.

6. An improved procedure may be again to focus on the total for local authorities' current expenditure (which under present arrangements is what the Government can influence, albeit only indirectly and inconclusively), and treat the distribution between services as secondary. (The treatment in the White Paper needs further consideration.)

7. Such a procedure for the Survey would repeat the broad approach of 1981, but it would be adopted from the start, deliberately, so that the distribution of the totals could be discussed in a more considered and orderly way than in 1981. The aim would be a distribution more realistic than in 1981, thus minimising the risk mentioned in paragraph 5 of needless encouragement to overspend, and to establish from the start that money allotted to the total local authorities' programme is not transferable to other programmes.

8. Such a procedure would call for a preliminary decision by July on the total, at least for the year next ahead. This is awkward for the timetable, but as argued elsewhere, if maximum downward pressure is to be exerted on local authorities' budgeting, the earlier the Government's intentions are made known, the better.

The problem of substance

9. The Government's plans for aggregate local authority current expenditure provide a basis both for voluntary co-operation by local authorities with the Government's intentions and for the calculation of grant as a proportion of planned, rather than actual expenditure. Since taking office, the Government has sought to strengthen its influence by:

a) translating aggregate plans into targets for individual English authorities;

b) penalising failure to meet those targets by cutting grant;

c) reforming the rate support grant system in both England and Wales so as to make measures of need more objective, and to taper off grant for excessive spenders;

d) taking and using powers to cut grant for Scottish authorities which spend excessively, and to prevent them from making the cut good by borrowing.

10. The Government can control its own contribution to local spending. It can thus discourage authorities from extravagance. But some of the highest spenders, ~~including the GLC,~~ largely escape this influence since they receive no RSG. And authorities which choose to do so can still maintain high levels of expenditure by increasing rates.

11. Most local authorities in England are now budgeting to spend within or just above their targets in 1982-83. Three authorities, GLC, West Midlands and Merseyside, whose planned expenditure is about 6% of the total for GB, account for one-quarter of the planned overspending. This illustrates both a good response from a majority to the Government's effort to restrain their spending, and the ineffectiveness of existing controls to protect the totals against determined overspenders.

12. Ministers agreed that further selective powers of restraint are required. In Scotland, where local authorities have no power

to raise supplementary rates, powers are being sought to compel excessive spenders to reduce their initial rate demands. In England and Wales, the proposal to legislate for rate limits enforceable by local referendums has been withdrawn;. powers are now being sought instead to ban supplementary rates. This will not prevent recalcitrant authorities from setting initial rates high. It may encourage them to rate higher than they would otherwise have done, as cover against contingencies. In this way, it could increase rather than restrain spending.

13. The Green Paper on alternatives to domestic rates refers cautiously to the possibility of further powers to limit local authorities'income and expenditure. In practice there would need to be individual cash limits or EFL/rate limits for each authority. The Green Paper says: "The case for the Government taking such powers has to be judged against the very considerable constitutional and practical difficulties that would be involved".

14. Selective powers of control are already effectively available in Scotland, and will be increased by the new rate-reducing power. The Attorney General has advised that similar powers would be much more difficult to implement in England and Wales, particularly because of the division of service responsibilities between Ministers in England; and that their exercise would risk successful legal challenge.

15. The Secretaries of State for the Environment and for Wales are opposed to direct controls. The Chief Secretary has said he believes direct controls may be the right course in the longer term. But they will clearly not offer an early solution. Powers on Scottish lines alone would not necessarily deliver expenditure totals. They are confined to the worst offenders, and their exercise this year has only reduced, not eliminated the threatened Scottish overspending.

16. Effective central control of local authorities' income or expenditure is difficult to picture without substantial reduction in their autonomy, perhaps to the extent where services are effectively controlled from the centre, with devolution rather than separation of powers, on the NHS model.

7. Controlling distribution between services within the total would further erode autonomy. Measures short of direct control, eg reverting to greater use of specific grants, might reinforce the Government's distributional priorities; but would increase pressures on the total, and making economies harder to find.

18. For the immediate future the main influence the Government can bring to bear on the aggregates remains through the support it chooses to provide for local authorities.

19. There may be scope for stepping up pressures on overspenders through block grant. Even without Government action, these pressures may in future be more effective. The full implications of the House of Lords judgment on GLC fares have yet to be established. But the Lords clearly gave some weight to the GLC's failure to consider the consequences for ratepayers when they knowingly sacrificed block grant by planning excess spending. This may induce other authorities to tread more warily.

20. The main other option is a direct cut in RSG. The Government inherited on RSG percentage of 61% in England and Wales reduced in 1981-82, but only by one percentage point, and for 1982-83 from 59.1% to 56% in England, and correspondingly elsewhere. But because plans have been substantially increased for realism, local authorities will receive a higher cash grant from the Government than they would have done had both plans and percentage remained unchanged.

21. If the inevitable upward pressure on rates could be tolerated, a significant cut in RSG remains the single most worthwhile option readily available, and not yet really tried.

5 January 1982

## IV DEVELOPMENTS IN FINANCIAL MANAGEMENT

The central thrust of current work to improve financial management in Government departments is the encouragement of financial responsibility in line management.

2. Government has developed and operated over decades an organisation in which line management is responsible for policies, activities and outputs, but responsibilities are centralised for most inputs: money, personnel, buildings, travel, postage, stationery, etc. This brings some advantages: in propriety, in uniformity, in expertise, in economy in detail. But the failure to relate costs and objectives, and the diffusion of accountability at the management levels at which effective decisions are taken are contrary to current management doctrine, and judged inimical to the best standards of efficiency and economy as a whole.

3. The intended change, already adopted in some of the more obviously "commercial" areas of Government, is extensive and will involve some risks. There is a need to change systems of accounting from the present (largely) input basis to a basis reflecting line management and its objectives. But this is a tool. The essential change is to identify and adopt structures of line management in which objectives and their full costs can be brought together, and the relevant managers made responsible and accountable for them.

4. Redefinition of tasks and responsibilities, coupled with the management information necessary to discharge them, should itself encourage more effective and business-like management in the civil service. But there is need also of more relevant training, and of a wider and more effective distribution of technical financial expertise (in accountancy, investment appraisal, evaluation of outputs).

5. The Treasury is leading in this work, helped by the merger with former CSD manpower control, and with support from Sir Derek Rayner and the Head of the Government Accountancy Service. Several

epartments have embarked on analysis of particular areas in which they hope to make progress; some groups of 1982 Rayner scrutinies will push in the same direction; a few departments are already tackling implementation. The Treasury is preparing general guidance (already informally discussed with selected departmental Principal Finance Officers) and will seek to act as both spur and co-ordinator, with some ability to offer technical assistance.

6. While the Treasury must and will prescribe broad directions, and a few detailed requirements, the essence of this operation is to carry responsibility down to line management. That must also mean down from the Treasury to departments. Outside consultants warn against trying to combine genuine line management responsibility with excessive central control. Some go so far as to question overall manpower and cost control.

7. The most promising development for the Treasury may be:

- to encourage the most rapid progress possible in restructuring financial responsibility in departments;

- to provide advice, warning and general monitoring of developments;

- to maintain tight cash and manpower limits (essential in the absence of net profit criteria in most of Government), but continue to delegate subordinate decisions as far as possible;

- to learn to use the information which will develop from new management accounting systems, to appraise departmental expenditures on the basis of relating costs and objectives, and to develop arguments around these relationships.

8. It should not be expected that benefit will show quickly: it takes time to introduce effective systems, and more time for those concerned to learn to operate effectively. But this is the most promising route to long-term improvements in efficiency and effectiveness.

9. In the medium term these changes need to be reflected in the structure of the Parliamentary Estimates and accounts. We do not want for ever to run two systems, one for management, the other for Parliament. This will involve a lot of work, but Parliamentary opinion goes in the same direction, so Parliamentary opposition is probably not to be expected.

10. As the work develops staff pressures, both of quality and of numbers, may prove something of a constraint. This will apply to some extent in the Treasury itself, and will certainly be encountered as a difficulty with some departments.

11. One of the problems is to see what can be done especially by the Treasury to push things forward as quickly as practicable. At some point in the coming months a Ministerial initiative may be indicated. But not quite yet.

5 January 1982

## LONGER TERM TRENDS IN PUBLIC EXPENDITURE

### The emerging picture

In preparation for the next public expenditure survey, Ministers will want to look at the longer term evolution of public expenditure in the light of their decisions in the first 2½ years of this Parliament. This paper begins to set the stage for this by looking at public expenditure against the background of the prospects for the economy. It is inevitably broad brush, but gives advance warning of problems lying ahead.

2. The projections in this paper assess the consequences of present policy. Figure 1 shows that total public expenditure, when built up from an analysis of what is happening within each programme, is still on an upward trend, although at a much slower rate than before 1979. It is unlikely to fall relative to GDP. Because of this the tax burden is likely to remain at its present high level and could even increase.

3. The projections for the individual programmes are shown in figures 2 and 3. Important features include some check to the growth of social security expenditure compared with the past two decades, and strongly rising expenditures on defence and on health.

### Basis of the public expenditure projections

4. The projections take account of recent decisions. We have not presumed on future actions but projected trends which broadly reflect decisions taken so far. Thus, for example, the NATO defence target is maintained indefinitely.

5. The projections are at 1981-82 prices, but include relative price changes, rather than in cash, because of the difficulty of foreseeing the path of inflation many years ahead. This is reasonably satisfactory for the programmes and the planning total. The projections include estimates of the likely changes in relative prices of inputs such as labour and more sophisticated equipment. Account has also been taken of other "determinants", such as demographic trends and (for social security) unemployment. The projections are inevitably subject to a fairly wide margin of error and should be seen as thick lines on a graph rather than precise figures. The years 1985-86 and 1990-91 represent the mid-eighties and the end of the decade rather than precise dates.

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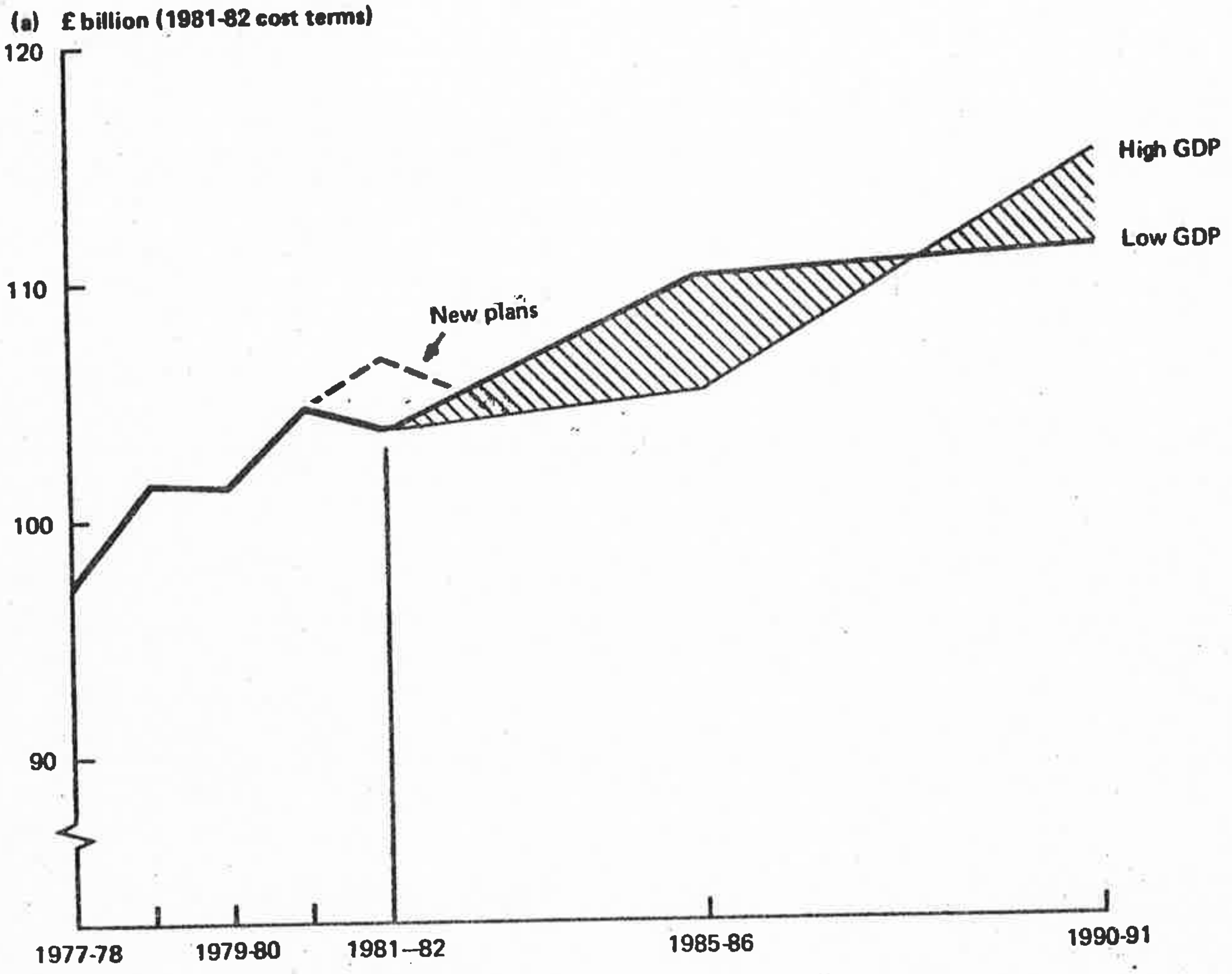
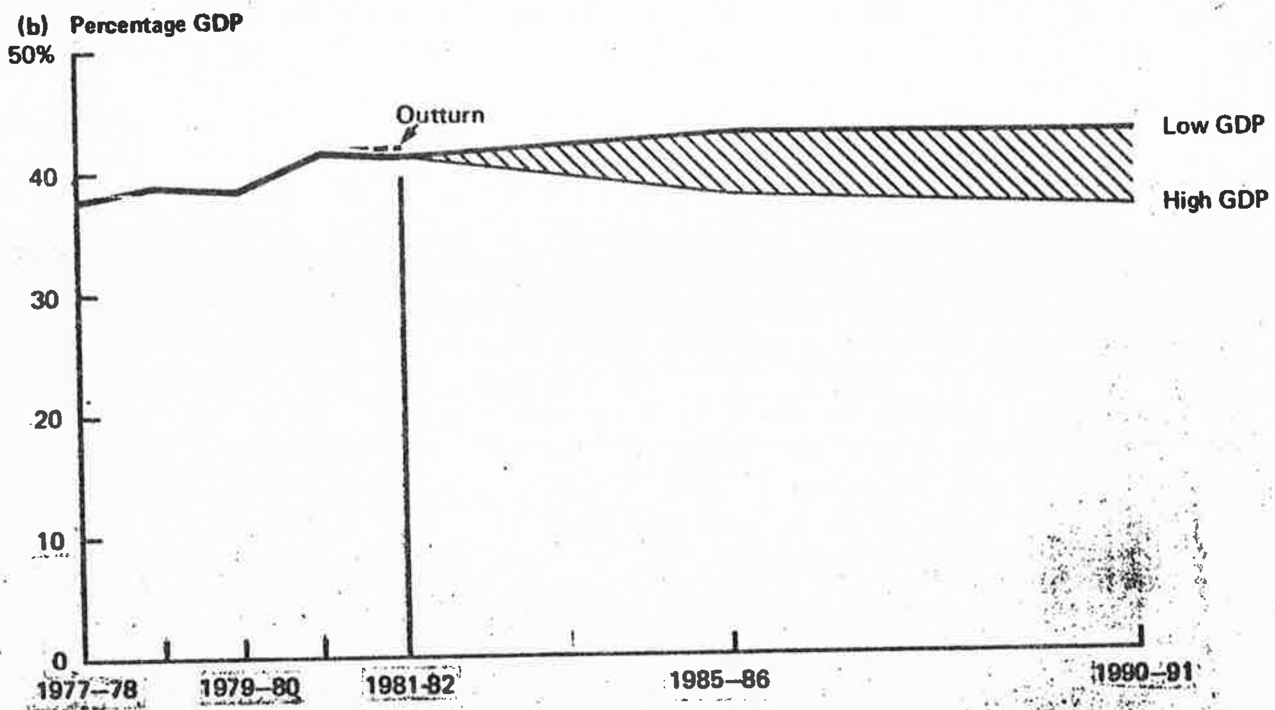
FIGURE 1

Planning total




Note: Pre 81-82 figures are based on Cmnd 8175 unless stated otherwise.

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FIGURE 2 Public expenditure by programme, cost terms

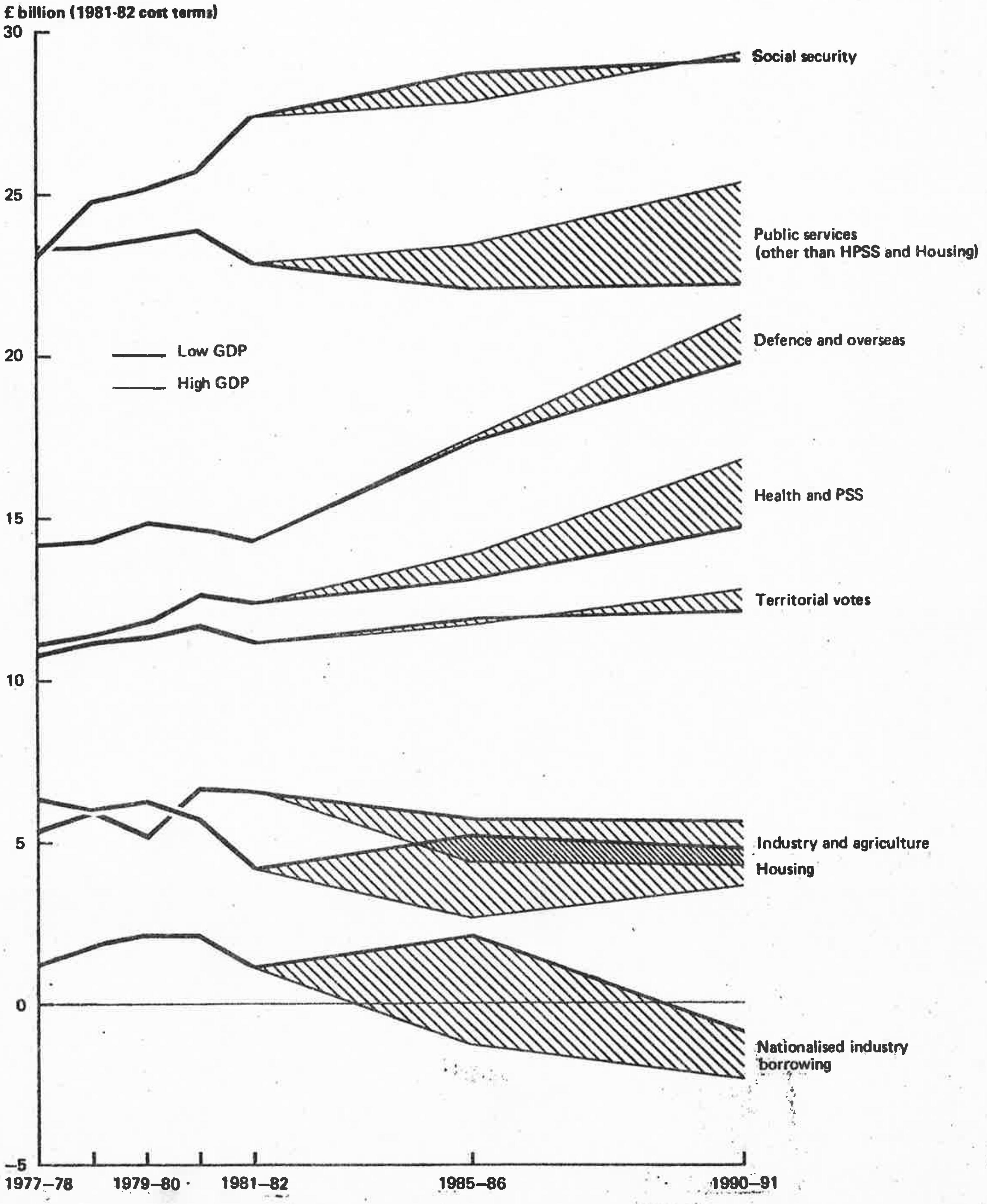
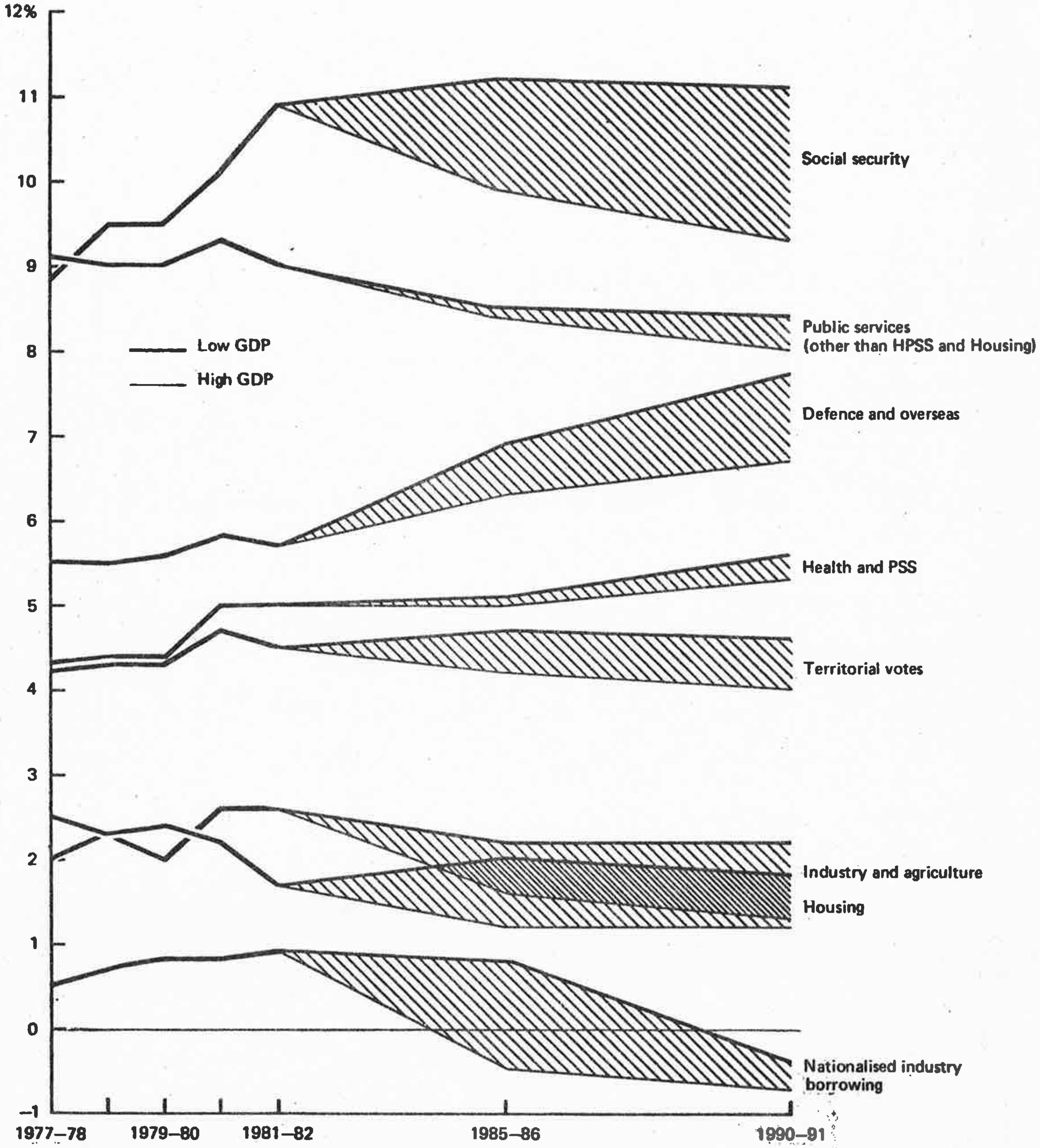
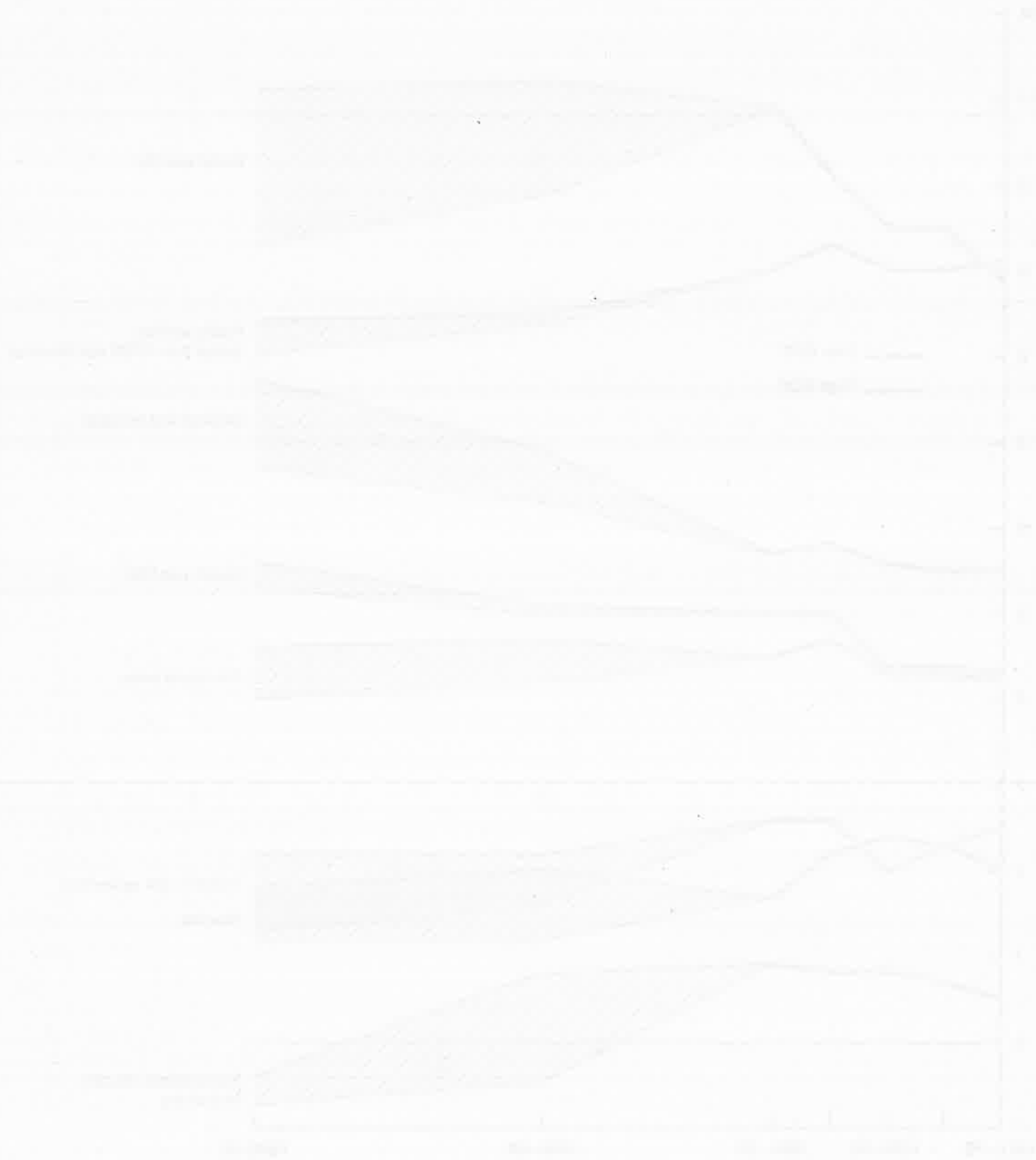


FIGURE 3 **Public expenditure by programme relative to GDP (Percentage)**





The economic scenarios

6. Two broad scenarios are used, drawn from earlier work.* They show GDP growth rates of ½ per cent and 2½ per cent a year. The low projection illustrates a continuation of the poor growth performance since 1973, the high one a gradual return to a growth picture which by the nineties is broadly similar to that achieved in the fifties and sixties. The recent Industry Act forecast is close to the low growth scenario. For this reason, and because of the tendency in the past to over-predict economic growth and under-predict public expenditure, the figures for public expenditure on the low growth scenario deserve more attention.

7. Economic growth has several effects on the public expenditure totals. The higher the rate of productivity growth the higher will be average real earnings in the private sector. This will pull up public sector earnings and so raise the real costs of public service programmes. The public's demand for some services is related to income levels; as people get richer they want more health and education and a better environment. But this effect is largely suppressed in the projections. For the high GDP scenario, especially, this may be optimistic. Social security expenditure is also affected by the level of activity; in the low growth scenario it is assumed that unemployment will remain high.

The position in more detail

8. (a) Planning total

Figure 1 shows the public expenditure planning total in 1981-82 prices and as a share of GDP, in the mid-1980s and the end of the decade. It also sets out the expected outturn in 1981-82 and recently agreed total for 1982-83. If economic growth were buoyant, the impact of high productivity on public sector costs could push the total sharply upwards later in the decade. But despite the higher total in cost terms, public expenditure declines as a share of GDP in the high GDP scenario. Growth brings its own rewards. The low GDP scenario implies that public expenditure may remain nearly constant as a proportion of GDP throughout the decade.

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* These two scenarios were approved by the then Financial Secretary earlier this year and seen by the Chancellor in July in the course of correspondence with the Trade Secretary. They became public knowledge in the course of Department of Trade evidence to the Stansted Inquiry.

(b) Defence and overseas services

The defence expenditure projections show what would be the effect if the NATO 3 per cent real growth target were continued throughout the decade. In the low GDP scenario defence expenditure rises from 5 per cent of GDP now to nearly 7 per cent by the end of the decade. Expenditure on overseas aid and other overseas services is especially subject to political developments but is assumed not to change substantially.

(c) Industry and employment

Expenditure in support of agriculture is related to the working of the CAP, the funding of which is uncertain in the longer term. In deference to present policy nationalised industry net borrowing is projected to turn around dramatically by 1990-91 in the low GDP scenario and by 1985-86 in the high case. These changes arise not from any major assumed change in investment, but from much higher assumed levels of internal financing as a result of higher prices and greater efficiency. As noted earlier this would be difficult to achieve. The energy and industry programmes are dominated by subsidy payments, which in practice are affected strongly by the trading performance of individual firms and industries. Projections in this area are particularly uncertain. Expenditure on employment measures is dependent on policy responses to the level of employment. It is assumed in the low GDP scenario that it continues at its 1981-82 level, and in the high GDP scenario that it declines to the levels of the mid 1970's.

(d) Public services

Expenditure on the public services (such as health, education and environmental services) is projected to increase in cost terms in both scenarios, although in the high GDP case this is due largely to relative price increases. As will be seen from the graphs, the main reason for this is the rise in expenditure on health and personal social services. This rise is due largely to the increase in the most expensive client groups for these services (the over-75s and women of child-bearing age). The fall in the number of children of school age lies behind the fall in education expenditure although, as this programme shows, there are difficulties in adjusting expenditure downward when the size of the client group declines. Substantial reductions over the past two years have been made in public service investment, especially in housing. In the low GDP case, some subsequent recovery is assumed, possibly as a concession to pressures for employment creation.

(e) Social security

The level of social security expenditure is as high or higher in the low as in the high growth case. (With low GDP growth there is more unemployment pay: with high GDP growth some growth is assumed in the real value of benefits.) Social security is therefore a much higher proportion of GDP in the low growth scenario. The projected rate of growth of social security is much less than that of the past two decades. This is because of specially favourable demography: birth rates were low in the interwar years and there is no significant increase in the number of pensioners. In later years, and especially beyond 2000, demography, combined with the build up of Better Pensions, will, under present legislation, lead to large increases in the cost of pensions.

## Implications

9. The projections both of the economy and of public expenditure are uncertain, and the further ahead one tries to look the more uncertain they become. But we feel that the general picture they portray is sufficiently clear. Figure 4 illustrates some of the expenditure trends in a low growth world. Figure 1 shows the broad implications for the tax burden. These gloomy prognostications are some way distant from the Government's objectives in 1979. To some extent this is because the economy has been slow in responding to policy changes. But the strength of the upward pressures on public expenditure have also been responsible. These pressures could well continue to push expenditure upwards despite the unpopular actions which the Government has taken.

10. If we were to return to a relatively high rate of economic growth, the picture would be more encouraging, although, as this paper has indicated, this could bring about some additional problems. But although growth would help, it is necessary first to achieve it.

11. These considerations suggest an approach on several fronts:-

(a) First, what can be achieved by an even tougher stance on public expenditure. The need to persist with increasing defence expenditure at 3 per cent a year in real terms regardless of the growth of GDP has to be questioned. The pledge to maintain pensions in real terms may become unrealistic if the living standards of the working population do not revive. It may be necessary to be more vigorous in reducing expenditure in programmes such as education where client groups are falling despite local opposition to reducing the numbers of schools.

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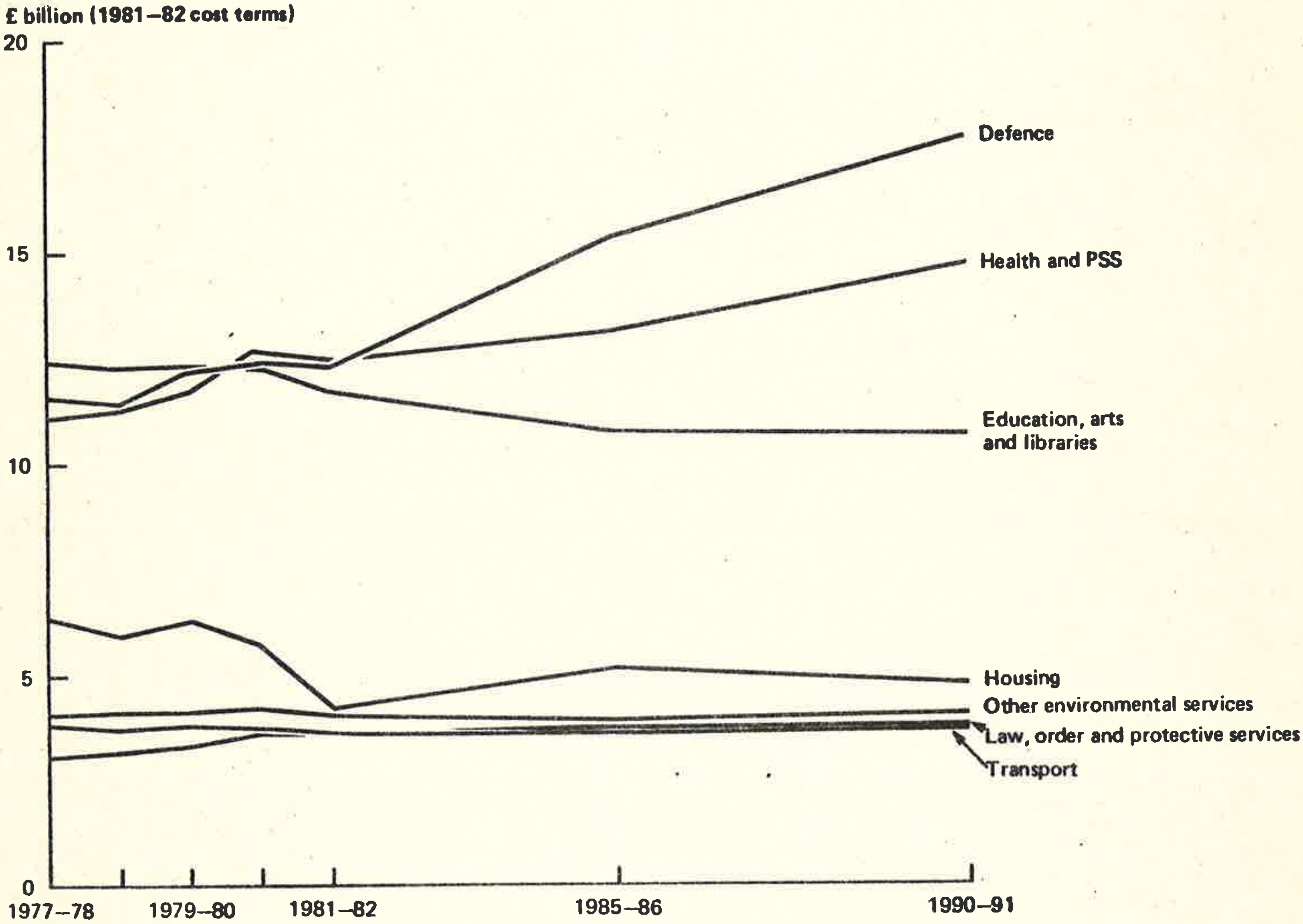
FIGURE 4 **Expenditure on public services and defence, low GDP scenario**

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(b) Second, can more money be raised from charges for public sector activities, or other new arrangements, on the grounds that levying money in this way might have less disincentive effect than conventional taxes? The Institute of Economic Affairs has suggested a number of areas where this could be done, although there are some obvious difficulties. The study of new ways of financing health care is exploring this type of approach, although as that study is showing there can be reasons of economy and efficiency for central funding of public services.

(c) Third, assuming that, whatever may be done on public expenditure, it will remain necessary to levy taxes on much the present scale, should ways of changing the structure of taxation be examined with the objective of reducing its harmful economic effects? Increasing the coverage of VAT (eg to energy), despite manifesto commitments, is relevant here. There is also a strong case for achieving as much tax as possible in ways which have low disincentive effects, such as the present regime for taxing North Sea oil production.

(d) Finally, what could be done to develop public awareness of the limits to public expenditure; to encourage a political climate which eschews pledges which then tie Ministers' hands; and to create a climate where it might be possible to question major longer term commitments, such as Better Pensions? It might be helpful to encourage (or even commission) work by non-official bodies on longer term public expenditure trends and their implications.

Public Sector Group Economists
4 January 1982

Copies attached for

Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (L)
Sir Douglas Wass
Sir Anthony Rawlinson
Sir Kenneth Couzens
Mr. Burns
Mr. Barratt
Mr. Middleton
Mr. Ridley
Mr. Cropper
Mr. Harris

1. MR. KEMP
2. MRS. GILMORE

CHEVENING

Press Office have asked for a line to take about the Chevening meeting in case the press get to hear of it (something which would be undesirable). I suggest the following:

Is there a meeting? Who is going?

The Chancellor wanted an opportunity to get together informally with colleagues and senior advisers, away from the usual office pressures. (If pressed .... not an unusual meeting; in line with the practice in many private organisations.)

Cost?

Being held in a Government owned property, and you can certainly expect that the Treasury would not be extravagant.

Wives?

Yes. (If asked: they are paying their own way.)

Subjects

Easy to work them out for yourself: the economic prospects, money, tax and public expenditure. And Budget, of course.

D.R. Norgrove
D.R. NORGROVE
6 January 1982



152

FROM: CHRIS MELLISS
DATE: 7 January 1982

MR BURNS

cc Mr Cassell
Mrs Lomax

CHEVENING SIMULATIONS

The attached table gives the results, on the same basis as those shown to you yesterday, of reducing the rate of growth of earnings in each wage round by 1%, implying on the overview forecast a rate of increase of ~~4%~~ 6 compared to 8% in 1985/86. 7% ? ~~a~~ a level 4% below the base

CHMelliss
C MELLISS
MP1 Division

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1% OFF EARNINGS GROWTH IN EACH WAGE ROUND

| % Change From Base | 1982/83 | 1983/84 | 1984/85 | 1985/86 |
|---|---|---|---|---|
| RPDI | -0.3 | -0.4 | -0.4 | -0.1 |
| GDP | 0 | 0.1 | 0.3 | 0.5 |
| UNEMPLOYMENT (NARROW, 000's) | -5 | -15 | -35 | -60 |
| AVERAGE EARNINGS | -1.5 | -2.5 | -3.5 | -4.0 |
| RPI | -0.6 | -1.3 | -2.0 | -2.6 |
| CHANGE IN RPI INFLATION | -0.6 | -0.7 | -0.7 | -0.6 |
| EFFECTIVE EX RATE | 0.6 | 1.0 | 1.4 | 1.6 |
| SHORT INTEREST RATES | - | - | - | - |
| £M3 | -0.6 | -0.9 | -1.2 | -1.3 |
| M1 | -0.6 | -1.0 | -1.5 | -1.9 |
| ICC'S NAFA (£bn)(1) | 0.6 | 0.5 | 0.6 | 0.1 |
| PSBR/NOM GDP at market prices | 0 | -0.2 | -0.2 | -0.3 |
| NOMINAL GDP | -0.7 | -1.4 | -2.0 | -2.4 |

(1) + is improvement

oss Liquidity Adjustment

FROM: CHRIS MELLISS
DATE: 6 January 1982

MR BURNS

cc Mr Cassell
Mrs Lomax

CHEVENING SIMULATIONS

I attach summary tables for three simulations.

(a) 1% off the rate of growth of £M3, achieved by varying interest rates.

(b) 5% higher exchange rate achieved by reducing interest rates.

(c) 5% higher exchange rate achieved by an increase in confidence working through expectations.

2. All these simulations include the gross liquidity adjustments currently being used in EEPM work. These essentially override the model equations for stocks, investment and dividend payments, by giving a weight to the desired position of the ICC's liquidity as measured by a reduced form equation for gross liquidity. You will note the result, counter intuitive perhaps, that ICC's NAFA rises (improves) with the exchange rate after an initial deterioration. Of course profits and companies' disposable income do deteriorate significantly. The improvement on NAFA is easier to rationalise when interest rates rise (Simulation (b)) since there would be a substantial rise in the rate of return of financial relative to real assets. When nominal interest rates are fixed (Simulation (c)) this argument is only applicable to the extent of the small rise in real interest rates.

C L Melliss.

C MELLISS
MP1 Division

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Simulation.(a)

1% OFF MONETARY GROWTH ANNUALLY .

| % Change From Base | 1982/83 | 1983/84 | 1984/85 | 1985/86 |
|---|---|---|---|---|
| RPDI | 0.1 | -0.1 | -0.2 | -0.3 |
| GDP | -0.1 | -0.4 | -0.7 | -0.9 |
| UNEMPLOYMENT (NARROW, 000's) | 10 | 50 | 90 | 120 |
| AVERAGE EARNINGS | 0 | -0.2 | -0.8 | -1.7 |
| RPI | 0 | -0.2 | -0.6 | -1.0 |
| CHANGE IN RPI INFLATION | 0 | -0.2 | -0.4 | -0.4 |
| EFFECTIVE EX RATE | 1.4 | 2.7 | 4.2 | 5.9 |
| SHORT INTEREST RATES | 0.8 | 1.3 | 2.1 | 3.1 |
| £M3 | -1.1 | -2.1 | -3.0 | -3.9 |
| M1 | -1.0 | -2.3 | -4.1 | -6.3 |
| ICC'S NAFA (£bn)(1) | -0.4 | 0 | 0.5 | 0.5 |
| PSBR/NOM GDP | 0 | 0.2 | 0.4 | 0.6 |
| NOMINAL GDP | -0.2 | -0.7 | -1.4 | -2.3 |

(1) + is improvement

Simulation starts in 1982 Q1

Simulation (b)

EXCHANGE RATE + 5% BY VARYING INTEREST RATES

| % Change From Base | 1982/83 | 1983/84 | 1984/85 | 1985/86 |
|---|---|---|---|---|
| RPDI | 0.4 | -0.2 | -0.7 | -0.6 |
| GDP | -0.3 | -1.1 | -1.3 | -0.9 |
| UNEMPLOYMENT (NARROW, 000's) | 30 | 130 | 200 | 150 |
| AVERAGE EARNINGS | 0 | -0.7 | -1.8 | -3.4 |
| RPI | 0 | -0.7 | -1.2 | -1.8 |
| CHANGE IN RPI INFLATION YR ON YR | 0 | -0.7 | -0.5 | -0.6 |
| EFFECTIVE EX RATE | 5 | 5 | 5 | 5 |
| SHORT INTEREST RATES | 2.6 | 2.4 | 2.7 | 3.2 |
| £M3 | -3.6 | -3.5 | -2.5 | -1.7 |
| M1 | -3.4 | -5.0 | -6.5 | -7.7 |
| ICC'S NAFA (£bn)(1) | -1.3 | 0.2 | 2.3 | 1.4 |
| PSBR/NOM GDP | 0.1 | 0.6 | 0.9 | 0.7 |
| NOMINAL GDP | -0.5 | -2.0 | -2.8 | -3.2 |

(1) + is improvement

Simulation (c)

EXCHANGE RATE +5% BY CONFIDENCE INTEREST RATES FIXED

| % Change From Base | 1981/82 | 1982/83 | 1983/84 | 1984/85 | 1985/86 |
|---|---|---|---|---|---|
| RPDI | | 3 | 0 | -0.4 | -0.4 |
| GDP | | -0.2 | -0.7 | -0.8 | -0.3 |
| UNEMPLOYMENT (NARROW, 000's) | | 19 | 89 | 114 | 69 |
| AVERAGE EARNINGS | | -0.05 | -1.0 | -2.6 | -4.5 |
| RPI | | -0.6 | -1.6 | -2.5 | -3.6 |
| CHANGE IN RPI INFLATION | | -0.6 | -0.1 | -0.9 | -1.[illegible] |
| EFFECTIVE EX RATE | | 5.0 | 5.0 | 5.0 | 5.0 |
| SHORT INTEREST RATES | | - | - | - | - |
| £M3 | | -0.5 | -1.1 | -1.2 | -0.6 |
| M1 | | -0.1 | -0.9 | -1.9 | -2.6 |
| ICC'S NAFA (£bn)(1) | | -0.6 | 0.1 | 2.0 | 1.8 |
| PSBR/NOM GDP | | -0.05 | 0.3 | 0.6 | 0.4 |
| NOMINAL GDP at mkt prices | | -0.5 | -1.9 | -2.9 | -3.7 |

(1) + is improvement

COVERING CONFIDENTIAL

Budget Judgement

PCC(82)2

HER MAJESTY'S TREASURY

POLICY CO-ORDINATING COMMITTEE

# APPROACH TO THE BUDGET

Note by the Secretaries

The attached paper by Mr Burns, prepared for Chevening, is circulated for discussion at PCC on Tuesday 12 January, 1982.

D R NORGROVE

J G COLMAN

8 January 1982

(20)

APPROACH TO THE BUDGET: SUMMARY

This note summarises the main issues considered in my paper, as background to the discussion at Chevening.

Recent Experience and Prospects

2. My note starts from the 1981 MTFS, and the forecast that went with it and asks:-

(i) whether fiscal and monetary policy have been more or less restrictive than intended.

(ii) in what way the outturn for 1981 and the prospects have changed since last March.

3. On policy, I argue that fiscal policy has been moderately restrictive, broadly as intended. £M3 has again been a bad indicator of monetary conditions, but other indicators suggest policy has been fairly consistent with the aim of exerting steady but not excessive downward pressure on monetary variables.

4. On the economy, output has developed much as expected. But inflation has been worse. For next year, the recovery could be a little more faltering than we thought in March. The outlook for inflation is significantly worse. The company sector's financial position, and poor profitability, and the risk of a sharp growth in imports are the main obstacles to faster growth next year.

5. The financial picture looks more difficult than it did in March. The 1981 MTFS money supply figures for 1982/83 now look very ambitious, especially given changes in bank behaviour.

Interest rates have been, and may continue to be, much higher than expected in March. with poor prospects for a substantial fall next year. The exchange rate may be fragile. But there is room for about £1-1½bn tax cuts within the £9bn PSBR suggested in last year's MTFS, although some of this is because of the effects of the Civil Service dispute in delaying tax receipts.

## Objectives

6. I have assumed you will want to strike a balance between securing some further progress on inflation, and improving the prospects for output. That might mean an outcome on both output and inflation no~~w~~t very different from that shown in the forecast. A more ambitious approach to inflation would involve taking risks on output. A much more reflationary stance would run risks with inflation, especially in 1983/84, and could jeopardise the exchange rate.

## Financial Framework

7. The uncertain inflationary outlook means we need to avoid a sharper fall in the exchange rate than foreseen in the forecast. Relying on interest rates to support the exchange rate would be of limited value to inflation, in the short run. Maintaining confidence will require a credible financial framework, consistent with the aim of exerting steady but not excessive downward pressure on the monetary aggregates. The scope for raising the MTFS targets, and modifying the status of £M3 is limited.

## Size of the PSBR

8. The difficulties we see on the money supply, interest rates and the exchange rate point to taking a cautious attitude towards the PSBR. The prospects for output and inflation together do not point to substantially revising the judgement you made last year. I judge that would be consistent with maintaining a broadly neutral stance in 1982/83, in real terms.

9. It will be politically difficult to go much below £9bn and there will be outside pressure for going well above it. But I think the financial picture makes it difficult to contemplate going above £10bn. And there is a real risk that a substantial reflation now would largely fuel imports. and produce disappointing results in extra activity.

10. If you go for £9bn, rather than the £7½bn shown in the forecast I think we should also be prepared to accept the higher £M3 growth involved (say 12% instead of 11%) rather than consider interest rates higher than those shown in the forecasts. Given the company sector position, an increase in the PSBR which was offset by higher interest rates would probably give a disappointing, and short lived, boost to output.

<u>Composition of Tax Changes</u>

11. I have not discussed these in any detail. But the forecasts now suggest that the case for tax reliefs to companies rather than persons may be stronger than we thought before Christmas.

## APPROACH TO THE BUDGET

### Introduction

1. The Government's financial strategy aims to bring down inflation and provide a stable financial environment in which real output can grow without a counter-productive rise in inflation. The purpose of the MTFS is to describe the financial framework within which economic policy is being operated. The policy decisions that are needed in the budget are:

(i) to judge the appropriate behaviour of the various monetary and exchange rate indicators required to deliver inflation objectives. These should then provide the guide-lines for interest rate decisions through the year;

(ii) to judge the appropriate size and composition of the PSBR to meet the financial objectives without excessive strain on interest rates. Given public expenditure plans this means judging the balance of taxation that will assist the adjustment of the economy to lower inflation and faster growth of output, taking account of longer-term incentive effects.

There are also important presentational issues about the choice of financial indicators and the status of £M3, which must be borne in mind in taking decisions. But they are contingent on the policy decisions that are actually taken, and the logic lying behind them. To be credible, a new version of the MTFS will need to reflect the way policy will in practice be operated next year.

2. Over the past two years there has been a substantial reduction in inflation. After the sharp impulse to inflation in 1979 the growth of money GDP has fallen to around 10% in 1981-82 from nearly 20% two years earlier. Wages and prices have however decelerated less rapidly and as a result much of the burden of adjusting to a lower growth in money GDP has fallen on real output. Given the stance of policy, excessive wage and price pressures have thus

contributed to the depth of the recession. The recession and general pressure on the company sector has brought a sharp recovery in productivity, at the expense of much higher levels of unemployment than expected. More recently output has been rising following the earlier deceleration of wage costs and inflation. But the decline in inflation has been interrupted and, partly in consequence, the recovery in output may falter in 1982.

Policy stance

3. Government policy has been to contain the medium-term growth in money GDP by exerting "steady but not excessive downward pressure on the growth of the monetary variables". It is useful to review progress in this direction so far.

4. The monetary aggregates are often a leading indicator of movements in money GDP and within this framework are expected to provide a useful measure of the overall thrust of policy. In the short-run the relationship between any one measure of money and money GDP is influenced by a range of factors including the behaviour of the exchange rate, and the balance between interest rates and fiscal policy, as well as institutional changes. A full assessment of domestic monetary conditions over the past three years therefore needs to take account of movements in all the monetary aggregates and the exchange rate. The exchange rate is an important indicator because it is a key element in the transmission mechanism through which changes in the money supply affect money GDP and inflation. Changes in the normal relationship between money and the exchange rate are therefore likely to disturb the link between money on the one hand and money GDP and prices on the other, at least for a time. This has been the experience of the past three years.

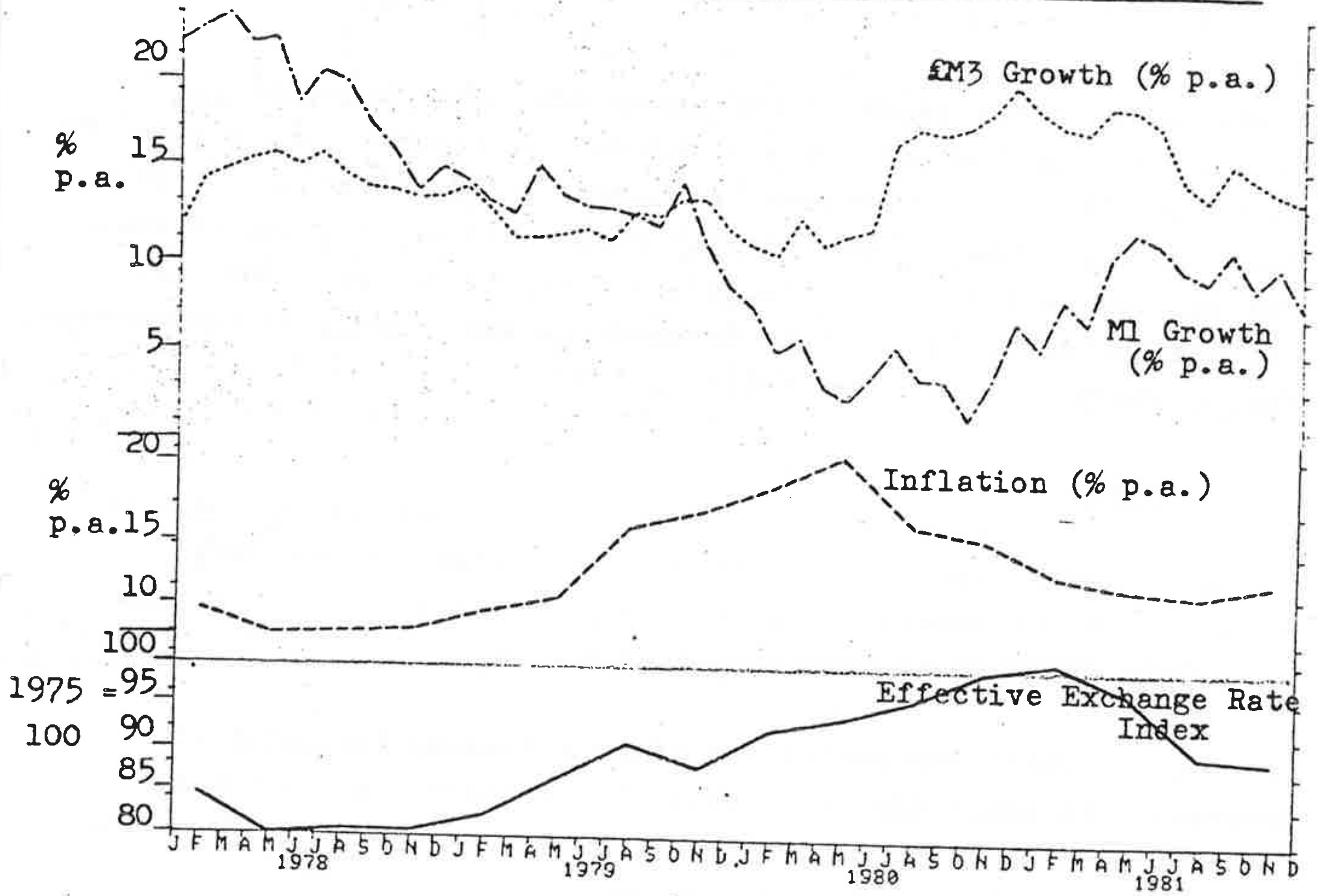
Monetary Conditions

5. An examination of recent monetary experience (Charts 1 and 2) suggests the following broad lessons:

(i) The growth of M1 and £M3 has been very different over the last two years.

CHART 1

## MONEY SUPPLY GROWTH, INFLATION AND THE EXCHANGE RATE




## Monetary Growth and Inflation

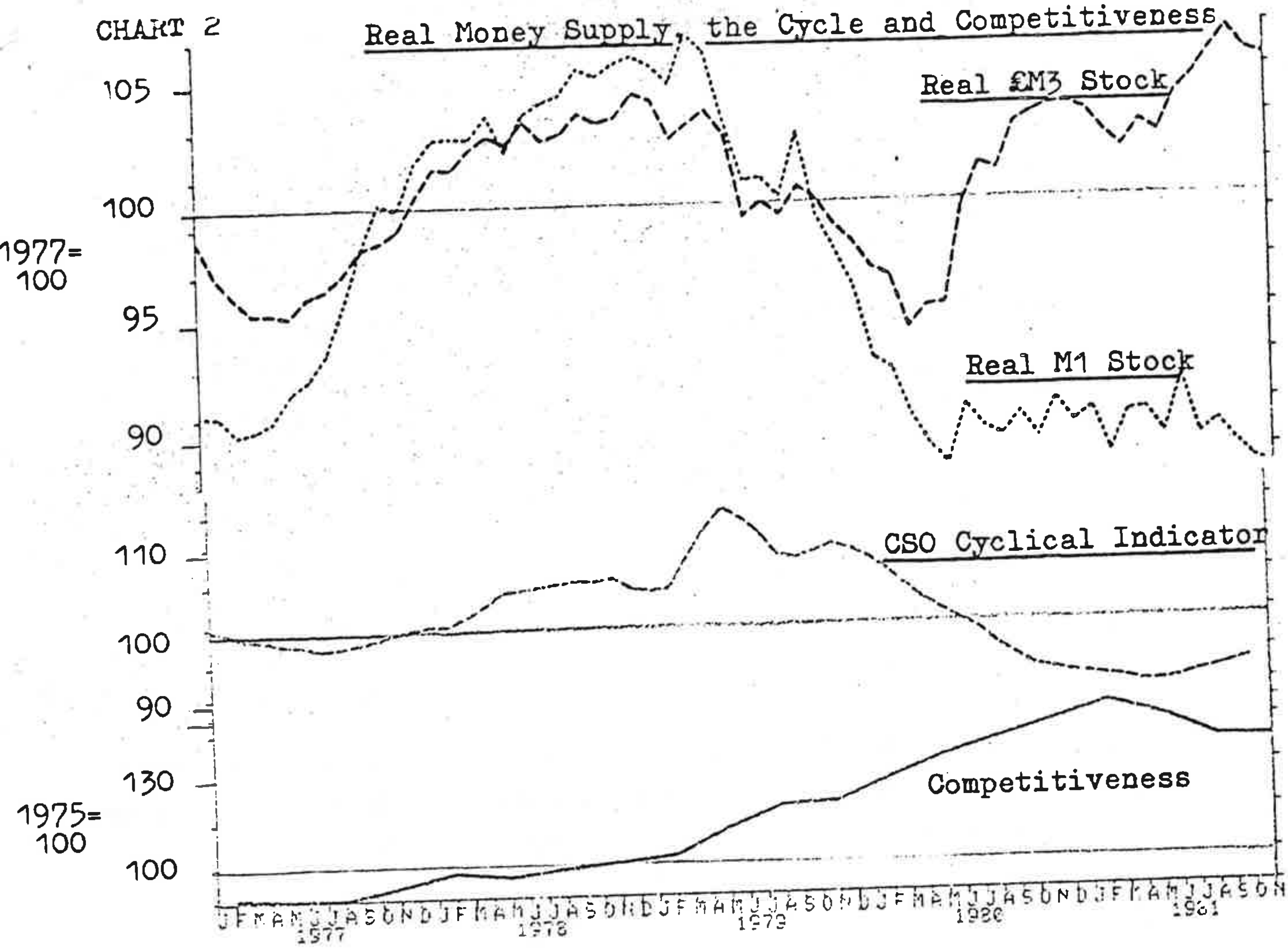
% change over previous year

| | M1 | £M3 (adjusted* figures in brackets) | PSL2 | RPI | Effective Exch. Rate Index (level in br-ckets) | |
|---|---|---|---|---|---|---|
| 1978 Q1 | 23.7 | 15.0 (14.5) | 15.1 | 9.5 | -4.8 | (84.8) |
| 1979 Q1 | 12.7 | 11.3 (12.0) | 13.1 | 9.6 | -2.8 | (82.4) |
| 1980 Q1 | 5.8 | 12.5 (15.3) | 12.2 | 19.1 | 12.9 | (93.0) |
| 1981 Q1 | 6.8 | 17.4 (14.4) | 12.8 | 12.7 | 9.0 | (101.4) |
| Q2 | 11.3 | 17.8 (10.7) | 13.3 | 11.7 | -3.5 | (97.8) |
| Q3 | 10.9 | 15.7 (13.1) | 13.8 | 11.2 | -6.3 | (90.6) |
| Q4 | 7.8 | 13.6 (12.0) | 11.7 | 12.2 | -10.2 | (90.0) |

Figures for the monetary aggregates related to the nearest banking month

*Adjustments to £M3 relate to the effect of the civil service strike and the corset.

CHART 2




## Real Money Supply and Output

% change over previous year

| | Real M1 | Real £M3 | Real PSL2 | Competitive-ness | Real GDP |
|---|---|---|---|---|---|
| 1978 Q1 | 13.4 | 5.4 | 5.5 | 8.6 | 2.9 |
| 1979 Q1 | 2.6 | 1.4 | 3.0 | 5.4 | 2.1 |
| 1980 Q1 | -11.7 | -6.1 | -6.3 | 25.1 | 0.9 |
| 1981 Q1 | -5.2 | 4.3 | 0.2 | 19.6 | -3.6 |
| Q2 | - | 5.8 | 1.8 | 9.0 | -3.0 |
| Q3 | -0.4 | 3.9 | 2.2 | -1.3 | -1.6 |
| Q4 | -4.0 | 1.2 | -0.5 | -5.4 | 0.1 |

↑ a negative sign indicates a gain in competitiveness

Figures for real GDP in the first quarters 1978-1981 relate to half year changes to remove steel strike effects etc.

(ii) The exchange rate has tended to move inversely with the growth of M1 rather than £M3 (with a short lag).

(iii) In real terms both M1 and £M3 fell sharply from mid-79 to mid-80; this preceded the sharp fall in output.

(iv) Between mid-1980 and late 1981 real £M3 has risen and real M1 stabilised. This was followed by some recovery of output.

(v) Over the past few months the annual growth rates of real M1 and real £M3 are showing signs of falling, largely as a result of some increase of inflation.

(vi) The fall in output coincided with a large loss of cost competitiveness and the recovery in output with some regaining of cost competitiveness as the exchange rate fell.

(vii) The sharp fall in the inflation rate followed the exchange rate appreciation and loss of competitiveness: the recent interruption in the decline in inflation has followed the exchange rate decline.

6. This highlights the extent to which it has been difficult to interpret the behaviour of the monetary aggregates, particularly £M3, for some time. Last year the after-effects of the corset were the main source of distortion. The Civil Service strike and its aftermath have distorted this year's figures. It has also been difficult to gauge how much of the recent rapid expansion of bank lending for house purchase is genuinely additional or is merely substituting for lending by building societies. We may still be seeing some of the after effects of the corset, as the bank adjust to their new found freedom.

7. What is clear is that £M3 growth has been well above target this year yet again - even when full account is taken of our best guesses at the effect of the main distortions. The other monetary

aggregates, however, have all grown less than £M3; and though the exchange rate fell last summer, the preceding rise and the recent stability do not seem consistent with the slack financial conditions indicated by £M3. Month-to-month fluctuations in M1 have been erratic, but the annual growth rate is currently less than 8%, even lower than in the preceding year. This all suggests that monetary conditions have, in fact, been tighter than the £M3 figures have indicated.

8. The evidence does not suggest, however, that conditions have been excessively tight. The growth of wider private sector liquidity (PSL2) has been in double figures for some time. This is close to or below the rate of inflation and the growth in money GDP.

9. On balance, I think the evidence from the monetary indicators is broadly consistent with the aim of "steady but not excessive downward pressure on the monetary aggregates".

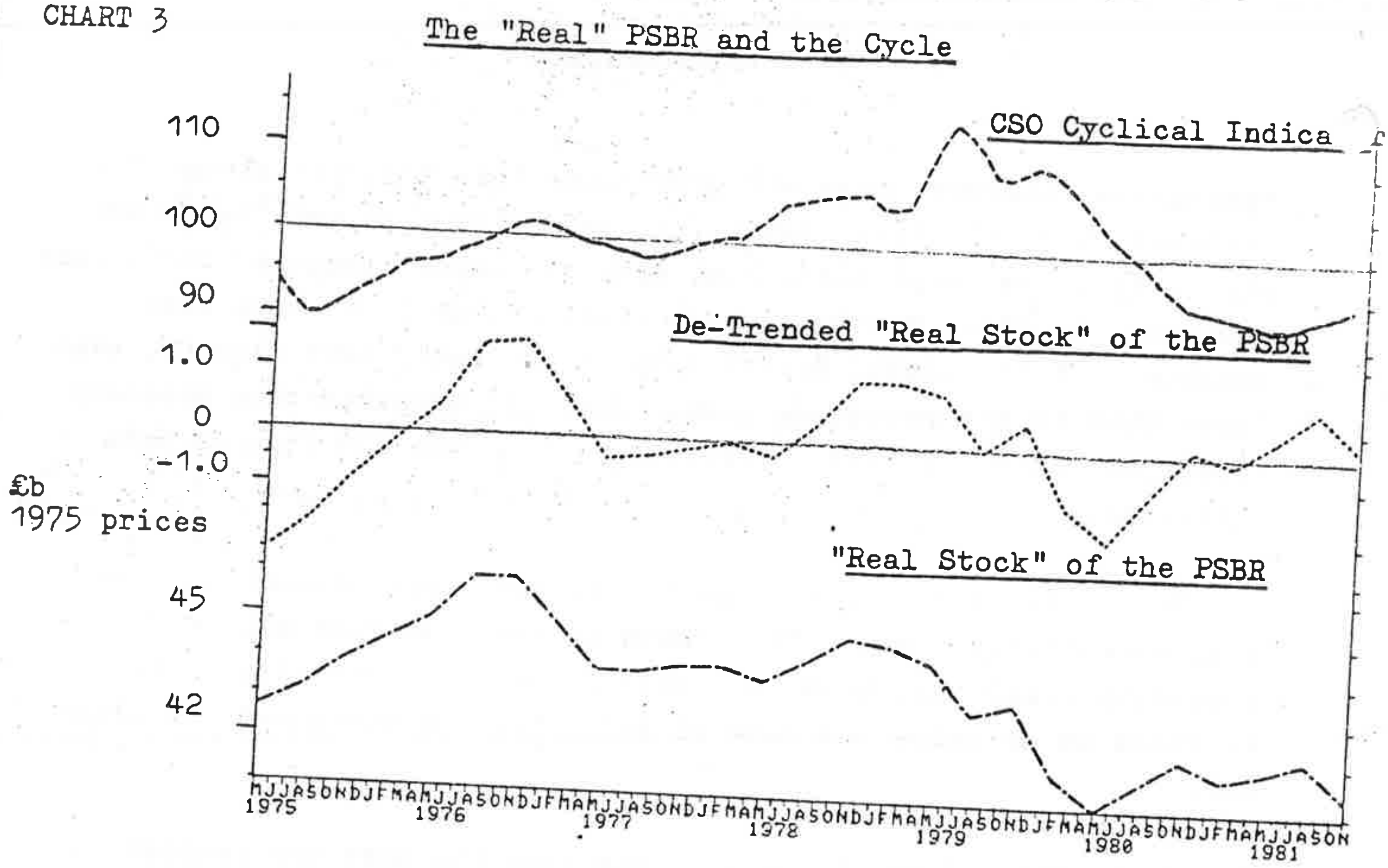
Fiscal Conditions

10. As with monetary conditions, it is impossible adequately to summarise the fiscal balance in a single statistic. Chart 3 gives a range of measures. Little attention should be paid to the level in any particular year: it is the broad year to year movement that matters.

(i) Expressed as a proportion of money GDP, the PSBR has been broadly stable since the Government took office, rising in 1980-81 compared with the previous year but projected to fall back this year.

(ii) After applying a cyclical correction (though this is difficult to do unambiguously) fiscal stance has tightened every year since 1978-79.

CHART 3




The "real" PSBR is the nominal PSBR less the erosion by inflation of the outstanding stock of public sector liabilities. It roughly corresponds to the change in the real value of the national debt, or the real stock of the PSBR (but it does not reflect changes in the capital value of gilts due to interest rates). As the chart shows the "real" PSBR stock has been on a downward trend in recent years in line with experience over the past two decades. The de-trended real PSBR shows the effects of removing this trend. The PSBR net of debt interest payments is not identical to the real PSBR (in part because of variations in the real interest rate), but it shows a broadly similar picture.

FISCAL STANCE

| | 1978-79 | 1979-80 | 1980-81 | 1981-82 |
|---|---|---|---|---|
| PSBR (£b) | 9.2 | 9.9 | 13.2 | 10.4 |
| PSBR (% of GDP) | 5.4% | 4.9% | 5.7% | 4.1% |
| "Real" PSBR (% of GDP) | +0.4% | -4.5% | -0.4% | -2.1% |
| PSBR less net debt interest (% of GDP) | 1.5% | 0.6% | 1.3% | -0.8% |

(iii) The real PSBR (ie the nominal PSBR, adjusted for inflation) shows a very sharp tightening of fiscal conditions in 1979-80. In 1980-81 they eased somewhat with the expansion of the nominal PSBR and the reduction of inflation. In the present financial year they have tightened again as the PSBR has been reduced and inflation has stabilised.

(iv) Taking out debt interest payment shows a similar path to the "real" PSBR.

11. In assessing the pattern it is important to remember that Government policy has been directed to reducing the size of the PSBR (as a proportion of GDP) over a run of years. Moreover the fact that the cyclically-adjusted PSBR falls does not mean that the extra Government expenditure and lower revenue due to the recession do not have the effect of holding up aggregate demand.

12. There is a good case for paying some attention to the "real" PSBR and the PSBR excluding interest payments, although they need careful interpretation. It can be argued that the erosion of the real value of public sector debt by inflation is a tax paid by the private sector (as holders of the national debt) and received by the Government (in the form of a reduction in the real value of its liabilities). Higher debt interest payments - part of Government expenditure - are largely a compensation for this and the two should be treated symmetrically.

13. Although a useful measure of the tightness of fiscal policy, such figures require careful interpretation. The suggestion that the actual PSBR as conventionally measured should be increased to offset a rise in inflation is quite out of line with Government policy. The sharp fall in the real PSBR in 1979-80 was the result of a rapid rise in the rate of inflation due to excessive wage increases, the oil price surge and the once-for-all effects of the rise in VAT. However this measure of the "real" PSBR is an indicator of the pressure of fiscal policy on output. And for a given inflation objective it is possible to draw inferences about the nomin

PSBR consistent with exerting an appropriate degree of pressure on financial conditions. On this basis fiscal policy over the past year does not look unduly restrictive.*

## The MTFS and the Prospect

14. Table 1 compares our interim forecast with the forecasts prepared at the time of the last Budget. The figures, particularly those beyond 1982, are of course highly provisional at this stage and may change quite substantially.

(i) The overall fiscal stance in 1981 looks like turning out much as envisaged in March, and while the £M3 target looks like being substantially overshot, other indicators suggest that monetary conditions have generally been moderately restrictive. Both monetary and fiscal conditions may have tightened during the second half of the year as inflation moved up.

(ii) Real output has developed broadly as expected, with evidence of fairly strong recovery during the second half of the year.

(iii) The outcome on both prices and earnings has however been worse than expected in March. The acceleration in inflation since mid 1981 is partly due to the lower exchange rate.

(iv) The fall in the exchange rate has however brought a gain in competitiveness - though it is worth noting that exports have been much more resilient to the previous sharp deterioration in competitiveness than seemed likely in March, and despite a much faster than expected recovery in imports, the current balance is still in surplus.

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*After taking account of the effects of the Civil Service dispute. This year the effects on revenue are expected to be broadly neutral, but the PSBR may be £½-¾bn higher as a result of higher debt interest payments.

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TABLE 1

Interim Forecast (1981 MTFS in brackets)

| | Money GDP at market prices % change | Real GDP % change | RPI (% year to Q4) | Private cyclically adjusted average earnings (% year to Q3) |
|---|---|---|---|---|
| 1978 | 15.0 | 3.1 | 8.1 | 15.1 |
| 1979 | 17.2 | 1.7 | 17.3 | 17.7 |
| 1980 | 16.7 | -2.1 | 15.3 | 24.3 |
| 1981 | 10 (10) | -2 (-2) | 12 (10) | 13 (10) |
| 1982 | 11½ (10) | 1 (1) | 10 (7½) | 9 (7) |
| 1983 | 9 (10) | 1½ (2½) | 7½ (7½) | 8 (6) |

| | £M3 (% change through year) | Short term interest rates (financial year) | Effective exchange rate (1975=100) | PSBR (financial year) (£bn, % money GDP) | Fiscal Adjustment (£bn) |
|---|---|---|---|---|---|
| 1978 | 11.7 | 10.8 | 81.5 | 9.2 (5.2) | - |
| 1979 | 13.2 | 14.9 | 87.3 | 9.9 (4.9) | - |
| 1980 | 18.0 | 15.6 | 96.1 | 13.3 (5.8) | - |
| 1981 | 15 (8) | 14½ (12) | 95 (101) | 10½(4) [10½(4¼)] | - |
| 1982 | 11 (7) | 14½ (11½) | 87 (100) | 7½(2¾) [9(3¼)] | - (1½) |
| 1983 | 9 (6) | 12 (10) | 83 (99) | 6½(2) [6(2)] | [3] (3) |

The forecast figures on this table are provisional views only and are subject to possibly substantial changes as the forecast is completed. This applies particularly to figures for 1983.

15. The prospects for 1982, and to a lesser extent 1983, have changed for the worse in a number of ways.

(i) Further progress in reducing inflation in 1982 may be modest, with both prices and wages likely to grow considerably more rapidly than projected in March. Inflation should however be into single figures by 1983.

(ii) Underlying this deterioration is a significantly lower, and possibly more fragile, exchange rate (partly reflecting the prospect of higher US rates later this year).

(iii) The recovery in real output looks more faltering than it did in March, with output only rising a little during 1982, and sustained growth not really getting underway until the following year.

16. Nor is the financial picture reassuring.

(i) On conventional assumptions about indexation, the PSBR 1982-83 may be about £1½bn below the cash figure implied by the March MTFS. But this is largely due to the once-for-all recovery of revenue delayed by the Civil Service dispute. Within this total both expenditure and revenue are substantially higher.

(ii) While the scope for tax cuts in 1983-84 within the PBSR ratios shown in the 1981 MTFS does not look significantly different from March (on the present tentative figuring) interest rates are higher.

(iii) Despite higher nominal (and real) interest rates, £M3 may well be above the top of the range shown in March, with the other monetary aggregates growing at very similar rates.

(iv) Prospects for a recovery in company profitability now look less good, partly due to a worse starting point in 1981.

17. Against this, some aspects for the forecast are better.

(i) The prospects for exports look better than they did in March, only partly because a lower exchange rate implies significantly better competitiveness.

(ii) Even if, as expected, imports continue to recover strongly as demand picks up, the current balance should be well in surplus (compared with the small deficit expected in March).

(iii) Productivity has responded more strongly to the cyclical upturn, and the prospects of a sustained improvement in productivity now look better based. But this means higher unemployment in the short run.

18. The hesitation in real output foreseen for 1982 contrasts with the current strength in manufacturing output and companies' improved optimism about output and orders. But the forecast is supported by the CSO's longer leading indicators, which have been suggesting some faltering in recovery for some time now. Part of the explanation is the likelihood of a deterioration in companies' financial position as de-stocking comes to an end and profitability, though improving, remains low. This may constrain company expenditure on stocks, investment and employment. The forecast also suggests a sustained squeeze on real personal disposable incomes through 1982 which could prevent consumers' expenditure rising above end 1980 levels.

19. Underlying these difficulties is the sluggish response of earnings. As far as this next year is concerned, the damage was done in the 1979-80 and 1980-81 wage rounds. A better outcome on earnings would not significantly improve the prospects for output in 1982 though it would mean lower inflation and an improvement in the company sector's financial position. But the outlook for 1983 would be better. To illustrate the orders of magnitude involved we estimate that a 1% reduction in earnings growth in each

wage round, starting with the present round, might increase output by about ¼% and reduce the rate of inflation by around ¾% by the end of 1983.

20. Another problem, with important implications for the shape of the 1982 Budget, is the risk that much of any increase in total real expenditure will be met by higher imports, rather than higher domestic output, especially in the early stages of the recovery. This is what happened in 1977-78. For 1982 the forecast shows real TFE growing very much faster than real output. Past experience suggests that the faster the upturn in demand, the greater the risk that a high proportion will leak into imports.

<u>Policy Decisions needed for 1982-83</u>

21. Decisions are needed on the overall financial framework, within which the Budget will be presented, and on the size and composition of the PSBR. My interpretation of your aim in the budget is to keep inflation coming down while sustaining some recovery of output. This will involve a credible presentation of the budget decisions as a development of present strategy, rather than a major modification of it. Given the forecast, that raises some specific issues:-

(i) <u>The Monetary Targets</u>:- Sticking to the old MTFS ranges for £M3 does not look feasible either to us or to outside commentators. But how far can they be raised? And how is thi to be justified? How far should the exclusive reliance on £M3 in the MTFS be modified?

(ii) <u>The PSBR</u>:- Is the £9bn figure for the PSBR implied by the 1981 MTFS still the right one to go for, given the spill over of revenue due to the Civil Service dispute, the poor outlook for interest rates, and the need to maintain confidence, especially in the foreign exchange market? How much scope is there for stimulating demand, given the risk that a sudden upturn would largely fuel imports? And where should any tax cuts be principally directed - companies or persons?

Exchange Rate

22. The movement of the exchange rate will continue to be important in determining the prospect for inflation. (The forecast already takes account of the continuing effect of the 1979-80 appreciation in reducing inflation.) We have already emphasised that sterling has considerable downside potential particularly if world oil prices continue to weaken and there is a suspicion of a major relaxation of UK policy. The importance of the exchange rate change can be seen in the following calculation. If because of better or worse confidence

(i) the exchange rate was stable at a trade weighted rate of 90 rather than falling, inflation would be 1% lower, by the beginning of 1983. Prospects for output would be worse with more adverse financial pressures on the company sector;

(ii) the exchange rate were 5% lower than forecast in 1982 then we would not expect inflation to slow down much if at all through 1982, so remaining above or around 11%. The prospects for output would be a bit better with an increasingly better balance between company and personal sector incomes through 1983.

23. The inflationary risks of a sharp fall in the exchange rate pose important policy issues. Raising interest rates to meet a decline in the rate, in response to higher world interest rates or deteriorating confidence, will only be of limited value. A timely rise in interest rates should, of course, be helpful in stabilising financial markets. But even if the exchange rate is prevented from falling altogether, there may still be an adverse effect on inflation. Higher interest rates themselves put up the retail price index (which includes the mortgage rate) with significant knock on effects to wage settlements (and benefit upratings). As an illustration, a 2-3 point rise in interest rates might be needed to check a 5% fall in the exchange rate: as a result the RPI might be 1% higher in the first year. For the same reason, pushing up the exchange rate (relative to the forecast) by increasing interest rates may bring virtually no return in terms of lower prices in the

Table 2

## Effect of 5% change in the Exchange Rate

| | 5% higher exchange rate due to better confidence (interest rates unchanged) | 5% higher exchange rate due to higher interest rates |
|---|---|---|
| **Price Level (RPI)** | | |
| 1982 Q4 | -0.8 | 0 |
| 1983 Q4 | -1.7 | -0.7 |
| 1984 Q4 | -2.6 | -1.3 |
| **Rate of Inflation** | | |
| 1982 Q4 | -0.8 | 0 |
| 1983 Q4 | -0.8 | -0.7 |
| 1984 Q4 | -0.9 | -0.6 |
| **Real GDP** | | |
| 1982 | -0.2 | -0.2 |
| 1983 | -0.6 | -0.9 |
| 1984 | -0.8 | -1.4 |

The above figures are taken from simulations of the effect of a 5 per cent change in the exchange rate from the path shown in the forecast. In the first column the exchange rate is 5 per cent higher because of improved confidence (or lower world interest rates). In the second column UK interest rates are raised (by 2-3 per cent) to produce a 5% higher exchange rate. The effects on inflation in this second case are considerably smaller, particularly in the first year (reflecting the impact of the higher mortgage rate on the RP. and eventually on wage settlements).

The absolute difference between the two columns is a measure of the effect of a change in interest rates on output and inflation for a given exchange rate.

first year or so, though there should be some longer term benefit. And the combination of a higher exchange rate and higher interest rates would hit company finances (and probably output) very hard.

24. These difficulties suggest that it would be unwise to rely exclusively on interest rates to support the exchange rate, and point to pursuing fiscal policies which will help to prevent a major reversal in confidence. It is true that the links between the PSBR and the exchange rate run in two directions. A higher PSBR may mean running more risk of a fall in the exchange rate (unless interest rates are raised): but a lower exchange rate would help to reduce the PSBR (partly because a lower $/£ rate increases the sterling price of oil and hence tax revenues from the North Sea). In principle, the prospect of a better than expected PSBR if the rate falls provides some scope for off-setting the inflationary impact of a lower rate, by cutting expenditure taxes. But such a policy could only be temporarily successful in containing inflation. Going for a high PSBR, on the assumption that, should the rate collapse, the automatic benefit to the PSBR could be used to undo the inflationary damage caused by a lower rate, would be both risky and short-sighted.

25. Concern about inflation means that the exchange rate must play an important part in decisions about the balance of policies. The need to avoid a sharp fall in the rate means that there is only limited room for manoeuvre both on the size of the PSBR and the monetary targets for 1982-83.

Monetary Aggregates

26. The forecast shows a projected growth of £M3, although much lower than in 1981-82, still well above the 1981 MTFS target range, despite high interest rates and a PSBR of £7½b. Next year, like this year, the pressure is expected to come from bank lending. Some of this is clearly straight substitution for other credit - a conclusion which is reinforced by the slow growth in PSL2 relative

to £M3 (compared with past trends) both in the recent past and in the forecast. The move towards greater intermediation by the banks may also reflect uncertainty about inflation which has encouraged tra actions in short term financial assets. At least so long as the exchange rate remains fairly firm, these balances may remain a medium for saving rather than spending. Subject to this caveat, these developments provide reasonable grounds for accepting higher £M3 figures than suggested in the MTFS. Moreover, the rapid growth in £M3 over the last two years means that meeting the MTFS targets now would imply an exceptionally sharp monetary slowdown (from 15% to 7-9%). But some deceleration in recent rates of growth is needed, if the strategy of exerting steady but not excessive downward pressure on the monetary aggregates is to be credible.

27. The forecast also suggests that in contrast to this year M1 growth may be higher than the growth of nominal incomes if there is some success in bringing down interest rates with the fall in inflation. This is a problem that has worried us for some time. The move to higher inflation (and higher interest rates) since about 1973 has been associated with a significant fall in real M1 balances as people economised on the use of non-interest bearing money. (This may be one reason why the rapid inflation of 1974-75 was not fully foreshadowed by previous M1 growth). Some fall of inflation could reverse this decline of real M1 balances. This would imply that an acceleration in the growth of M1 was consistent with a continued reduction of inflation.

28. None of this will be easy to explain convincingly and the status of £M3, in particular, has yet to be decided. While some raising of the targets shown in the last MTFS should be consistent with the main thrust of the strategy, there are clear risks in going too far. Given the uncertainty about the future course of bank lending, the exchange rate and world interest rates, presenting - and achieving - an acceptable financial picture for next year may depend o taking a fairly cautious attitude towards the PSBR.

Fiscal Stance

29. The 1981 MTFS suggested a PSBR for 1982-83 of £9b. This, in turn was an upward revisions from the £6½b suggested by the 1980 MTFS. The initial figure in the 1980 MTFS was chosen as being appropriate to meet the declining £M3 target. But this was against the background of a better outlook for both prices and output than has been the case. As a result the figure was revised upwards last year to take account of the unexpected severity of the recession. This was still considered to be sufficiently restrictive to secure further progress in reducing inflation.

30. In terms of the concept of fiscal stance outlined earlier in the paper (ie the nominal PSBR adjusted for inflation), a neutral fiscal stance for 1982-83 would imply a PSBR of about £9b in cash terms.* On balance, I see little reason to revise our earlier judgement. There has been a slight deterioration in the prospects for growth. But there are also greater uncertainties on the inflation front, given the potential fragility of the exchange rate and the projected high growth of the monetary aggregates.

31. Therefore I conclude that there is some scope for bringing the PSBR up to the £9b* set out in last year's MTFS But I would want to argue at the same time that:

(i) If we want this to be reflected in terms of better output the £9b PSBR would need to be associated with faster monetary growth than in the current forecast. As the Annex shows, tax cuts which are offset by higher interest rates are likely to crowd out other spending, particularly if the company sector is already under financial pressure.

*Including the extra tax receipts delayed by the Civil Service dispu

(ii) A fiscal relaxation in the form or price or cost reducing measures would produce the best outcome for inflation and, probably, output. But the improvement to inflation will only be temporary and it will eventually be reversed. The risk of having to claw back in the following year a £1-2bn tax cut in 1982-83 looks remote on the present forecast (assuming public expenditure turns out as planned). But it is worth bearing in mind that the more indirect taxes are cut this year, the less scope there will be next year for further cuts.

(iii) The case for directing tax cuts principally to companies rather than persons now looks stronger in the light of the forecast. One of the obstacles to faster recove: in 1982 is the poor financial position in which companies may find themselves. It will be important not to do anything to intensify the squeeze on companies (eg a large further increase in personal allowances offset by higher interest rates).

32. I see several problems in raising the PSBR very much above £9b. One is the risk that an unduly rapid increase in demand would be met largely out of imports with little benefit to output, but some risk to the exchange rate and prices. Interest rates are another problem. The prospect for a significant fall in interest rates looks poor in the forecast even with the PSBR at £7½bn and monetary growth around 11%. A £9bn PSBR would add something like a further 1% to monetary growth in 1982-83. It will be very difficult to raise the monetary figures much further. But that implies that a PSBR over £9bn would be associated with an even worse outlook for interest rates. I also have very much in mind the possibility of adverse confidence effects on the exchange rate and interest rates. Of course it is difficult to judge precisely at what point a change in the figures for the planned PSBR or monetary growth would be seen by markets as an abandonment of the whole strategy, rather than a sensible adjustment of it to altered circumstances. It will be difficult enough to present ranges for money growth well above the existing MTFS path as consistent with maintaining the broad thrust

of the MTFS. To couple this with a subtantial increase in the PSBR over £9b would make it extremely difficult to claim that the strategy had not been abandoned. This might indicate an absolute upper limit of £10b, which would be around the figure expected for this year.

8 January 1982

EFFECTS OF A HIGHER PSBR

The attached summary table shows the likely effect of £1bn change in the PSBR, achieved by varying personal allowances and various indirect taxes.

2. The results depend critically on the stance of monetary policy. The effects on real output are small and largely temporary if interest rates are raised to offset the effects of fiscal relaxation on extra £M3 or the exchange rate. The maximum effect on output is achieved by tax cuts which are accommodated by higher monetary growth (ie holding interest rates more or less unchanged). But reflation financed by money creation is worse for inflation. In time, this will feed back on to real output, and while longer lasting, the stimulus to activity may also be largely temporary.

3. Cuts in indirect taxes which directly reduce the price level (VAT and the specific duties) will temporarily reduce the rate of inflation. Though the price level may be lower for a number of years, such changes typically increase the rate of inflation after about two or three years at most. This favourable effect on prices is one reason why cost-cutting tax reductions have the most powerful effect on real output, within any given policy framework.

4. Increases in personal allowances have no direct impact on the price level. But they too may produce a small temporary reduction in inflation if they help to moderate wage demands. The scale of any such effect, particularly in the context of a tax cut, is highly uncertain. The figures shown in the Table allow for some moderation in wage settlements, but only about half the effect achieved by cuts in taxes which have a direct effect on the RPI.

5. The risk with reductions in NIS is that they may increase earnings, at least over a period of time. Some of the initial benefit to company incomes may be lost. Again, the scale of this effect is very uncertain. Our calculations assume that roughly

1/5 of the reduction in NIS leaks back into wages in the first year, building up to nearly one half after three years or so. Much of the remaining benefit is eventually passed on to consumers in the form of lower prices although profit margins on exports are likely to improve. This implies a significant, albeit temporary, improvement in the company sector's financial position. Given the underlying forecast, we have assumed that companies react to this by spending more, especially on stocks and employment. Cuts in NIS have the effect of stimulating output, at relatively small cost (and even some benefit) in terms of inflation in the short run though the trade-off is not quite so favourable as with other indirect taxes (VAT and the specific duties). As with the other taxes considered, however, the macro economic effects depend critically on how monetary policy is being operated.

Table : [illegible]

| | Personal Allowances | Specific Duties | NIS | VAT |
|---|---|---|---|---|
| | around 9% increase (on top of revalorisation) | (excl. derv and rebated oil) -12% (from indexed base) | -1¾% | -2½% |
| **1. Fixed Interest Rates** | | | | |
| Real output % change from base | | | | |
| 1982 | 0.1 | 0.1 | 0.1 | 0.2 |
| 1983 | 0.3 | 0.4 | 0.5 | 0.5 |
| 1984 | 0.5 | 0.6 | 0.8 | 0.9 |
| Rate of Inflation % change on year earlier | | | | |
| 1982 Q4 | 0.1 | -0.7 | -0.1 | -1.2 |
| 1983 Q4 | 0.2 | 0.1 | 0.2 | 0.05 |
| 1984 Q4 | 0.5 | 0.3 | 0.7 | 0.4 |
| £M3 % change on year earlier | | | | |
| 1983 Q1 | 0.9 | 0.6 | 0.6 | 0.6 |
| 1984 Q1 | 0.5 | 0.4 | 1.0 | 0.5 |
| Exchange Rate Level | | | | |
| 1982 | -0.7 | -0.5 | -0.8 | -0.6 |
| 1983 | -1.2 | -1.0 | -1.5 | -1.3 |
| PSBR 1983-4 | 835 | 750 | 1130 | 1190 |
| **2. Higher Interest Rates, unchanged money supply** | | | | |
| Real output % change from base | | | | |
| 1982 | 0.05 | 0.1 | 0 | 0.2 |
| 1983 | 0.05 | 0.2 | 0.2 | 0.3 |
| 1984 | 0 | 0.2 | 0.1 | 0.5 |
| Rate of Inflation % change on year earlier | | | | |
| 1982 Q4 | 0.05 | 0.8 | 0.2 | -1.2 |
| 1983 Q4 | -0.05 | -0.2 | -0.2 | -0.3 |
| 1984 Q4 | 0.05 | 0 | +0.1 | 0 |

/continued

Table

Higher interest rates, unchanged money supply (cont'd)

| | Personal Allowances (+9%) | Specific Duties (-12%) | NIS (-1¾%) | VAT (-2½%) |
|---|---|---|---|---|
| Short Term Interest Rates % pts | | | | |
| 1982-83 | 0.5 | 0.4 | 0.5 | 0.4 |
| 1983-84 | 0.7 | 0.5 | 0.9 | 0.4 |
| Exchange Rate Level | | | | |
| 1982 | 0.3 | 0.2 | 0.4 | 0.2 |
| 1983 | 0.5 | 0.3 | 0.7 | 0.2 |
| PSBR 1983-4 | 1240 | 1040 | 1550 | 1500 |
| **3. Higher Interest Rates, unchanged exchange rate** | | | | |
| Real output % change from base | | | | |
| 1982 | 0.05 | 0.1 | 0 | 0.2 |
| 1983 | 0.1 | 0.1 | 0.2 | 0.2 |
| 1984 | 0.05 | 0.2 | 0.2 | 0.3 |
| Rate of Inflation % change on year earlier | | | | |
| 1982 Q4 | 0.1 | -0.6 | -0.1 | -0.9 |
| 1983 Q4 | 0.1 | 0 | 0 | 0 |
| 1984 Q4 | 0.3 | +0.2 | 0.4 | 0.2 |
| £M3 % change on year earlier | | | | |
| 1983 Q1 | -0.3 | -0.7 | -0.6 | -1.0 |
| 1984 Q1 | -0.1 | -0.1 | -0.1 | -0.1 |
| Short Term Interest Rates % pts | | | | |
| 1982-83 | 0.6 | 0.7 | 0.7 | 0.8 |
| 1983-84 | 1.0 | 1.1 | 1.2 | 1.2 |
| PSBR 1983-4 | 1200 | 1065 | 1485 | 1515 |