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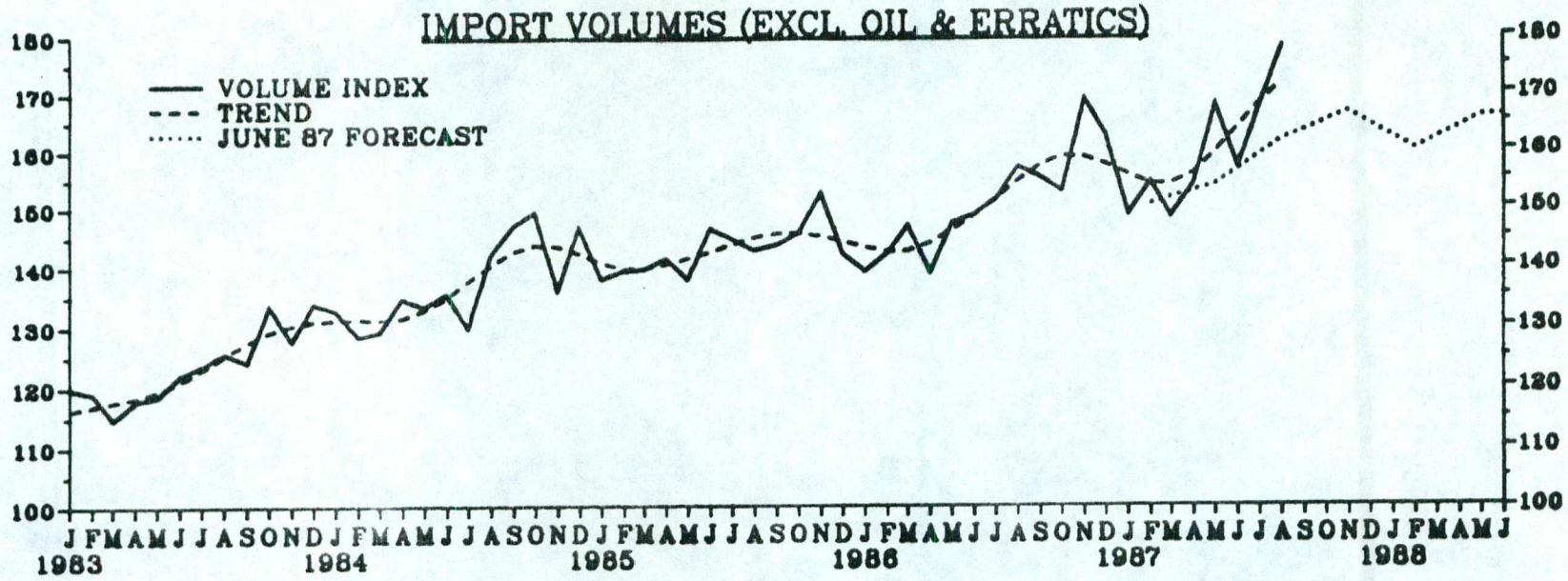
FROM: PAUL DAVIS
DATE: 9 October 1987

CIRCULATION AS MONTHLY NOTE ON TRADE

MONTHLY NOTE ON TRADE - OCTOBER 1987 - ADDENDUM

1. I attach a copy of a chart showing import volumes (excluding oil and erratics) to replace the one shown on page 11 of the note.

PAUL DAVIS
EA2 Division



UPDATED MAGUS.EXTRADE ?

MAGUS.MIMBOTPUB

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FROM: **P N SEDGWICK**
DATE: 9 OCTOBER 1987

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Mr Call

TREASURY ECONOMIC FORECAST

I attach a copy of the main report of the recent forecasting exercise, which reflects judgements taken at a series of meetings with Sir T Burns. The assumptions in the forecast on monetary policy and the fiscal stance were taken in consultation with Sir T Burns and Mr Cassell as the results of the forecast emerged.

2. The other detailed reports on this exercise are

World Economic Prospects (Mr Matthews, IF2)

Public Finances (Mr Mowl, PSF)

The Financial Prospect (Mr Bottrill, EA2).

P.N.S

P N SEDGWICK

TREASURY ECONOMIC FORECASTING EXERCISE

OCTOBER 1987 REPORT

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TREASURY ECONOMIC FORECASTING EXERCISE

REPORT BY EA AND PSF

(1) SUMMARY

The forecast covers the period to the end of 1989 (1989-90 for public finances). Table 1 summarises the results and compares them with earlier exercises and with the current average of outside forecasts.

(i) Main results

(a) Following the latest CSO upward revisions, in the Blue Book and subsequently, the growth of **money GDP** in 1986-87 is, at 6½ per cent, very close to that envisaged in the 1986 MTFS. With only limited data available on the early quarters of 1987-88 the prospect is for money GDP growth of 9 per cent, over a point above the figure in the 1987 MTFS. This overshoot could be greater if, following past practice, the CSO revises up the GDP data for the early part of the financial year. The forecast is for overshoots of the MTFS growth rates for money GDP that average almost 2 percentage points in 1988-89 and 1989-90. Both higher real growth and higher inflation than assumed in the MTFS contribute to these overshoots.

(b) Both real **GDP** and **domestic demand** appear to be growing at higher rates in the UK than in the rest of the G7. The forecast is for growth of consumers' expenditure of 4¾ per cent in 1987 and 4½ per cent in 1988, lower than the very high rate of 5¾ per cent recorded for 1986. This deceleration of consumers' expenditure is, however, offset by a strong rise in investment. Total domestic demand grows at 4 per cent in 1987 and 1988, before dropping to 3 per cent in 1989. UK domestic demand growth in 1987 and 1988 is on average 1 per cent higher than the average for the rest of the G7.

The latest forecast is for GDP growth of 4 per cent in 1987 - in line with the June forecast, but above the FSBR forecast of 3 per cent. With nearly all indicators suggesting that activity continues to be strong in the second half of 1987, forecast GDP growth in 1988 is 3 per cent (half a percent higher than in the FSBR and the June forecast) and 2½ per cent in 1989. Growth of **manufacturing output** could be over 5 per cent in 1987, though somewhat lower thereafter. **Unemployment** should continue to fall at a rapid rate in the near future, though as output growth moderates the rate of decline is likely to be less.

(c) **RPI** inflation in 1987(4) is likely to be very close to the FSBR forecast of 4 per cent, though above the 1986 Autumn Statement forecast of 3¾ per cent. The forecast is for a pick up to 5¼ per cent by

1988(4). This owes something to the rise in short term interest rates - and therefore the mortgage rate - that is judged necessary to keep the sterling index constant while the UK economy is relatively so buoyant. However, most of the rise in RPI inflation between the fourth quarters of 1987 and 1988 is the result of

the assumed **revalorisation** of **specific duties** in the 1988 budget after the standstill this year,

a large rise in **LA rates** in 1988-89, given the forecast of their current expenditure and the recent RSG settlement,

and some substantial increases in certain **nationalised industry prices** (plus BGC), following a period in which nominal prices have hardly risen and real prices have fallen substantially.

These factors, together with a gradual increase in unit labour costs, will have an increasing influence on the RPI from the second quarter of 1988.

With the exception of the assumed rise in the mortgage rate nearly all the factors that are forecast to cause a rise in RPI inflation between 1987(4) and 1988(4) will cause the inflation rate of the **GDP deflator** (at market prices) to rise between 1987-88 and 1988-89. The GDP deflator is also likely to be boosted by rising costs and margins in the construction industry, where the recent boom in output seems likely, on the strength of a recent further surge in orders, to continue for some while. The forecast is for construction prices to accelerate a little later than suggested in the June forecast, from early 1988 onwards.

The forecast has the relatively satisfactory recent performance of **unit labour costs in manufacturing** continuing, although growth in the range of 2½-4 per cent throughout the period is slightly above average growth in the UK's principal competitors. Strong productivity growth and the continued fall in employers' pension contributions keep growth of unit labour costs in manufacturing some 5 percentage points below growth in average earnings. Indeed these factors probably reduce the incentive for employers to press for more moderate growth in earnings.

(d) **GNP growth of the major 7** (less the UK) is likely to remain close to the 2¾ per cent recorded for 1986. There has, however, been an upturn in the growth of industrial production and world trade in manufactures which should continue in 1988. Short term interest rates are forecast

to rise further in the US - with rates in Japan and Germany remaining unchanged - to moderate the likely fall in the dollar exchange rate.

(e) It is extremely difficult to analyse the recent behaviour of the **current account**, a difficulty compounded by frequent and large revisions to the 'recorded' data for invisibles and doubts about the seasonal adjustment of visible trade. The visible balance was surprisingly favourable in the early months of the year. Since then there has been a sharp deterioration.

Internal forecasts for 1987 made during much of 1986 and the early part of 1987 showed relatively small current account deficits (as a proportion of GDP) on the basis of rather less domestic demand and output in the UK economy than has in the event occurred. At the same time the world economy has been less buoyant than forecast. For given activity at home and abroad the current account has so far been better than expected. As with the June exercise, the present forecast attempts to take account of this record.

In both 1988 and 1989 North Sea production is forecast to fall by about 5 per cent. With a constant (indexed) oil price at $18 this will produce falls in the **balance of trade on oil** of just under £1b. in each year. Over the forecast period UK labour costs rise slightly more than those in competing economies (in domestic currencies), so that, with short term interest rates set to keep the sterling index at 72.5, there is a small deterioration in measured competitiveness over the period. This, together with higher growth of domestic demand and output in the UK than in the rest of the G7, produces a £2½b. deterioration in **the non-oil current account** between 1986 and 1988, producing overall current account deficits of £2½b. and £4½b. in 1987 and 1988 respectively. While the growth of domestic demand falls in 1989 it remains above growth in the rest of the G7, contributing to a further deterioration in the current account.

(f) The emergence of a growing current deficit coupled with continued outward investment flows implies a need for substantial offsetting **capital account** inflows. The forecast is that UK companies and banks are able to attract these at the projected interest rates, and that confidence in sterling is sufficient to keep the sterling index constant. (With the dollar assumed to fall gradually, the assumption of a flat sterling index implies a very small fall in the £/DM rate over the period.) A weakening of sentiment would make it more difficult to finance the projected current deficit, and put upward pressure on interest rates.

TABLE 1 : SUMMARY OF FORECAST

	FSBR 1987	SUMMER 1987	OCTOBER 1987	AVERAGE OUTSIDE FORECAST SEPTEMBER 1987
A THE WORLD ECONOMY				
1. GNP (MAJOR 7 EXCLUDING UK)				
(per cent change on a year earlier)				
1986	2.6	2.5	**2.7**	
1987	2.6	2.3	**2.5**	
1988	3.0	2.8	**2.6**	
1989	3.0	2.8	**2.4**	
2. DOMESTIC DEMAND (MAJOR 7 EXCLUDING UK)				
(per cent change on a year earlier)				
1986	3.8	3.7	**3.8**	
1987	3.0	2.6	**2.6**	
1988	3.2	2.8	**2.6**	
1989	3.0	2.8	**2.5**	
3. WORLD TRADE IN MANUFACTURES				
(weighted by UK market shares: per cent change on a year earlier)				
1986	2.4	2.1	**1.3**	
1987	3.4	2.6	**2.6**	
1988	4.1	3.2	**3.4**	
1989	5.0	4.3	**3.8**	
B UK ACTIVITY AND DEMAND				
4. GDP VOLUME (non-North Sea GDP in brackets)				
(per cent change on a year earlier)				
1986	2.6(2.7)	2.8(2.9)	**3.1(3.2)**	
1987	3.0(3.1)	3.9(4.1)	**4.1(4.5)**	3.2
1988	2.4(2.9)	2.3(2.8)	**3.0(3.5)**	2.4
1989	2.4(2.8)	1.7(2.1)	**2.4(2.8)**	
5. VOLUME OF DOMESTIC DEMAND				
(per cent change on a year earlier)				
1986	3.2	3.5	**3.8**	
1987	3.5	3.6	**3.9**	
1988	2.4	3.3	**4.1**	
1989	2.2	2.0	**2.9**	
6. UNEMPLOYMENT (UK S.A. EXCLUDING SCHOOL LEAVERS million)				
1986 Q4	3.14	3.14	**3.14**	
1987 Q4	2.88	2.73	**2.74**	2.84
1988 Q4	3.01	2.58	**2.52**	2.82
1989 Q4	2.94	2.61	**2.54**	
C INFLATION AND MONEY GDP				
7. MONEY GDP (MARKET PRICES)				
(per cent change on a year earlier)				
1986-87	6.1	6.3	**6.6**	
1987-88	7.5	8.8	**8.9**	
1988-89	6.4	7.9	**8.5**	
1989-90	6.1	7.1	**7.8**	

	FSBR 1987	SUMMER 1987	OCTOBER 1987	AVERAGE OUTSIDE FORECAST SEPTEMBER 1987
8. RPI (excluding mortgage interest payments in brackets) (per cent change on a year earlier)				
1986 Q4	3.4(3.4)	3.4(3.4)	**3.4(3.4)**	
1987 Q4	3.9(3.4)	3.8(3.6)	**3.9(3.7)**	4.0
1988 Q4	3.3(3.0)	5.1(4.4)	**5.3(4.6)**	4.6
1989 Q4	3.3(3.2)	4.2(3.9)	**4.3(3.9)**	
9. GDP market price deflator (per cent change on a year earlier)				
1986-87	3.2	3.0	3.0	
1987-88	4.5	5.0	4.6	
1988-89	4.0	5.7	5.4	
1989-90	3.6	5.1	5.2	
D **PUBLIC FINANCES**				
10. PSBR - £ billion				
1986-87	4.1	3.3	**3.5**	
1987-88	3.9	1.0	**-1.2**	3.4
1988-89	4.4	0.8	**-5.0**	
1989-90	4.9	0.8	**-5.4**	
11. PSBR - % OF GDP				
1986-87	1.1	0.9	**0.9**	
1987-88	1.0	0.2	**-0.3**	
1988-89	1.0	0.2	**-1.1**	
1989-90	1.0	0.2	**-1.1**	
12. ANNUAL FISCAL ADJUSTMENT - £ billion				
1988-89	3.2*	7.4*	**13.6***	
1989-90	1.7*	1.1*	**2.8***	
allocated to				
(a) reducing personal taxes				
1988-89	3.2	3.7	**4.1****	1.8
1989-90	1.7	0.5	**2.0**	
(b) reducing PSBR				
1988-89	0.0	3.7	**9.5**	
1989-90	0.0	0.6	**0.8**	

*Assuming PSBR ratio of 1 per cent as in 1987 MTFS.
**This is one third of the fiscal adjustment remaining after the higher than previouslyassumed level of privatisation receionts has been used to reduce the PSBR.

E **MONETARY CONDITIONS**				
13. SHORT TERM INTEREST RATES (per cent))				
1986 Q4	11.2	11.2	**11.2**	
1987 Q4	10.3	9.5	**10.5**	9.5
1988 Q4	10.1	10.5	**11.0**	8.9
1989 Q4	9.7	10.5	**11.0**	

	FSBR 1987	SUMMER 1987	OCTOBER 1987	AVERAGE OUTSIDE FORECAST SEPTEMBER 1987
14. MO				
(per cent change on a year earlier)				
1986-87	4.3	4.3	**4.3**	
1987-88	4.0	4.3	**5.1**	
1988-89	3.4	4.0	**4.4**	
1989-90	3.0	3.4	**3.4**	
15. STERLING INDEX (1975=100)				
1986	72.8	72.8	**72.8**	
1987	70.3	71.7	**72.0**	71.8(Q4)
1988	69.3	72.0	**72.5**	70.5(Q4)
1989	67.3	72.0	**72.5**	
16. £/DM EXCHANGE RATE				
1986	3.19	3.19	**3.19**	
1987	2.78	2.93	**2.95**	
1988	2.67	2.86	**2.94**	
1989	2.52	2.77	**2.87**	
17. RELATIVE UNIT LABOUR COSTS (1980=100)				
1986	77.6	77.7	**77.3**	
1987	74.0	75.2	**74.8**	
1988	73.5	77.1	**76.7**	
1989	70.1	78.6	**76.9**	
F TRADE AND CURRENT ACCOUNT				
18. VOLUME OF NON-OIL EXPORTS OF GOODS AND SERVICES (EXCL. ERRATICS)				
(per cent change on a year earlier)				
1986	1.9	1.9	**2.0**	
1987	5.8	4.4	**6.1**	
1988	4.0	3.6	**2.6**	
1989	5.1	4.5	**3.0**	
19. VOLUME OF NON-OIL IMPORTS OF GOODS AND SERVICES (EXCL. ERRATICS)				
(per cent change on a year earlier)				
1986	5.5	5.4	**5.7**	
1987	6.9	3.9	**7.2**	
1988	1.9	4.7	**4.8**	-2.2
1989	2.7	3.5	**2.9**	
20. CURRENT BALANCE				
£ billion				
1986	-1.1	-0.1	**-1.0**	
1987	-2.7	-0.5	**-2.4**	-1.1
1988	-1.7	-0.9	**-4.3**	-2.3
1989	-0.4	-2.3	**-5.6**	

(g) The prospects for **public finances** are again better than in earlier forecasts. The cumulative PSBR in the first six months of 1987-88 is about £3½b. below the budget profile. The major part of this shortfall is on the CGBR(O), with higher tax receipts the main explanation, but with central government expenditure below profile. Local authority borrowing has also been below profile. For 1987-88 the forecast is for a negative PSBR of £1b.

The forecasters attempt to predict the level of **public expenditure** that will occur. The forecast therefore implicitly includes judgements both on the results of the current round of Ministerial discussions (and for 1989-90 the results of the autumn 1988 discussions) and on the influence of the forecast evolution of the economy on demand led public expenditure. (Annex I summarises the assumptions on public expenditure.) The forecast has the outturn for the **planning total** (less privatisation receipts) in 1988-89 and 1989-90 respectively £5b. and £10b. above the previously announced plans (including the reserve). The emerging outcome for 1987-88 and the forecast for public expenditure in the later years implies that the ratio of general government expenditure (excluding privatisation receipts) to GDP starts off 1¾ percentage points below the value in the last PEWP and continues to fall further in 1988-89 and 1989-90.

Even with their current spending likely to exceed provision at much the same rate as in recent years and with the proportion of expenditure financed by central government grant falling, **local authorities' borrowing** should be close to its 1986-87 level during the forecast period as a result of a large increase in rates and buoyant capital receipts. **Public corporations' finances** benefit from the buoyant level of activity over the forecast. Nevertheless rising real levels of investment lead to an increased requirement for external finance, despite positive real price increases.

With the forecast levels of nominal and real demand and output higher than in earlier forecasts, forecast **tax receipts** (pre-fiscal adjustment) are higher. More real fiscal drag has contributed to slight upward revisions since June to the effective tax rates for PAYE and onshore CT. The share of pre-fiscal adjustment non-North Sea taxes in non-North Sea money GDP rises over the forecast period.

With the shares of public expenditure and pre-fiscal adjustment government revenues in GDP behaving so differently there are large fiscal adjustments. The forecast makes the stylised assumption that - after adjusting the PSBR for the higher than previously assumed

level of privatisation receipts - for 1988-89 one third of the available fiscal adjustment is allocated to cuts in personal taxes and the other two thirds to reduce further the PSBR below the level in the 1987 FSBR. In 1989-90 the PSBR ratio is maintained at the assumed level for the previous year and the additional fiscal adjustment that is available is allocated to cuts in personal taxes. This produces cuts in personal taxes of £4¼b. and £2b. in 1988 and 1989 budgets. Even with these assumed cuts the share of post fiscal adjustment government revenues in money GDP does not change over the forecast period. The PSBR adjusted for privatisation receipts and the PSFD are - as proportions of money GDP - lower in 1988-89 and 1989-90 than at any time since the war except in the late 1940s and early 1950s and in 1969-70 and 1970-71. (See Annex II.)

(h) The forecast for public finances in the UK implies a markedly greater ex post tightening of fiscal policy than in the rest of the G7 taken together, as shown by the **general government deficit** - the only comparable measure of fiscal stance available for all G7 countries.

TABLE 2 : GENERAL GOVERNMENT FISCAL DEFICITS AS A SHARE OF GDP (%)

	1979-85	1986	1987	1988	1989
UK	3.1	2.6	~~2.9~~ 1.8	~~1.4~~ 1.1	0.6
G7 (less UK)	3.1	3.1	2.8	2.7	2.7

(Corrected in Mowl of 12.10)

(ii) Main issues and risks

2. It is invidious to label individual judgements as particularly important or vulnerable. Nevertheless in the current exercise there has inter alia been detailed discussion of

- **the likely extent of the fall in the private sector surplus,**
- **the prospects for pay,**
- **the short term prospects for the current account,**

and - **the robustness of the projections for public sector finances.**

(a) The forecast implies a decline in the **financial surplus of the private sector** from its current high level. (Annex II sets out the data for sectoral surpluses and deficits over a long historical period.) Some fall in the company sector surplus seems very likely given the good prospects for capital investment revealed in intentions surveys. Indeed there must be a significant risk that, following the recent buoyancy of the economy, investment will be stronger than in the forecast.

The prospect for the personal sector is particularly uncertain. The personal sector accounts include companies' pension funds which, following the strong rise in equity markets at home and abroad, have found themselves with assets well in excess of their liabilities. The principal reaction of companies has been to attempt to rein back their surpluses by cutting employers' contributions. This reduces measured personal sector (though not household sector) saving. This process is likely to continue, particularly as companies will be taking steps to meet the requirement, introduced in the 1986 budget, that pension funds' surpluses, measured on the Government Actuary's assumptions, should not exceed 5 per cent of liabilities. To allow for this the forecast has the personal saving ratio declining slightly, even though there is a rise in the savings ratio if employers' contributions are ignored. (See Chart C on page .)

In normal circumstances the personal sector saving ratio would rise significiantly at a time of strong growth in disposable income. This does not appear to have happened either in 1986 or - on the basis of available data - in 1987. But despite this it is possible that, contrary to what is forecast some rise could occur in 1988, producing lower growth of domestic demand and a more favourable current account than now forecast.

While such a development is possible there is a greater risk that personal saving, adjusted for the fall in employers' contributions, will not rise as much as envisaged in the forecast. The drop in the growth of consumers' expenditure from the 5¾ per cent recorded for 1986 to the forecasts of 4¾ and 4½ per cent in 1987 and 1988 depends critically on the judgement that the saving ratio, when adjusted for the fall in employers' contributions, will rise to a level over 1½ percentage points above the recorded 1986 level. Some rise in saving by households would be expected as both inflation and interest rates rise next year, but the extent of the forecast rise does mark a major break with behaviour so far in the 1980s. A faster than forecast growth of consumers' expenditure or company spending in 1987 and 1988 would have adverse consequences for the current account and domestic inflationary pressures.

(b) While there are already signs that private sector **pay settlements** and **average earnings** have begun to accelerate, the record on **labour costs** has been satisfactory. With the economy growing rapidly and RPI inflation rising there is a risk that the acceleration of earnings could be greater than the very slight upturn envisaged in the forecast.

(c) The very strong productivity growth in recent years does suggest that the UK's industrial performance has improved relatively to the rest of the G7 and that as a result a significant trend deterioration in trade performance is less likely. The evidence on this is, however, far from conclusive. A stronger than forecast surge in imports in response to strong domestic demand growth in the second half of 1987 and 1988 could be evidence that the forecast is too optimistic about industrial performance. This would mean both weaker GDP growth (with net exports lower) and a worse current account than forecast.

(d) The continuous improvement in recorded and forecast public finances since mid 1986-87 almost strains credulity. The prospect for onshore corporation tax is particularly important with increases on a year earlier of £3-3½b. forecast for both 1987-88 and 1988-89. By 1989-90 forecast CT receipts are approximately three times the 1984-85 level. If public expenditure were to over run the last published plans by less than the forecast assumes the improvement in public finances would be even more marked and the scope for fiscal adjustment correspondingly greater.

Most of the improvement since the June forecast in the overall prospect for public finances in 1988-89 and 1989-90 is the result of a higher forecast level of activity. The share of pre-fiscal adjustment of non-oil taxes in money GDP is about ½ a percentage point higher in both 1988-89 and 1989-90, whereas the level of real GDP is 2 per cent higher in 1989. If growth were less than forecast the ex post fiscal position would obviously be a good deal less favourable. Nevertheless, with a total fiscal adjustment in 1988-89 of £13½b. there would still be scope for some combination of further reductions in borrowing and tax cuts, even if taxes were markedly less buoyant than in the forecast.

(2) THE WORLD ECONOMY

3. There was a slowdown in the first half of 1987 in domestic demand growth in the United States, Germany and France that was not offset elsewhere among the major industrial countries. Exports of the group as a whole are, however, picking up and their import growth is slowing, so that the gap between domestic demand growth and real GNP growth in 1987 should be much lower than in 1986. Stockbuilding was particularly strong in the major countries in the first half of 1987 and, to the extent that this was involuntary, subsequent destocking could depress growth. This could be offset by the effects of the Japanese Government's fiscal package and, in 1988, tax cuts in Germany. The WEP sees real domestic demand in the other

major countries as a whole growing by 2.6 per cent in 1987, and real GNP growing by 2.5 per cent, with similar growth rates over the next two years. This is broadly in line with our latest estimates of growth in productive potential.

4. The forecast for the world economy incorporates the judgement that downward pressure on the dollar exchange rate will be fairly mild. This would enable the Federal Reserve to keep interest rate rises to the minimum necessary to control domestic inflationary pressures. With only a modest reduction in the Federal budget deficit in prospect (despite the new Gramm-Rudman deficit reduction programme), the resulting forecast shows the US current account deficit declining only gradually. There is a significant risk that such a slow turnaround would lead to a serious weakening of confidence in the dollar and a sharp drop in its exchange rate, causing the Fed to raise US interest rates substantially. In Japan and Germany the monetary authorities remain very reluctant to lower interest rates, and they may want to raise them for domestic reasons. Nevertheless strong upward pressure on their exchange rates might force them into further modest cuts. The forecast has German and Japanese short rates at their current levels, which with the assumed rise in US rates, involves a small rise in average world short rates.

5. Prospects for **oil prices** are clouded by developments in the Gulf and doubts about OPEC's ability to restrict production. The forecast is that the oil price (North Sea average) will be around $18 per barrel in the period to end-1988, and that the real price will be constant thereafter. **Non-oil commodity prices** have been rising in real terms during 1987. The forecast is for a further gradual rise in real non-food commodity prices until the end of 1988 as world industrial production strengthens, but food prices are expected to remain weak.

TABLE 3 : G7 (excluding UK) GROWTH AND INFLATION
(IMF World Economic Outlook in brackets)

Percentage changes on a year earlier	1986	1987	1988	1989
Real GNP	2.7	2.5(2.5)	2.6(2.7)	2.4
Domestic Demand	3.8	2.6(2.6)	2.6(2.7)	2.5
Industrial Production	0.9	2.8	4.4	4.3
Consumer prices	1.8	2.6(2.9)	3.0(3.4)	2.8

Note: IMF figures include UK

6. Total imports grew by almost 5 per cent in 1986 when oil trade was very buoyant following the fall in the price. Imports of manufactures are estimated to have grown by only 2 per cent. In 1987 the forecast is for

lower total world import growth, of about 3½ per cent, but a pick up in the growth of imports of manufactures to around 4 per cent. In later years world trade is expected to pick up as NODCs, and to a much lesser extent OPEC, increase their imports.

7. Total world trade in manufactures continues to grow more quickly than developed countries exports of manufactures throughout the forecast period because it is assumed that developing countries, and the Asian NICs in particular, will continue to increase their market share. Weighting developed countries exports by UK market share also reduces their growth, because OPEC is a relatively important UK market. Of the difference in 1987-88 and 1988-89 between growth in total world trade in manufactures and the UK market weighted version of developed countries trade in manufactures roughly two thirds results from the difference of coverage (ie the developed countries' loss of share to the NICs) and one third from the weighting.

TABLE 4 : THE VOLUME OF WORLD VISIBLE TRADE

(IMF World Economic Outlook in brackets)

percentage change on year earlier	1986	1987	1988	1989
Total world imports	4.7(4.9)	3.5(3.6)	4.2(4.5)	4.0
of which:-				
- Major seven	9.1	4.9	3.9	3.3
- OPEC	-20.5	-10.1	0	2.5
- Non-OPEC developing countries	1.2	3.3	5.5	6.0
Total world imports of manufactures	1.9	3.8	4.9	4.8
Main developed countries' exports of manufactures weighted by UK market share	1.3	2.6	3.4	3.8

(3) TRADE AND THE BALANCE OF PAYMENTS

8. The current balance, which recorded a surplus in the first four months of the year, returned to deficit in May and has shown average monthly deficits since then averaging £400 million, although individual monthly figures have been erratic. A return to deficit in the latter half of the year had always seemed likely. The scale of the deterioration, however, has been greater than expected at the time of the June forecast, although the current account for the year as a whole could still be close to the £2½ billion deficit forecast in the FSBR.

TABLE 5 : UK CURRENT ACCOUNT (£bn)

	Visible trade balances			Net invisibles			Current balance
	Manufactures	Oil	Other	Services	IPD	Transfers	
1986	-5.5	4.1	-7.0	5.0	4.7	-2.2	-1.0
1987	-7.9	4.3	-6.4	5.6	5.5	-3.4	-2.4
1988	-10.2	3.3	-6.3	5.5	6.8	-3.4	-4.4
1989	-11.6	2.4	-6.2	5.7	7.6	-3.5	-5.8

9. The forecast current deficit of £2½ billion for 1987 compares with a revised estimated deficit of £1 billion in 1986. The widening in the deficit is more than accounted for by a larger deficit on trade in manufactures, which is offset only in part by a higher surplus on oil trade, a smaller deficit on trade in other goods, and a modest improvement in invisibles. In 1988 the forecast is for the current account deficit to increase to around £4½ billion followed by a further widening to £5¾ billion in 1989, with an increasing deficit on manufactured trade and a worsening in the oil balance more than offsetting a rise in the invisibles surplus.

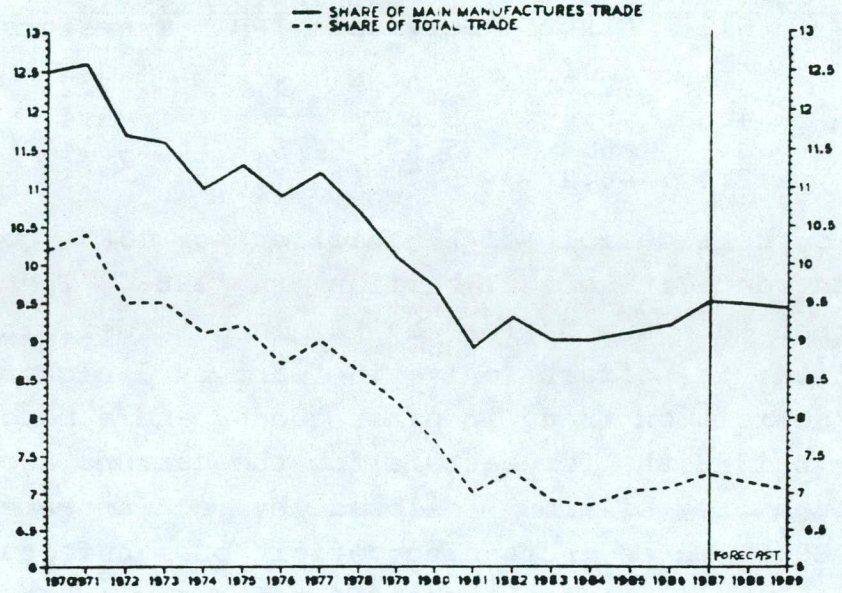
Non-oil visible trade

10. The rising deficit on trade in manufactures in 1987 and 1988 mainly reflects faster domestic growth in the UK compared to overseas. While labour cost competitiveness has deteriorated since the end of 1986, it is still significantly better than the average for 1984 and 1985. Over the forecast period there is a slight deterioration. (See Table 26.)

11. The volume of manufactured exports, which remained flat in the first half of 1987 after the surge towards the end of last year, appears to have begun rising again in recent months. Recorded growth, which may benefit from residual seasonal factors in the rest of this year, seems likely to continue at a modest rate to the end of next year, reflecting the slow rise in the world trade and the effects of the competitiveness loss during 1987. Growth may quicken thereafter as world trade rises more rapidly.

12. The UK's share of developed countries' exports of manufactures, which rose during 1986, may be slipping slightly during 1987, with further small falls forecast for 1988 and 1989. The forecast is for a slight fall also in the UK's share of the wider measure of world manufactured trade which includes NICs' exports. (See Chart A.). This projected share performance reflects mainly an assumption that the loss of competitiveness early this year has tended to restrain export growth fairly quickly, despite the fact that the forecast gives weight to the UK's improved export supply performance since 1981.

CHART A : UK VOLUME SHARES OF TRADE IN MANUFACTURES



13. The volume of manufactured imports which fell sharply in the first quarter of 1987, has risen rapidly again since April. Some of this volatility may reflect residual seasonal factors, but a strong rise in domestic demand for manufactures, rising capacity utilisation, and some loss of recorded competitiveness since the end of 1986 have probably been important factors. The erratic nature of the monthly figures makes difficult the assessment of the underlying trend. The forecast has a further rise in imports during the rest of this year followed by a more gradual rise during 1988 and 1989 as domestic growth falls.

14. Non-manufactured exports and imports have fallen back recently, following the exceptionally rapid growth of trade in wheat and olive oil towards the end of 1986 and in early 1987. (This rapid growth of imports and exports, largely the result of the peculiarities of the CAP, had little effect on the current balance.) Exports are projected to resume growth in 1988 and 1989 as world demand rises, but imports may be rather sluggish as the recent surge in basic material imports ends and imports of food, drink and tobacco return to their modest trend growth.

15. The non-oil terms of trade rose sharply in the first half of this year from the trough at the end of 1986 reflecting partly sterling's appreciation and partly the weakness of world food prices. The forecast is for little change in 1988 and 1989.

Oil trade

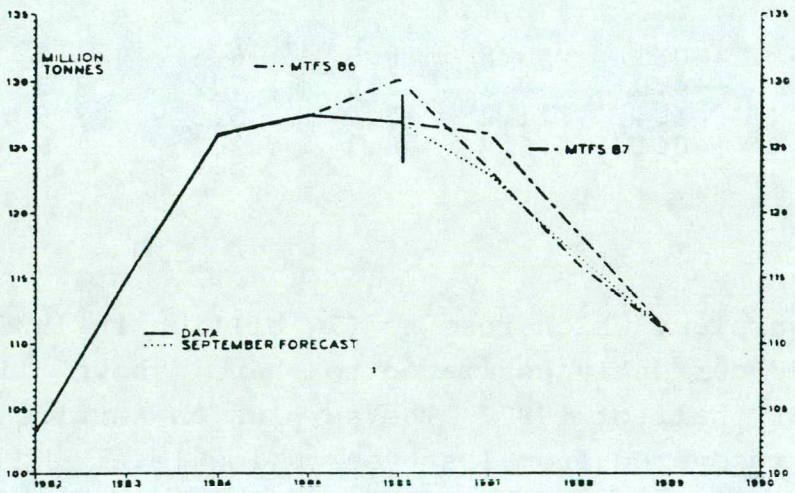
16. The strengthening in world prices during the first half of 1987 has helped to offset a lower than expected volume of North Sea output. On the assumption that oil prices remain close to their present level for the rest of the year and that some - but not all - of the production shortfall is made good, the oil trade balance should be a little higher than last year's £4 billion surplus.

TABLE 6: NORTH SEA OIL

	Average N.Sea oil price		N.Sea output	Oil trade balance	N.Sea* taxes
	$/barrel	£/barrel	mn.tonnes	£ bn	£ bn
1986	14.2	9.7	126.9	4.1	4.8
1987	17.7	11.0	122.9	4.3	4.6
1988	18.0	10.7	116.5	3.3	4.5
1989	18.7	10.8	110.8	2.4	4.5

* financial year totals

CHART B : FORECASTS FOR NORTH SEA OIL PRODUCTION



17. The forecast that the average North Sea oil price will remain at $18 a barrel until the end of 1988 and then rise in line with world inflation implies a small fall in North Sea sterling prices next year as the dollar weakens and little change in 1989. North Sea output falls by 5 per cent a year in 1988 and 1989. The fall will largely be reflected in lower exports. The oil trade surplus is forecast to fall by about £1 billion in 1988 and a further £0.9 billion in 1989.

18. Table 7 summarises the forecast for trade volumes. Changes in aggregate exports and imports of goods and services mask divergent movements in components. The projected 3½ per cent a year growth in the volume of manufactured exports excluding erratics in 1988 and 1989 is offset partly by lower arms shipments to Saudi Arabia, a fall in oil exports and a reduction in the recent exceptionally high level of gold exports, together with a more modest growth in services credits, so that total exports only rise by 1½ per cent a year. Total imports are forecast to rise less rapidly than manufactured imports excluding erratics. This reflects mainly a decline in non-manufactured imports partly as a result of the ending of exceptional trade in olive oil and a fall in gold imports (offsetting the fall in exports).

TABLE 7 : EXPORTS AND IMPORT VOLUMES
(per cent changes on previous year)

	Manufactures excl. erratics	Erratics	Oil	Other goods	Total goods	Services	Total goods and services
Exports							
1986	1.1	28.0	2.0	5.5	3.7	1.0	3.1
1987	6.6	2.4	-0.6	6.9	5.2	4.5	5.0
1988	3.5	1.9	-4.0	0.7	1.5	1.9	1.6
1989	3.5	1.6	-6.5	2.2	1.6	1.8	1.6
Imports							
1986	5.6	-0.1	13.8	8.5	6.5	4.9	6.2
1987	9.6	+4.0	0.2	1.6	7.2	3.3	6.5
1988	7.5	-1.4	11.2	-3.0	5.3	3.6	5.0
1989	4.0	0.1	6.7	-0.7	3.2	2.6	3.1

10. Invisibles

19. The invisibles surplus, which rose to £7½ billion in 1986' compared to £5 billion in 1985, is currently estimated to have shown little further growth in the first half of 1987. The surplus on services has risen as travel earnings have recovered from last year's low level and earnings from financial services are estimated to have continued to rise. Net earnings from interests, profits and dividends (IPD), however, have fallen from the high level of late-1986 as the pound's appreciation has reduced the sterling value of overseas earnings, and margins on banks' overseas business have been squeezed.

TABLE 8 : THE BALANCE OF INVISIBLES (£ billion)

	Services	N.Sea IPD	Other IPD	EC transfers	Other transfers	Total invisibles
1986	5.0	-1.6	6.3	-0.7	-1.5	7.5
1987	5.6	-1.7	7.2	-1.7	-1.7	7.6
1988	5.5	-1.2	7.8	-1.6	-1.8	8.7
1989	5.7	-0.2	8.2	-1.7	-1.9	9.6

20. The invisibles surplus is forecast to rise from about £7½ billion this year to £8¾ billion in 1988 and £9½ billion in 1989. The services surplus is unlikely to rise in 1988 as UK growth remains buoyant compared to overseas, but may improve in 1989 as the growth gap narrows. The main increase in the invisibles surplus seems likely to reflect falling payments abroad, North Sea oil companies - as oil output declines - and a rise in other net IPD earnings as portfolio yields rise abroad and banks' margins return to more normal levels. Net transfers to the European Community are projected to show little change in 1988 and 1989 from this year's level. The precise profile of payments and receipts will of course depend on a number of factors on which decisions have not yet been taken.

(4) DOMESTIC DEMAND AND ACTIVITY

(a) Personal income and expenditure

21. Published figures for the first half of 1987 and retail sales for the year to August show consumer spending relatively sluggish at the start of the year, but picking up strongly since the spring. However, discrepancies in the national accounts for the first half of 1987 indicate a significant underrecording of one or more components of expenditure, so that growth of consumer spending growth may well not have fallen to 4 per cent as the recorded figures currently suggest. The figures for retail sales show growth as high as in 1986. Consumer spending seems to have been very strong in the third quarter of the year, and car registrations in August were 6 per cent higher than in August 1986.

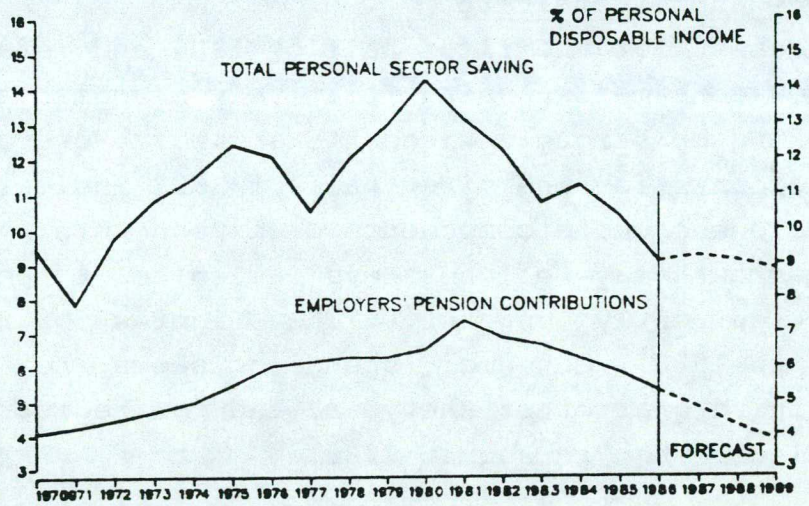
TABLE 9: RETAIL SALES AND CONSUMERS EXPENDITURE

	Retail Sales			Consumers' expenditure	
		Percentage change on			(percentage
	1980=100)	previous period	year earlier	(£ billion 1980)	change on year earlier)
1986 Q1	119.3	1.7	4.3	39.5	5.1
Q2	121.3	1.7	4.7	40.1	6.6
Q3	123.7	2.0	5.5	40.7	5.8
Q4	126.5	2.3	7.3	40.9	5.6
1987 Q1	125.4	- 0.9	5.1	41.1	4.1
Q2	128.2	2.3	5.8	41.8	4.2
Q3*	131.9	3.2	7.0		
Jan	123.6	- 2.4	4.6		
Feb	127.0	2.8	7.1		
Mar	125.5	- 1.2	3.8		
Apr	130.0	3.6	7.7		
May	125.4	- 3.5	4.8		
June	129.4	3.2	5.0		
July	131.2	1.4	7.0		
Aug	132.5	1.0	6.9		

* Average of July and August

22. Between 1980 and 1986 the personal saving ratio has fallen by about a third, and it is currently close to the levels recorded in the latter part of the 1960s and in the early 1970s, before the dramatic rise in inflation. Part of the recent fall in the saving ratio (and part of its rise in the second half of the 1970s) is probably attributable to the behaviour of employers' contributions to pension funds. (See Chart C). Employers' pension contributions are recorded as part of personal income, but short-term fluctuations in them are unlikely to affect personal expenditure to anything like the extent that changes in after tax wages and salaries do. Instead they are likely to show up in fluctuations in the personal saving ratio.

CHART C. EMPLOYERS' PENSION CONTRIBUTIONS AND THE PERSONAL SAVING RATIO

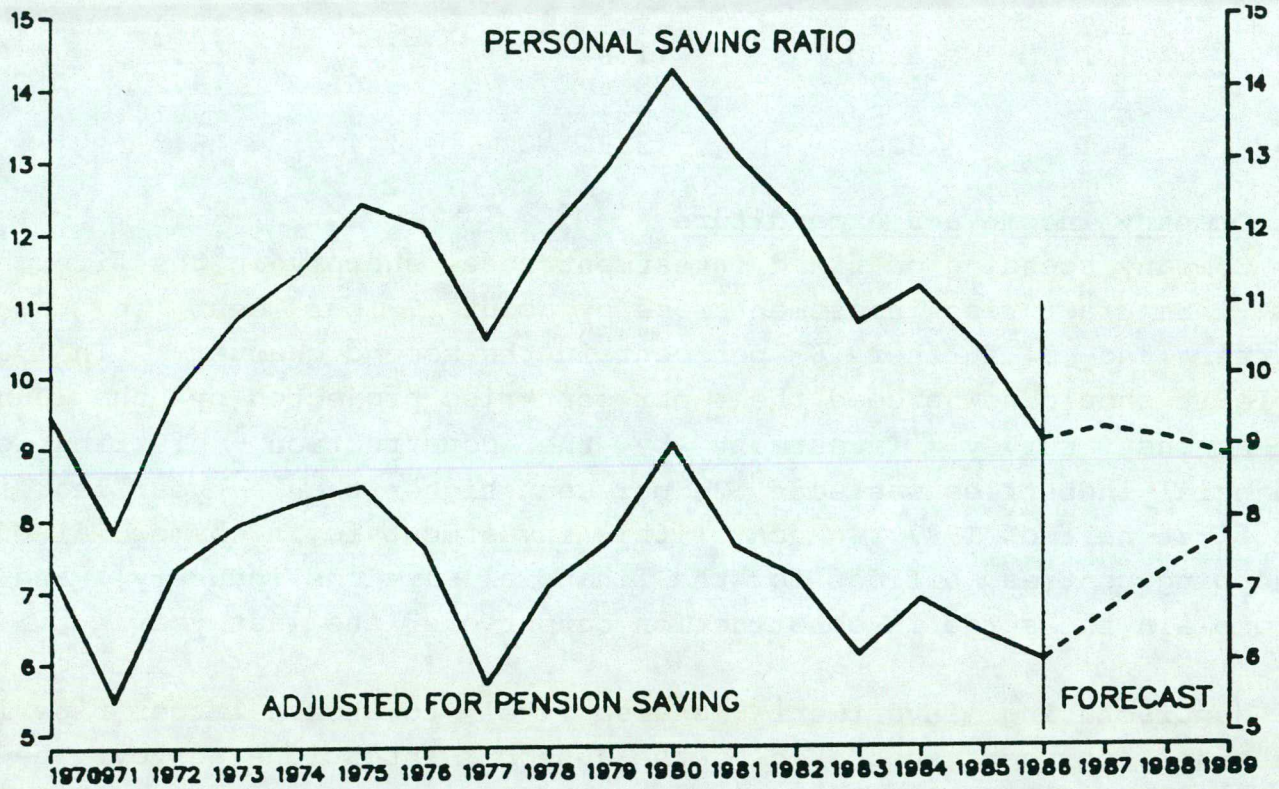


23. The rise to 1981 in pension fund contributions as a proportion of personal disposable income reflected expanding coverage of schemes and topping up payments made to cover actuarial deficits caused by the rise in inflation and the plunge in the stock market in the mid 1970s. In 1980 and 1981 there was also a rise in redundancy payments and an effect from the composition of employment. The fall in employment in this period particularly affected manual workers who would be less likely to be covered by private pension schemes.

24. The subsequent fall in pension contributions relative to wages and salaries must reflect in large part the impact on pension funds of the recovery in profitability and stock markets and the fall in inflation experienced since 1981. This has led to large actuarial surpluses, and an increasing number of firms have temporarily stopped making pension contributions. The 1986 Budget, which required reductions in actuarial surpluses where these exceeded liabilities by more than 5 per cent, and the

continuing rise in profitability and dividends are likely to ensure a further fall in pension contributions relative to pay. This in turn is likely to mean that the personal saving ratio is likely to fall a little further between 1987 and 1989, even though higher inflation and interest rates may be tending to restrain spending (see chart D). (The apparent rise in the recorded personal saving ratio so far in 1987 may be an illusion, reflecting under-recording of consumer spending.)

CHART D : PERSONAL SAVING ADJUSTED FOR PENSION FUND CONTRIBUTIONS



25. The published figures show real personal investment in dwellings weak in the first half of 1987, falling some 4 per cent from the second half of 1986. Spending on both improvements and investment in new dwellings was apparently lower than a year earlier in the second quarter of 1987, a development that is hard to understand given the general buoyancy of personal spending and in particular given the rise in the rate of house completions over the last year.

26. Nevertheless it does look as though housing starts, which were rising through 1986 and into the first quarter of 1987, have now flattened out. Even so for 1987 as a whole housing starts may be at least 5 per cent higher than last year. Completions should go on rising into 1988. In spite of the surprising investment figures for the first half of 1987, the forecast is for a 10 per cent rise in investment in dwellings in the year as a whole, followed by a 6 per cent rise in 1988. By 1989 investment in new dwellings may have stopped rising, although expenditure on improvements should continue to grow quite strongly.

27. Fast growth in both house prices and real personal investment combined with a falling saving ratio mean that the personal sector's financial surplus, which has already declined from about 6 per cent of GDP in 1980 to just over 1 per cent in 1986, is likely to fall further.

TABLE 10: REAL PERSONAL INCOME AND EXPENDITURE

	Real personal disposable income	Real consumers' expenditure	Real investment in dwellings	Persons' net acquisition of financial assets	Personal saving ratio	Saving ratio excluding pension saving
	(Percent changes on previous year)			(£ bn)	(per cent)	(per cent)
1985	2.7	3.7	-3.9	9.0	10.4	6.4
1986	4.3	5.8	11.8	4.7	9.1	6.0
1987	4.9	4.7	9.4	3.6	9.2	6.7
1988	4.4	4.6	6.1	2.6	9.1	7.3
1989	3.1	3.4	3.9	1.4	8.8	7.8

(b) Company income and expenditure

28. Company spending on fixed investment rose sharply in the first half of 1987. Manufacturing investment rose by about 7 per cent in the first quarter and a further 6½ per cent in the second quarter. In 1987 as a whole it should now exceed the 4 per cent rise projected by the June DTI intentions survey. Investment by the construction, distribution and financial industries was some 12½ per cent higher than a year earlier in the first half of 1987. Much of this investment is in commercial building (shopping centres, offices for the financial services industry) and helps to explain the surge in construction output over the last year.

29. Manufacturing investment is also likely to show a larger rise in 1988 than the 6 per cent suggested by the June DTI intentions survey. The latest quarterly CBI survey indicated a substantial upward revision during the summer to intended expenditure on both buildings and plant and machinery. Other private sector business investment may also rise quite strongly again next year, and the build up of work on the Channel Tunnel will contribute to a further rise in construction work. Table 11 summarises the forecast for investment. Nationalised industry investment is much less buoyant than private sector investment, and reduces the growth of "other business" investment shown in table 11.

SECRET

TABLE 11: GROSS FIXED CAPITAL FORMATION

(percentage changes on previous year)

	1986	1987	1988	1989
Business	- 3	6½	5½	3½
of which				
North Sea	- 14½	- 20	4	- 4½
Manufacturing	- 5	7	10½	8
Other business	- 1	8½	4	2½
Private dwellings	7½	7	5½	3
General government	5½	- 2½	- 3	0
Total	½	5	4½	3

30. Manufacturers reduced their stocks during the first half of 1987. Some of this destocking may have been unintended: by the summer manufacturers were telling the CBI for the first time this decade that on balance they no longer held excessive stocks. This year has also seen a decline in the balance of firms expecting stocks to fall. Distributors' stocks rose during the first half of 1987, though not enough to prevent a fall in the ratio of stocks to sales. The rise in consumer goods imports in the third quarter may indicate a stronger rebuilding of stocks. The forecast is for some further gradual fall in the stock output ratio, but at a slower pace than recorded in recent years. (The main reaction to the tax changes in the 1984 which raised the cost of stockholding should now have taken place.) This implies an increased rate of stockbuilding over the forecast period, though stockbuilding remains on a modest scale compared with many years of the 1960s and 1970s.

31. Non-North Sea industrial and commercial companies' profits net of stock appreciation rose by 13 per cent between the first halves of 1986 and 1987. Part of this rise is accounted for by reallocation of newly privatised companies (especially BGC) to the private sector. Excluding the profits of such companies the growth of profits was probably 10-11 per cent over this period - a slower rate of growth than recorded in recent years but still above the growth of money GDP. For 1987 as a whole the underlying growth of non-North Sea ICCs' profits is forecast to be similar to that experienced in the first half of the year. Profit growth may slow further in 1988, as output growth slows down and the rate of increase in costs rises slightly. This outlook for profits, at a time when company expenditure is likely to be rising strongly, implies a fall in companies' financial surplus - not, however, to an extent that should pose any general financial problems for companies.

TABLE 12: THE FINANCIAL POSITION OF INDUSTRIAL AND COMMERCIAL COMPANIES

	Profits as a share of money GDP (per cent)		Rate of return on assets, non-oil ICCs' (per cent)	Net acquisition of financial assets (£ bn) (all ICCs)	Borrowing requirement (£ bn) (all ICCs)
	Total	Non-oil			
1973-85 average	12.0	8.9	5.5	2.2	3.6
1986	15.0	12.5	8.9	6.4	6.1
1987	15.9	13.2	9.6	9.3	14.0
1988	15.2	13.0	9.2	4.2	11.0
1989	15.2	13.2	9.3	4.5	10.0

32. Table 13 shows the forecast for industrial and commercial companies' gross trading profits. The table also shows companies' net income - which is net of interest payments and receipts and corresponds roughly to the base for corporation tax. The slowing of net income growth in 1988 partly reflects the rise in interest rates forecast for the start of the year.

TABLE 13: PROFITS OF INDUSTRIAL AND FINANCIAL COMPANIES

(percentage changes on previous year)

	Non-North Sea Industrial and Commercial Companies*		Financial Companies
	Gross Trading Profits	Net Income	Net Income
1986	19 (16)	26	21
1987	16 (13)	18½	19
1988	7½	3½	16½
1989	7½	6	6½

* Figures in brackets show growth of profits adjusted to exclude the effects of newly privatised companies being included.

(c) Aggregate demand and output

33. The average estimate of GDP grew by 3¾ per cent between the first halves of 1986 and 1987, while the output estimate grew by around 4¼ per cent (4¾ per cent non-North Sea). Output growth was particularly strong in the construction sector (up by 7½ per cent), and manufacturing output also recorded a rise of 5 per cent. The full extent of the rise in output is not explicable in terms of recorded expenditure. The expenditure estimate of GDP shows less than a 2½ per cent rise over the same period.

34. For 1987 as a whole the output measure of GDP seems likely to record a rise of 4 per cent or a little more. It is likely that the

average estimate of GDP will eventually show a similar increase. But there is some risk that, if the problems with the expenditure measure persist into the second half of the year, recorded growth could be a little under 4 per cent on the average estimate when the first figures for calendar 1987 are published by the CSO at around the time of the Budget. Given the record of upward revisions to GDP at the times of fast output growth it is quite likely that recorded growth for the average measure of GDP in 1987 will eventually settle down at a figure above 4 per cent.

Can't have stories of undershooting

35. Growth is expected to fall back to around 3 per cent in 1988 (3½ per cent non-North Sea). This slowing down is caused by a worse trade performance and by some deceleration in personal spending. After two years of above trend growth in 1987 and 1988, 1989 could see somewhat slower growth if the investment cycle has started to turn down by then.

TABLE 14: EXPENDITURE AND OUTPUT

(percentage changes on previous year)

	1986	1987	1988	1989
Domestic demand	3.8	3.9	4.1	2.9
Exports of goods and services	3.1	5.0	1.6	1.6
Imports of goods and services	6.2	6.5	5.0	3.1
Compromise adjustment	0.4	0.8	0	0
GDP(A)	3.1	4.1	3.0	2.4
Non-oil GDP(O)	3.1	4.5	3.5	2.8
Manufacturing output	1.1	5.2	2.9	3.2

(5) INFLATION

36. RPI inflation is likely to average close to 4 per cent in the fourth quarter of 1987, in line with the forecast published in the FSBR. Producer output prices, on the other hand, seem likely to rise some ½ per cent more on average this year than forecast at Budget time, principally as a result of higher input prices. In the third quarter of 1987 materials and fuel input prices were some 7 per cent higher than forecast at Budget time. Inflation as measured by the main national accounts deflators, however, was actually lower in the second quarter than expected at Budget time. There is currently an unusually large difference between inflation as measured by the RPI and inflation as measured by the national accounts consumption deflator. The national accounts deflators are subject to revision, and revisions tend to be upward.

Producer prices

37. Productivity growth of around 7 per cent has left manufacturers' unit labour costs virtually unchanged over the last year. In spite of the rise in materials costs over the last year, manufacturers' total unit costs are still no higher than they were at the start of 1985. Over the forecast period there is likely to be a modest rise in unit labour costs, as productivity growth reverts to its estimated underlying rate of increase, and real commodity prices may continue a gradual recovery from their exceptionally depressed levels of 1986. However, with a stable exchange rate for sterling, manufacturers will find it difficult to raise profit margins to anything like the extent they have done over the last three years. A slight reduction in inflation is expected during 1988, and inflation may fall further in 1989 if the economy slows down as forecast and competitive pressures intensify.

TABLE 15: MANUFACTURING COSTS AND PRICES

(percentage changes on previous year)

	Unit labour costs	Cost of materials and fuels	Estimated total costs	Domestic producer output prices*
1986 Q4	0.2	- 5.6	- 0.4	3.9
1987 Q4	0.9	7.7	2.2	4.8
1988 Q4	3.0	2.2	2.9	4.4
1989 Q4	2.8	3.1	2.4	3.2

* excluding food, drink and tobacco

Retail prices

38. Although retail price inflation in the fourth quarter of 1987 may turn out marginally below the Budget forecast, inflation is likely to rise during the first half of 1988 to around 5¼ per cent by the end of the year. This rise in inflation reflects in particular substantial electricity and gas price increases, a large rise in local authority rates, the loss of the benefits of the non-revalorisation of specific duties in the 1987 Budget, and a forecast rise in mortgage rates, as well as the effect of faster growth of unit labour costs.

39. Table 16 sets out changes in **nationalised industry** prices charged to domestic consumers over the year to 1987 Q4 and 1988 Q4, and gives real price increases over a run of financial years.

TABLE 16 : NATIONALISED INDUSTRY PRICES

(a) Nominal price increases for consumers

	Year to 1987 Q4	Year to 1988 Q4
Post	2.6	4.5
Rail	5.7	5.0
Electricity	- 0.3	8.0
Coal and coke	- 0.1	2.2
Bus	4.9	4.3
Water	5.6	6.4

(b) real price increases (weighted average for consumers and industry)

	1983-4	1984-5	1985-6	1986-7	1987-8	1988-9	1989-90
British Coal	2.3	0.0	- 1.9	- 3.1	- 4.5	- 2.9	- 2.4
Electricity	- 3.8	- 2.0	- 2.2	- 1.9	- 3.9	2.9	0.0
BSC	- 8.1	1.1	- 4.6	- 1.8	- 1.6	- 2.3	- 1.7
Post Office	- 2.0	- 1.5	- 4.2	- 2.0	- 0.8	- 0.4	- 1.0
Water	1.5	1.0	4.7	4.4	1.7	1.4	2.0
LTR	-15.7	- 3.2	1.5	2.2	2.1	4.4	4.1
British Rail	- 4.5	0.4	0.0	2.8	1.2	- 0.2	- 0.9

* Nominal changes deflated by the RPI

40. The larger increases in nationalised industry prices charged to consumers in 1988 will raise RPI inflation in 1988(4) by about ¼ per cent compared with inflation in 1987(4). Other factors that contribute to the rise in RPI inflation between 1987(4) and 1988(4) are as follows:

(i) The formula relating **gas prices** to oil prices and the RPI should give almost a 4 per cent rise in domestic prices next year, following a 4½ per cent fall this year (the difference is worth about 0.2 per cent on inflation).

(ii) The rate support grant settlement is assessed as implying an 12 per cent rise in average **local authority rate** poundages next year, compared with 7¾ per cent this year (the difference is worth 0.18 per cent on inflation).

(iii) A 1 point rise in **mortgage rates** compared with their end September level means that the path of mortgage interest payments adds about 0.4 per cent more to RPI inflation next year than this.

(iv) The assumed **indexation of specific duties** in the 1988 Budget will add a little over 0.3 per cent to RPI inflation in the latter part of 1988 compared with the latter part of 1987.

(v) **Food** prices are also likely to rise a little faster over the next year. Although world food prices are expected to remain relatively weak, a partial recovery in tropical beverage prices means that the prices of the foods the UK buys on world markets will rise a little more in 1988 than in 1987, and the faster rise in UK labour costs will also tend to put up food retail prices inflation.

(vi) **Petrol** prices have been unexpectedly low during the summer - the normal seasonal rise did not occur - in spite of the strength of crude oil prices. Over the next year there may be little change in petrol prices, other than that resulting from the assumed indexation of petrol duties in the 1988 Budget.

(vii) **Other private sector prices** have risen by 3½ per cent over the last year. (They would have risen by about 4 per cent but for the non-indexation of duties in the 1987 Budget.) Making a small allowance for the possibility that some of the acceleration of producer output prices in recent months has still to feed through into these prices and for the effect of the recent rise in pay settlements, these prices could rise by around 4¼ per cent over the next year.

41. The forecast for the RPI is summarised in table 17.

TABLE 17: COMPONENTS OF THE RETAIL PRICE INDEX

(Percentage changes on previous year)

	1986 Q4	1987 Q4	1988 Q4	1989 Q4
Food prices	3.2	3.4	3.9	3.5
NI prices	3.7	2.3	6.3	4.3
Housing prices	7.1	7.5	11.4	8.1
Other prices	2.6	3.4	4.1	3.5
- of which petrol	3.4	-12.6	1.8	3.4
- other items	3.8	3.4	4.2	3.4
All items RPI	3.4	3.9	5.3	4.3
RPI excluding mortgage interest payments	3.4	3.7	4.6	3.9

42. The annual rate of increase in the RPI should fall below 4 per cent [redacted] November when the mortgage rate increase that occurred in November 1986 drops out of the twelve month comparison. The inflation rate will rise again early next year on the assumption that the mortgage rate rises at the beginning of the year. Inflation is likely to rise quite sharply after March as post Budget increases in specific duties and rates and electricity price increases show up in the index. The forecast monthly path of retail price inflation up to the end of 1988 is shown below.

TABLE 18: MONTHLY PATH OF RPI INFLATION

		All items RPI	RPI excluding mortgage interest payments			All items RPI	RPI excluding mortgage interest payments
1987	August	4.4	3.7	1988	April	4.5	4.2
	September	4.2	3.4 3.5		May	4.9	4.3
	October	4.3	3.6		June	5.1	4.4
	November	3.8	3.7		July	5.2	4.5
	December	3.7	3.7		August	5.3	4.6
					September	5.5	4.7
1988	January	3.9	3.6		October	5.4	4.6
	February	3.9	3.6		November	5.3	4.5
	March	4.1	3.7		December	5.3	4.5

(c) The GDP deflator

43. The national accounts deflators published for 1987Q2 are surprisingly low. The CSO are currently looking at some aspects of the figure for the deflator for consumers expenditure, and have indicated that it is quite likely that the figure will be revised up. The latest published figure for the GDP deflator (showing a 4.1 rise in the GDP deflator at market prices over the year to 1987Q2) does not suggest any overrun of the Budget forecast for the current financial year which was for a 4½ per cent rise in the GDP deflator.

44. For 1988-89 most of the factors tending to push up the RPI (other than the path of mortgage rates) will also affect the GDP deflator. The GDP deflator will also be affected to the extent that the current boom in construction output feeds into construction prices and the forecast has a modest allowance for this effect in 1988-89.

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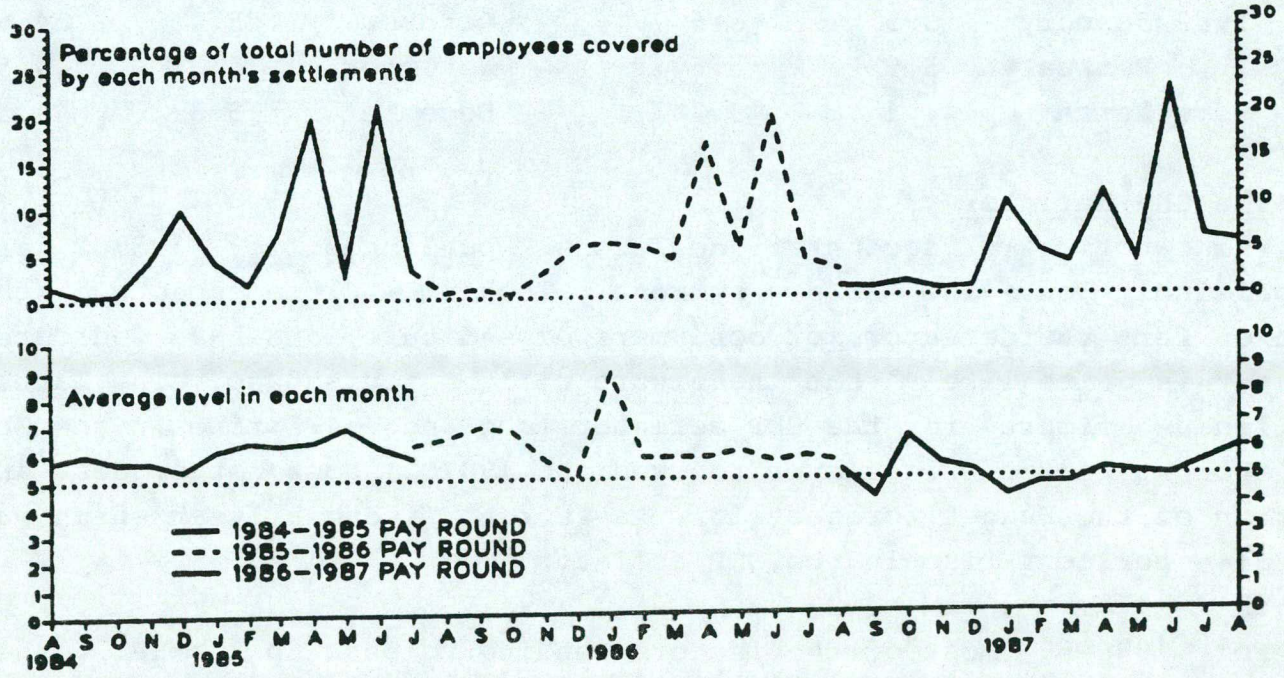
TABLE 19: FORECASTS FOR THE DEFLATOR FOR GDP AT MARKET PRICES

	1986-87	1987-88	1988-89	1989-90
MTFS				
Total	3	4½	4	3½
non-oil	6	4¼	3¾	3¼
Autumn forecast				
Total	3	4½	5½	5¼
non-oil	5¾	4	5½	5

(d) Earnings

45. Over the twelve months to August 1987, private sector pay settlements monitored by Department of Employment averaged 5 per cent, about ¾ per cent less than during the previous twelve month period. Settlements fell during the second half of last year, but appear to have bottomed out at around the beginning of 1987, and in the most recent month settlements averaged 6 per cent (see Chart E).

CHART E: PRIVATE SECTOR PAY SETTLEMENTS



46. Other evidence on settlements, such as that from the CBI's pay databank, tells a similar story. Although a relatively small number of employees are covered by the most recent settlements, the upward trend seems well established and it is not likely that as major settlements are concluded over the autumn they will generally be at rates below 6 per cent. This forecast assumes 6 per cent settlements on average over the next twelve months. Settlement rates may thereafter rise further (reflecting inflation at around 5½ per cent in mid 1988), but fall back in the second half of 1989 as the economy slows further and price inflation falls.

47. Overtime has been very high in recent months - at around record levels relation to the number of operatives - and is currently estimated to be responsible for around ½ percentage point of the 8 per cent growth of private sector earnings over the last year. Over the next two years cyclical effects will tend to reduce earnings growth, and will offset the effect of rising pay settlements.

TABLE 20: PRIVATE SECTOR SETTLEMENTS AND EARNINGS
(Contributions to changes between third quarters of successive years)

	1986-87	1987-88	1988-89
Settlements	5¼	6	6½
Drift	2¾	2	1½
Increase in average earnings	8	8	8

48. Over the twelve months to August growth in local authority earnings has been roughly in line with private sector, while central government earnings has been a little lower. Over the following twelve months, local authority pay seems likely to rise somewhat faster than private sector pay. The teachers are already due for 8.2 per cent from October and a further 1 per cent next April. The forecast assumes that they receive only 4½ per cent "new money" on top of this in the light of Cabinet's decision not to pay more than the increase in the RPI. Local authority manuals have already agreed an increase of 10½ per cent. Local authority construction workers may also do well, particularly given the pressures from construction workers' pay in the private sector (up over 10 per cent in the year to June). It seems likely that some important groups of local authority workers will continue to do better than the private sector. While others (eg further education teachers) may do worse, local authority pay on average looks likely to rise a little faster than private sector pay.

49. On the other hand, central government earnings are likely once again to rise more slowly than private sector earnings over the next year. If there is a relatively high settlement for health service employees, it could well be staged, while a settlement for civil servants below the private sector average is expected. In later years central government pay is expected to rise more closely in line with private sector pay.

TABLE 21 : PUBLIC AND PRIVATE SECTOR UNDERLYING AVERAGE EARNINGS
(percentage changes over years to August)

	Central Government	Local authorities	Private sector**
1986-87	7	8 (7)*	7½
1987-88	7	9½(9¼)*	8
1988-89	8	9 (8¾)*	8½

* figures in brackets excluding settlements for primary and secondary teachers
** adjusted for changes in overtime hours.

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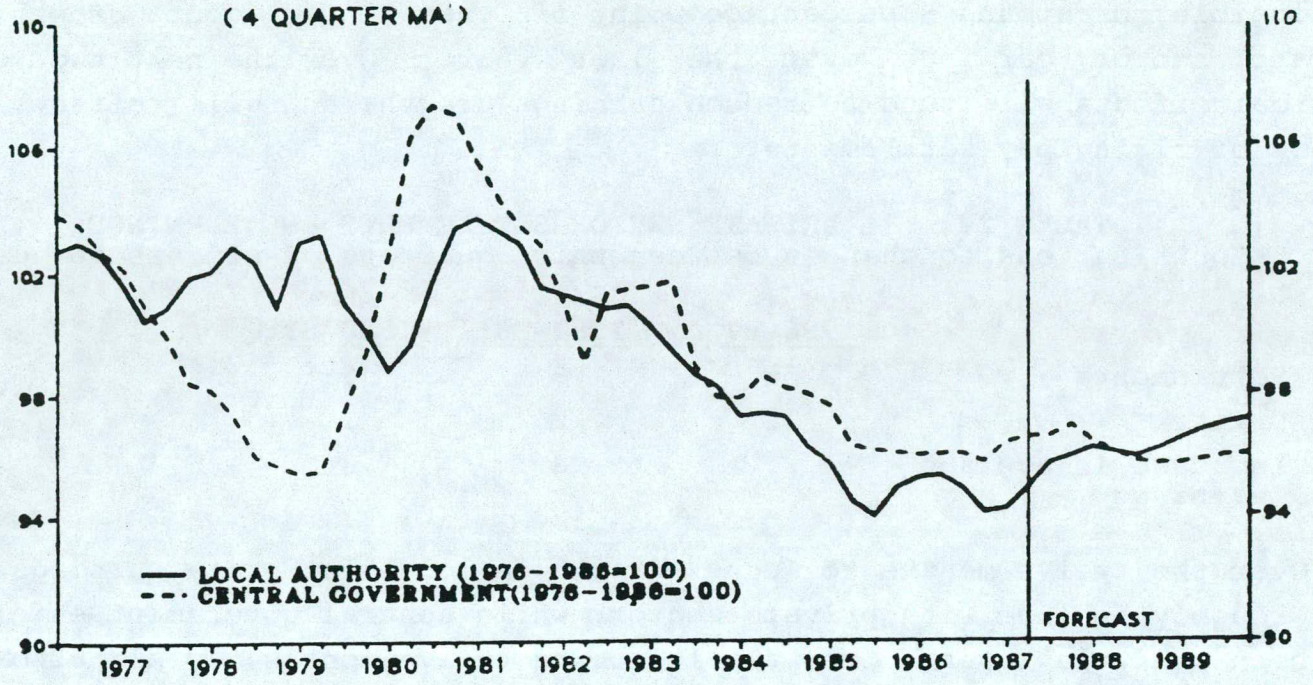
CHART F : RATIO OF LOCAL AUTHORITY AND CENTRAL GOVERNMENT EARNINGS TO PRIVATE SECTOR AVERAGE



(e) Labour costs

50. The forecast for private sector earnings combined with the forecast for productivity (discussed in section 6 below) produces forecast increases in labour costs in manufacturing that are modest by past standards, and close to those forecast for competitor countries.

TABLE 22 : LABOUR COST INCREASES IN MANUFACTURING

(percentage increases on previous year)

	UK	Major 7 (less UK)
1986	3.4	2.3
1987	0.0	1.3
1988	3.3	1.6
1989	2.6	2.3

(6) PRODUCTIVITY, EMPLOYMENT AND UNEMPLOYMENT

51. The latest upward revisions to manufacturing output mean that manufacturing productivity is now estimated to have risen by around 7 per cent in the first seven months of this year compared with a year earlier. While much of the recent rise in productivity is the result of a cyclical increase in the intensity of use of labour (as indicated by the rise in overtime hours), it seems that underlying productivity growth may have been a little higher recently than has been previously assumed. For this forecast the projection of underlying productivity

growth has been raised from 4 to 4¼ per cent a year.

52. Employment outside manufacturing rose by over 130,000 during the first quarter of 1987. Current indications are that the second quarter showed an increase of around 120,000. Growth in output per man outside manufacturing was unusually strong during 1986 - reflecting, among other things, redundancies in the coal industry and good productivity gains in other public corporations -, but as far as can be discerned has been much slower this year. Underlying growth in private sector non-manufacturing productivity is projected at around 1¾ per cent a year (about 2½ per cent a year in terms of full time equivalents).

TABLE 23: RECORDED AND FORECAST GROWTH OF OUTPUT PER HEAD

Annual averages, percentage changes

	1964-73	1973-79	1979-86	1986-89
Manufacturing	5¾	¾	3¾	5
Non-manufacturing*	3	½	1¼	1½
Total non-oil economy	2¾	½	1¾	2¼
Whole economy	2¾	1	2	1¾

* Includes private sector and nationalised industries other than in manufacturing and oil.

53. Labour supply is forecast to grow by about 680 thousand over the three years to 1989, about 200 thousand less than in the previous three years. This projection is somewhat higher than growth shown in the projections published in the Employment Gazette because the UK's relatively strong economic performance is likely to lead to both higher net inward migration and higher participation ratios than allowed for in the Department of Employment's projections.

TABLE 24: PRODUCTIVE POTENTIAL

(Annual averages; percent changes)

	Trend non-North Sea productivity growth	Labour supply	Non-North Sea productive potential	Contribution of North Sea	Whole economy productivity potential
1973-79	1	½	1½	½	2¼
1979-86	1½	½	2	¼	2¼
1986-89	2	¾	2¾	- ½	2½

54. Growth in the "working population" - the sum of employment and unemployment - has been very low over the past year: around 40,000 between mid 1986 and mid 1987, below the projected growth in labour supply, and down from increases of over 500,000 a year between mid 1983 and mid 1985. This is the phenomenon publicised by Layard and Clarke. The employment programmes which have been expanding recently and other measures such as Restart have tended to reduce the working population. (This is not the case with the Community Programme, whose participants are generally counted as employees and so remain in the working population).

55. But government programmes and Restart are not the only factors responsible for the recent slow growth of the working population. One important factor has been that the composition of employment growth has changed somewhat in favour of areas where most of the jobs are filled by men. Construction employment has started to rise, manufacturing employment has flattened out, and the programme of redundancies in the coal industry has - at least for a while - come to an end. Thus a higher proportion of new jobs have been going to claimants, and a smaller proportion to non-claimants. Moreover, the growth of the "working population" between 1983 and 1985 was quite exceptional relative to growth in the population of working age. It was never likely to be sustained and does not provide a reasonable benchmark against which to assess the impact of Restart and other recent measures. Between mid 1986 and mid 1987 the shortfall of growth in the working population relative to the projected increase in population of working age was some 130,000 - much less than the fall in unemployment over this period (roughly 290,000 including school-leavers). As shown in table 25, on our estimates of the effects of the various measures, about two thirds of the improvement in the adult unemployment trend as between the year to mid 1986 and the year to mid 1987 is attributable to underlying economic factors rather than to the effect of measures.

56. Unemployment is likely to fall more slowly during the forecast period. This is primarily because the 5 per cent growth in manufacturing output and 7 per cent rise in construction output forecast for this year are not forecast to be repeated over the next two years and so male employment growth will slow down. Nevertheless, helped by the removal from the count in September 1988 of everyone under 18, unemployment could go on falling into 1989.

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TABLE 25 CHANGES IN ADULT UNEMPLOYMENT

(seasonally adjusted 000s)

	Unemployment		Effects of employment and training measures, restart and availability testing	Underlying unemployment
		(Monthly aver)		(Month)
1985(2)-1986(2)	+ 88		- 64	152
1986(2)-1987(2)	- 238	-20	- 173	- 65
1987(2)-1988(2)	- 322	-27	- 117	- 205
1988(2)-1989(2)	- 135	-11	- 64	- 71

(7) FINANCIAL CONDITIONS

57. WEP has a rise in US interest rates during 1988, which is judged sufficient to limit the fall in the dollar exchange rate to modest proportions. With interest rates in the other major economies flat the average world interest rate rises. Because this rise in the average world interest rate is the consequence of likely downward pressure on the dollar exchange rate there could be some upward pressure on sterling against the dollar. However, the prospect that the UK current account deficit will widen in 1988 and 1989 could raise expectations of some decline in the sterling exchange rate with a need for an increase in interest rates in order to achieve a constant sterling index.

CHART G : STERLING AND THE CURRENT BALANCE

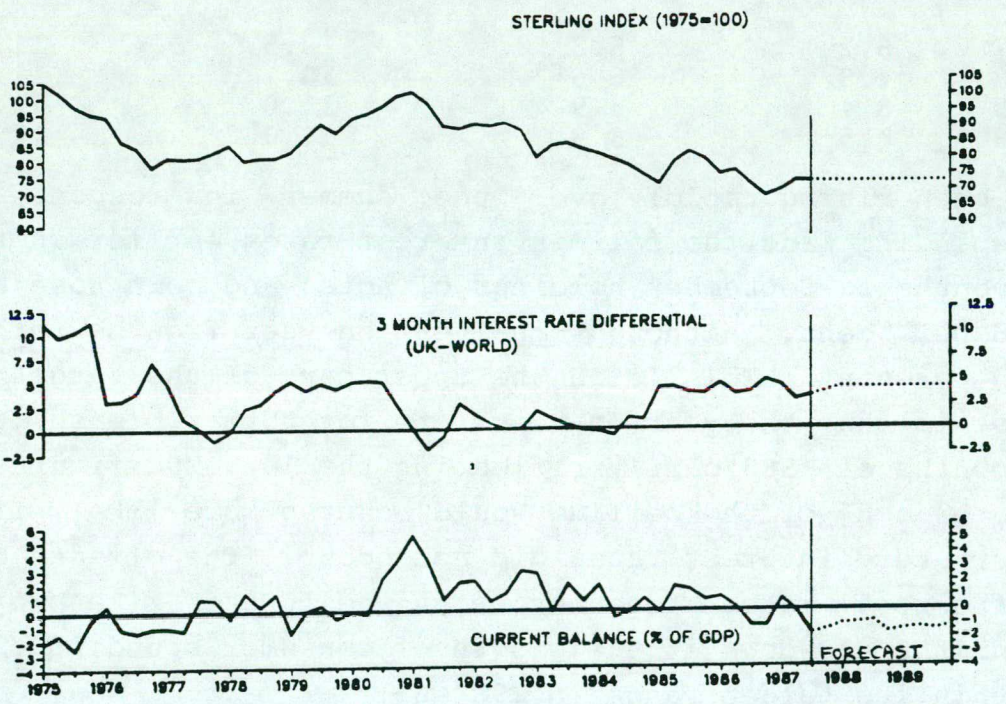

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TABLE 26: EXCHANGE RATES AND COMPETITIVENESS
(average yearly rates)

	US dollar index (1975=1000)	Sterling index (1975=100)	$/£	DM/£	Relative unit labour costs (1980=100)
1984	134.6	78.6	1.34	3.79	82.9
1985	140.7	78.2	1.30	3.78	84.5
1986	114.8	72.8	1.47	3.19	77.3
7 Oct	101.5	73.3	1.64	2.998	75.4
1987	102.4	72.0	1.61	2.94	74.8
1988	98.1	72.5	1.68	2.94	76.7
1989	94.6	72.5	1.73	2.87	76.9

58. Domestic factors also point to upward pressure on interest rates. MO will be very close to the top of its target range in the near future, reflecting strong growth in consumers' expenditure. Money GDP growth is expected to overshoot the objectives set in the 1987 FSBR in every year in the forecast period. Continued strong credit demand from the private sector - both companies and persons - tends to offset the decline in the needs of the public sector. The forecast has short-term interest rates rising over the next few months to reach 11 per cent by the middle of 1988Q1. This rise, however, is not sufficient to bring the growth of money GDP back to its MTFS path.

TABLE 27: INTEREST RATES

	3-month US interest rates	3-month world rates	3-month sterling LIBOR	Mortgage rate
7 October	7.9	6.9	10.2	11.3
1986-87	6.2	6.3	10.5	11.7
1987-88	7.3	6.6	10.1	11.5
1988-89	8.4	6.9	11.0	12.3
1989-90	8.5	6.9	11.0	12.3

59. M0 has been rising rapidly over the summer in response to buoyant consumer spending and the fall in interest rates earlier in the year. In the three months to September holdings of notes and coin rose at an annual rate of 8 per cent, although the year on year figures for M0 have been closer to 5 per cent. This is in the upper part of the target range, and the forecast is that the year-on-year rate for M0 may breach its ceiling in the early months of 1988 partly reflecting the low M0 figures in early-1987. (A breach of the ceiling would be even more likely if the assumed rise in short term interest rates did not occur.) The effects of the recent rise in interest rates together with the further rise projected in the forecast and the slowdown in the growth of consumer spending should bring M0 back within its target range in 1988-89.

TABLE 28: MONETARY AGGREGATES AND CREDIT

(per cent change on a year earlier)

	M0		M3	M4	Lending by banks and building societies
	MTFS range	Actual forecast			
August 1987	-	4.7	22.1	15.6	18.8
1986-87	2-6	4.3	19.0	14.9	18.5
1987-88	2-6	5.1	20.4	14.9	18.9
1988-89	1-5	4.4	16.2	13.8	17.2
1989-90	1-5	3.4	13.0	12.7	14.8

60. Broad money has continued to grow rapidly, with M3 increasing by 22 per cent in the year to August reflecting a continued strong rise in deposits by persons, ICCs, and building societies with some slowdown in deposits by other financial institutions after the surge early in the year. The forecast is that M3 growth may slow next year. Persons' deposits may continue to rise rapidly reflecting rising personal incomes and the relative attractiveness of high-interest bank accounts. Companies' deposits, however, may increase less rapidly than in the recent past as their investment in real asset rises. Deposits by financial institutions may grow markedly less quickly than recently as a result of lower inflows to pension funds and a slower rise in their total portfolio. The growth of M4 which contains a greater proportion of personal sector deposits, continues to rise less rapidly than M3 initially, but the gap closes later in the forecast period.

61. Lending by banks and building societies which rose by 19 per cent in the year to August, is forecast to rise by a further 17 per cent in 1988-89 before slowing in 1989-90. Lending to companies is projected to rise as less buoyant securities markets limit at least to some extent companies' scope to rely on equity issues. Lending to persons is also projected to rise steadily for both housing and other purposes. Competitive pressures on building societies and the limit on their access to wholesale funds continues to erode their share of new mortgage advances.

62. The PSBR is assumed to be funded fully outside the banking system, but the move to a negative borrowing requirement leads to net gilt repayments of £7 billion in 1988-89 and £6½ billion in 1989-90 - even on the assumption that receipts from National Savings are reduced to £1 billion a year. Gross gilt sales fall from £9½ billion in the current financial year to £3½ billion in 1988-89 and £1½ billion in 1989-90.

63. The emergence of a growing current account deficit coupled with continued net direct investment outflows and further portfolio investment abroad by financial institutions implies the need for substantial

offsetting capital inflows. The precise form of these is difficult to judge. The forecast assumes that corporate security issues on both the euro currency and US commercial paper market will play a significant role. Banks are also assumed to increase both their foreign currency and sterling borrowing from abroad for on-lending to residents. Net overseas sales of gilts are projected at zero. The forecast assumes that £1 billion of the intervention so far in 1987-88 is unwound before the end of the financial year with a further £1 billion in 1988-89.

TABLE 29: NET EXTERNAL CAPITAL FLOWS

	Direct invest-ment††	Non bank port-folio*	Banks' foreign currency†	Banks' ster-ling	Other	Official reserves	Balan-cing item	Current balance
1986	-6.0	-7.1	2.9	-0.4	2.8	-2.9	11.7	-1.0
1987	-10.0	7.1	6.2	3.8	2.8	-5.7	-1.8	-2.4
1988	-5.3	0.8	2.2	2.2	2.1	1.3	1.0	-4.3
1989	-5.5	0.9	4.2	2.2	2.5	0.3	1.0	-5.6

* includes gilts
† includes securities
†† includes oil

(8) PUBLIC FINANCES

64. Table 30 summarises the forecast and compares it with the numbers in the FSBR, and with the internal June forecast. The projections in the FSBR were on the basis of certain conventional assumptions and not a central forecast.

TABLE 30 : PUBLIC SECTOR EXPENDITURE, REVENUE, AND BORROWING
(£ billion)

	1986-87 Outturn	1987-88			1988-89			1989-90		
		FSBR	June Fore-cast	Oct. Fore-cast	FSBR	June Fore-cast	Oct. Fore-cast	FSBR	June Fore-cast	Oct Fore-cast
General Government Expenditure	165	174	173	172½	180	185	184	188	198	197
General Government receipts	160	169	172	173	178	187	192	187	201	206
Assumed cuts in personal taxes (cumulative)					3	3	4	5	5	6
GGBR	5	5	2	-½	5	2	-3	6	2	-4
Public corporations' overseas and market borrowing	-1½	-1	-1	-½	-1	-1	-2	-1	-1	-2
PSBR	3½	4	1	-1	4	1	-5	5	1	-5
(per cent of GDP) brackets)	(1)	(1)	(¼)	(-¼)	(1)	(¼)	(-1)	(1)	(¼)	(-1)

(a) 1987-88

65. The PSBR for 1987-88 is now forecast to be a surplus of £1b. The

margins of error attached to PSBR forecasts made at this time of the year, [redacted]lst lower than those for the Budget forecast, are still very high. The average absolute error is around 0.8 per cent of GDP (£3b.).

66. The latest forecast represents an undershoot on the FSBR forecast of £5b., and a reduction of £2b. from the June forecast. Table 31 shows the main components of the £5b. reduction in the PSBR forecast since the Budget. Over three-quarters of the predicted undershoot of the FSBR forecast is accounted for by lower central government own account borrowing, with most of the remainder due to lower local authorities' borrowing. The forecast of public corporations' market and overseas borrowing is little changed. Looked at another way three-quarters of the downward revision to the forecast has been on general government receipts, and one-third to general government expenditure.

TABLE 31 : CONTRIBUTION TO THE CHANGE IN THE 1987 PSBR FORECAST SINCE JUNE AND THE FSBR

	£ billion Changes since	
	FSBR	June
- higher North Sea revenues from a higher North Sea oil price;	-¾	-
- higher non-North Sea corporation tax reflecting upward revisions to 1986 profits data and higher dividend payments (generating ACT) in 1987;	-1	-½
- higher income tax, in line with experience to date and mainly reflecting higher money incomes;	-¾	-¾
- higher national insurance contributions, reflecting higher money incomes;	-½	-
- higher VAT, in line with outturn to date, and reflecting buoyant expenditure and - we think - a larger than expected reduction in arrears as a result of the Keith reforms;	-½	-½
- higher stamp duty as a result of the buoyant housing and stock markets;	-½	-
- higher privatisation proceeds;	-¼	-¼
- a lower public expenditure planning total (excluding privatisation proceeds);	-1	-1¼
- offsetting increases, mainly lower 'other' receipts and higher national accounts adjustments	+¼	+1¼
TOTAL CHANGE IN PSBR FORECAST	-5	-2

Mowl 12.10.

67. Lower expenditure and higher receipts have contributed roughly equally to the £2b. reduction in the PSBR since June. The main upward revisions on the receipts side have been to income tax, non-North Sea corporation tax and VAT. On the expenditure side the main reduction is lower local authority net capital spending, reflecting higher capital receipts, but the forecasts of social security spending and nationalised industries' EFLs have also been reduced.

(b) Fiscal adjustment and PSBR in 1988-89 and 1989-90

68. The MTFS assumption of PSBRs of one per cent of GDP would, on present projections, imply a massive fiscal adjustment in 1988-89 of around £13½b., with a further annual fiscal adjustment of £3b. in 1989-90. The forecast makes the stylised assumption that higher than previously planned privatisation proceeds are used to reduce the PSBR and that one third of the remaining available fiscal adjustment for 1988-89, calculated on this basis, reduces personal taxes, with the remaining two thirds reducing the PSBR to a surplus equivalent to about 1 per cent of GDP. The assumed cut in taxes is a little larger than in the June forecast. In 1989-90 the PSBR is maintained at the arbitrary surplus of 1 per cent of GDP, and there is scope for a further cut in personal taxes of £2b.

(c) Public expenditure

69. The forecast of the planning total excluding privatisation proceeds in 1987-88 has been revised down since June, and instead of a small overspend of the 1987 PEWP plans, a £1b. undershoot is now forecast. Substantial overspends of the PEWP totals are forecast for 1988-89 and 1989-90, only a little less than those forecast in June. The forecast for these years takes account both of the differences between the economic assumptions used in the PEWP and of the economic prospects in the forecast, together with other pressures on programmes which past experience suggests are likely. The forecast is in effect attempting to anticipate not only the final outcome of the current survey (and in the case of 1989-90 the next survey as well), but also any eventual over or underspend on the finally agreed planning totals. The forecast incorporates some modest additions to expenditure in 1989-90 following the buoyant performance of the economy in general and public finances in particular in 1987 and 1988. Privatisation proceeds of £5¼b. are assumed for 1987-88, in line with PE's latest assessment. Proceeds of £6b. a year are assumed for 1988-89 and 1989-90.

70. Table 32 sets out forecast increases in actual programme spending compared with the 1987 PEWP in terms of economic rather than departmental categories. About half the projected excess above current programme plans is accounted for by social security and local authority current expenditure. These are areas over which the Government has limited direct control.

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TABLE 32 : FORECAST ADDITIONS TO PROGRAMME BASELINES

£ billion

	1987-88		1988-89		1989-90	
	PEWP 1987	Forecast Claims on Reserve	PES 1987 Base-line	Forecast additions to baseline	PES 1987 Base-line	Forecast additions to baseline
Allocated to programmes						
1. Social Security (including HB)	44.7	0.5	46.1	2.2	48.0	4.1
2. LA current (excluding HB)	32.5	1.1	33.7	2.9	34.6	5.2
3. CG pay	24.8	0.5	25.8	1.5	26.6	2.9
4. CG procurement	24.6	0.1	25.0	1.4	25.9	2.3
5. LA capital	4.3	-0.7	4.0	-0.2	4.1	0.0
6. EC	0.9	0.4	0.4	0.9	1.1	0.6
7. Nationalised industries	0.7	-0.1	0.3	0.3	-0.1	0.7
8. Other	17.8	0.6	18.3	0.9	18.8	1.5
9. Total programmes	150.1	2.5	153.7	9.9	9.0	17.3
10. Expenditure met from existing reserve						
(i) allocated to programme baseline	0.0	2.5	0.0	5.5	0.0	7.5
(ii) unallocated	3.5	0.0	5.5	0.0	7.5	0.0
11. Underspend (-) Addition to Reserve(+)	0.0	-1.0	0.0	4.4	0.0	9.8
12. PLANNING TOTAL excluding privatisation proceeds	153.6	-1.0	159.2	4.4	166.5	9.8

71. The forecast of social security spending assumes that the underlying growth in spending - ie the growth after allowing for the effects of changes in unemployment, upratings, policy changes, demographic factors etc - which is projected to have risen rapidly in 1987-88, falls back somewhat in 1988-89 and 1989-90. The forecast of local authority current spending, most of which is pay, assumes that numbers employed will rise at much the same average rate as in the last 2-3 years and that earnings increases will be somewhat above the private sector average (see para 48). This, together with the RSG settlements announced in July, implies average rates increases of about 11 per cent in 1988-89.

72. The forecast of central government pay assumes little change in numbers and earnings increases averaging below the private sector in 1988-89 and much the same as the private sector in 1989-90 (see para 49). The forecast of central government procurement assumes that non-defence spending will rise in real terms at much the same rate as over the past 5 years, and that defence spending will rise at ½ per cent a year in real terms. Local authority capital receipts and gross capital spending are assumed to be higher than in the 1987 PEWP, but by roughly equal amounts in 1988-89 and 1989-90. The forecast has partially smoothed out the projected dip in net EC contributions in 1988-89 and the rebound in 1989-90.

73. The large upward revision to the planning total forecasts for 1988-89 and 1989-90 since the Budget are largely matched by a higher inflation forecast. Consequently the increase in the planning total in real terms is less than the cash increase. In real terms the planning total and GGE (see table 33) are much the same as earlier internal forecasts. The forecast of GGE in real terms is almost identical to that made a year ago for 1988-89 and less than 1 per cent higher for 1989-90.

TABLE 33 PAST AND CURRENT FORECASTS OF GGE EXCLUDING PRIVATISATION PROCEEDS

£ billion

Forecast	1986-87		1987-88		1988-89		1989-90	
	Current prices	Real Terms*	Current Prices	Real Terms*	Current Prices	Real Terms*	Current Prices	Real Terms*
Jan 1986	169	169	176	169	186	169	-	-
June 1986	169	169	177	170	186	171	-	-
Oct 1986	170	170	178	171	188	172	200	173
Jan 1987	170	170	179	171	190	173	202	175
FSBR 1987	169	170	179	171	185	171	193	172
June 1987	169	169	179	170	190	171	203	174
Oct 1987	170	170	178	170	190	172	203	175

* in 1986-87 prices

74. The ratio of GGE (excluding privatisation proceeds) to money GDP is forecast to show a sharp fall in 1987-88 and more modest falls in 1988-89 and 1989-90. It is below the PEWP/MTFS paths in all three years.

TABLE 34 : RATIO OF GGE EXCLUDING PRIVATISATION PROCEEDS TO MONEY GDP

per cent

	1985-86	1986-87	1987-88	1988-89	1989-90
1987 PEWP	44¾	44½	44	42¾	42½
1987 FSBR	44¾	44¼	43½	42½	41¾
Oct forecast	44¾	44	42¼	41¾	41¼

(d) General Government Receipts

75. The recent history of forecasts of general government receipts has been a series of successive upward revisions. The current forecast continues this pattern, with substantial upward revisions to 1988-89 and 1989-90

compared the with June forecast. The upward revision since June to the forecast for 1987-88 has been smaller (about £1b.), though this still leaves the 1987-88 forecast of revenues £4b. higher than that in the FSBR.

76. Part of the upward revision to 1987-88 receipts since the FSBR can be attributed to higher economic activity, including stronger than expected stock and housing markets, which have boosted stamp duty receipts. Higher non-North Sea corporation tax for the most part reflects stronger than previously estimated activity and profits in 1986. Higher non-North Sea corporation tax is the most important single factor behind the higher total receipts now forecast for 1988-89 and 1989-90, accounting for around half of the revision since June to 1988-89 and one-third of the revision to 1989-90. The revision to the forecasts partly reflects higher profits growth for 1987 (and thus higher tax receipts for 1988-89). The remainder of the upward revision since June to the receipts forecasts for 1988-89 and 1989-90 are for the most part attributable to higher income and expenditure (income tax, VAT and NICs account for between one-third and half of the total upward revision in each year), but the forecast of local authorities rates has been raised by between £¾ to £1b. in each year.

TABLE 35: COMPARISON OF FORECASTS OF GENERAL GOVERNMENT RECEIPTS (PRE-FISCAL ADJUSTMENT FOR 1988-89 AND 1989-90)*

£ billion

Forecast:	1986-87		1987-88		1988-89		1989-90	
	Cash	Real Terms	Cash	Real Terms	Cash	Real Terms	Cash	Real Terms
January 1986	157	153	166	159	178	162	188	164
June 1986	156	156	164	158	179	164	188	166
October 1986	156	156	165	159	181	165	196	169
January 1987	158	158	169	162	184	168	197	171
FSBR 1987	159	159	169	162	178	164	187	167
June 1987	159	160	172	164	187	168	201	172
October 1987	160	160	173	165	192	174	206	178

* Forecasts made before this and last year's Budgets have been adjusted to be consistent with current tax rates and allowances. Real terms figures are at 1986-87 prices.

77. Table 36 shows non-oil taxes and national insurance contributions (NICs) as a percentage of non-oil GDP. The changes to the tax forecast since the FSBR mean that the forecast now shows a substantial rise in the pre-fiscal adjustment tax burden for 1988-89, but this is offset by the assumed cut in taxes. The projected rise for 1989-90 is smaller, and is

again offset by the assumed tax cut. Thus with the stylised assumption used here on the allocation of the fiscal adjustment, the tax burden [redacted] 1989-90 is the same as the level for 1987-88. With oil revenues as a percentage of GDP expected to be broadly flat at the projected 1987-88 level, the ratio of total taxes to money GDP is forecast to follow a similar pattern to the non-oil ratio.

TABLE 36: NON-OIL TAXES AND NICs AS A PERCENTAGE OF NON-OIL GDP

	1985-86	1986-87	1987-88	1988-89	1989-90
FSBR					
(a) pre-fiscal adjustment	37.2	37.3	37.8	37.9	37.7
(b) post fiscal adjustment	37.2	37.3	37.8	37.1	36.6
June Forecast					
(a) pre-fiscal adjustment	37.3	37.7	38.0	38.4	38.8
(b) post fiscal adjustment	37.3	37.7	38.0	37.5	37.9
October Forecast					
(a) pre-fiscal adjustment	37.0	37.5	38.0	39.1	39.4
(b) post-fiscal adjustment	37.0	37.5	38.0	38.0	38.0

	1981-82	1982-83	83-84	84-85
FSBR	38.8	38.4	37.9	37.8

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ANNEX I: PUBLIC EXPENDITURE ASSUMPTIONS

The forecast of public expenditure in 1987-88 takes account of the latest monthly data on expenditure, the expected evolution of the economy over the rest of the year (which affects such programmes as social security) and Treasury expenditure divisions' assessments of the likely final outturn. For 1988-89 and 1989-90 the forecasters attempt to predict the level of public expenditure that will occur (as opposed to the programme plans which will eventually be agreed). The forecast therefore implicitly includes judgements both on the results of the current round of Ministerial discussions (and for 1989-90 the results of the autumn 1988 discussions) and on the influence of the forecast evolution of the economy on demand led public expenditure.

2. In constructing the forecast it is necessary to make detailed assumptions in certain areas. The main ones were as follows:

(i) The outturn percentage for local authorities' Aggregate Exchequer Grant, which on the basis of the forecasters' view of relevant expenditure, is forecast to fall from 45¾ per cent (GB, accruals) in 1987-88 to 45¼ per cent in 1988-89, is assumed to fall a further ½ percentage point in 1989-90.

Mowl 12.10.

(ii) The forecast assumes an increase in the VAT ceiling for EC own resources contributions from 1.4 to 1.6 per cent with effect from 1 January 1988 and that a Community Budget is agreed before 31 March 1988.

(iii) Privatisation proceeds are assumed to be £6 billion per annum in 1988-89 and 1989-90. For 1987-88 PE's latest best estimate of £5¼ billion is used.

(iv) The Treasury Supplement to the National Insurance Fund is assumed to be reduced by 2 per cent in 1988-89 and a further 2 per cent in 1989-90, to a level of 3 per cent.

?

3. The table below compares the forecast with the main economic assumptions used in the 1987 PEWP, the 1987 MTFS, and with assumptions which have either already been agreed, or proposed (Mr Davies' minute of 2 October to the Chancellor) for use in the forthcoming Autumn Statement and PEWP.

	1986-87	1987-88	1988-89	1989-90	1990-91
GDP Deflator (%)					
1987 PEWP	3	3¾	3½	3	
1987 MTFS	3¼	4½	4	3½	
October Forecast	3	4½	5½	5¼	
Proposed New Assumption	3	4½	5	3½	3
Money GDP (%)					
1987 PEWP	5½	7	6	5½	
1987 MTFS	6	7½	6½	6	
October Forecast	6½	9	8½	7¾	
Money GDP (£b)					
1987 PEWP	380.2	407.0	431.4	455.2	
1987 MTFS	382.4	411.0	437.2	463.8	
October Forecast	385.3	419.5	455.1	490.4	
Unemployment (Adult, GB millions)					
1987 PEWP	3.1	3.05	3.05	3.05	
October Forecast	3.0	2.7	2.5	2.5	
Agreed New Assumption	3.0	2.7	2.6	2.6	
RPI* (%)					
1987 PEWP			3¾	3½	
October Forecast			4.2	5¼	
Proposed New Assumption			4.2	5	3¼
Average Earnings (%)					
March Assumptions		6½	6	5½	5
October Forecast	8	8¼	8	8	
Agreed New Assumption		7½	6½	5½	5
UK 3 month LIBOR					
March Assumptions		9¾	9½	9½	9
October Forecast		10	11	11	
Proposed New Assumption		10	10	9½	9
UK 20 year gilt rate					
March Assumptions		9	9	9	9
October Forecast		10	11	11	11
Proposed New Assumption		10	10	9	9
6 month dollar LIBOR					
March Assumptions		7	8½	9	9½
October Forecast		7¾	8¾	9	
Proposed New Assumption		7½	8½	9	9

* increases in year to previous September

ANNEX II : SECTORAL SURPLUSES AND DEFICITS

Table IIA compares sectoral net acquisition of financial assets by sector (sectoral surpluses and deficits) as proportions of money GDP since 1948. The overseas sector surplus is the current account deficit with the sign changed. Similarly the public sector's surplus is the PSFD with the sign changed.

The large forecast residual error reflects and continues discrepancies between the measures of GDP in the first half of 1987. Normally the residual error comes down as the CSO reduces measurement of errors for a particular period.

For 1988-89 and 1989-90

(i) The **total private sector surplus** is lower than in any year since 1974-75. It is not particularly low compared with earlier experience.

(ii) The **personal sector surplus** is low in comparison with experience in the years from 1960. It is not low in comparison with the earlier period.

Table IIB shows the PSBR, the PSBR adjusted for privatisation receipts, and the PSFD (public sector financial deficit) as proportions of money GDP.

For 1988-89 and 1989-90

(i) The **PSBR** ratio, at -1 per cent, is lower than in every year since 1952 except 1969-70.

(ii) The **PSFD** ratio is lower than in every year except 1968-69, 1969-70, and the three years to 1950.

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TABLE IIA: NET ACQUISITION OF FINANCIAL ASSETS BY SECTOR (AS PER CENTAGE OF GDP)

	Personal (1)	ICC (2)	Financial (3)	Total Private Sector (4)	Public (5)	Overseas (6)	Residual Error (7)
Calendar Years							
1948	- 2.8	1.8	0.3	- 0.7	2.2	- 1.4	- 0.2
1949	- 2.6	2.1	0.3	- 0.1	2.4	- 1.2	- 1.1
1950	- 2.1	3.1	0.3	1.3	2.6	- 3.3	- 0.6
1951	- 3.2	2.5	0.3	- 0.4	- 1.6	2.2	- 0.2
1952	0.1	4.0	0.5	4.6	- 3.4	- 1.0	- 0.1
1952	- 0.4	3.7	0.3	3.7	- 4.1	- 0.8	1.2
1954	- 1.6	3.6	0.4	2.3	- 2.4	- 0.6	0.7
1955	- 1.4	2.1	0.4	1.1	- 2.0	+ 0.8	0.1
1956	0.2	2.0	0.3	2.6	- 2.6	- 1.0	1.0
1957	0.0	1.5	0.4	1.9	- 2.4	- 1.0	1.5
1958	- 0.6	2.1	0.3	1.8	- 1.9	- 1.6	1.7
1959	- 0.3	1.8	0.2	1.6	- 2.2	- 0.7	- 1.3
1960	1.1	0.9	0.2	2.3	- 2.7	+ 0.9	- 0.4
1961	2.3	- 0.2	0.2	2.4	- 2.6	- 0.2	0.5
1962	2.0	0.0	0.2	2.1	- 1.8	- 0.5	0.2
1963	1.9	1.4	- 0.2	3.0	- 2.6	- 0.4	0.0
Financial Years							
1963/64	1.9	1.8	- 0.3	3.4	- 3.3	0.0	- 0.1
1964/65	2.6	- 0.6	- 0.5	1.5	- 2.4	1.0	- 0.1
1965/66	3.6	- 1.0	- 0.5	2.1	- 1.7	0.2	- 0.6
1966/67	2.5	0.8	- 0.7	2.6	- 2.6	- 0.4	0.4
1967/68	2.0	1.6	- 0.8	2.8	- 4.2	1.1	0.2
1968/69	1.2	0.5	- 1.1	0.6	- 0.8	0.3	- 0.1
1969/70	1.5	0.7	- 1.6	0.6	1.7	- 1.5	- 0.8
1970/71	2.1	0.8	- 1.2	1.7	0.4	- 1.1	- 1.0
1971/72	0.1	2.4	- 0.7	1.8	- 1.1	- 1.7	1.1
1972/73	1.4	2.5	- 0.5	3.3	- 3.0	0.4	- 0.7
1973/74	3.4	0.0	- 0.7	2.7	- 4.6	2.0	- 0.1
1974/75	4.3	- 1.7	- 0.7	2.0	- 6.7	3.6	1.2
1975/76	4.1	0.9	- 0.7	4.3	- 7.3	1.0	2.0
1976/77	3.4	- 0.5	0.2	3.1	- 5.7	1.1	1.5
1977/78	2.6	1.1	0.3	4.0	- 4.4	0.0	0.4
1978/79	4.5	0.3	0.2	5.0	- 4.8	- 0.3	0.1
1979/80	4.4	- 0.3	0.2	4.2	- 3.9	0.1	- 0.4
1980/81	6.6	0.3	- 0.3	6.6	- 5.0	- 2.5	0.8
1981/82	4.9	0.3	- 0.2	5.0	- 2.0	- 1.8	- 1.2
1982/83	3.5	2.0	0.1	5.6	- 2.9	- 1.6	- 1.0
1983/84	2.9	2.4	0.4	5.7	- 3.7	- 0.9	- 1.1
1984/85	3.2	2.2	0.0	5.4	- 4.0	0.0	- 1.4
1985/86	2.3	1.9	0.3	4.6	- 2.3	- 1.1	- 1.2
1986/87	1.3	1.7	1.4	4.5	- 2.5	0.2	- 2.2
Forecast							
1987/88	0.5	1.9	0.9	3.2	- 1.0	1.0	- 3.1
1988/89	0.5	0.8	1.1	2.4	- 0.5	1.0	- 3.0
1989/90	0.2	1.0	0.9	2.1	- 0.3	1.2	- 3.0

NB: Columns 1 + 2 + 3 = 4
Columns 4 + 5 + 6 + 7 = 0

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Table IIB: PUBLIC SECTOR BORROWING as a percentage of GDP

	PSBR	PSBR less Privatisation proceeds	PSFD
1948			-2.2
1949			-2.4
1950			-2.6
1951			1.6
1952	5.0		3.5
1953	3.4		4.1
1954	2.0		2.4
1955	2.4		2.0
1956	2.7		2.6
1957	2.2		2.4
1958	2.1		1.9
1959	2.3		2.2
1960	2.7		2.7
1961	2.5		2.6
1962	1.9		1.8
1963	2.7		2.6
1963-64	3.3		3.4
1964-65	2.7		2.4
1965-66	2.6		1.7
1966-67	2.9		2.6
1967-68	4.9		4.2
1968-69	0.8		0.8
1969-70	-1.2		-1.7
1970-71	1.5		-0.4
1971-72	1.6		1.1
1972-73	3.6		3.0
1973-74	5.8		4.6
1974-75	9.0		6.7
1975-76	9.3		7.3
1976-77	6.4		5.7
1977-78	3.6	3.9	4.4
1978-79	5.3	5.3	4.8
1979-80	4.8	5.0	3.9
1980-81	5.4	5.5	5.0
1981-82	3.3	3.5	2.0
1982-83	3.1	3.3	2.9
1983-84	3.2	3.5	3.7
1984-85	3.1	3.7	4.0
1985-86	1.6	2.3	2.3
1986-87	0.9	2.0	2.5
		Forecast	
1987-88	-0.3	1.0	1.0
1988-89	-1.1	0.2	0.5
1989-90	-1.1	0.1	0.3

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FROM: **COLIN MOWL**
DATE: 15 OCTOBER 1987

PPS/CHANCELLOR

cc PS/Chief Secretary — Mr Grice
PS/Financial Secretary — Mr Matthews
PS/Paymaster General — Mr Melliss
PS/Economic Secretary — Miss O'Mara
PCC — Mr Riley
MEG — Mr Cropper
Mr Bottrill — Mr Tyrie
Mr S J Davies — Mr Call

TREASURY ECONOMIC FORECAST: CORRIGENDUM

Mr Sedgwick's minute of 12 October (Treasury Economic Forecast).

2. I regret that there was a mistake in table A(ii) which formed part of the answer to question (v) - "Errors in PSBR forecasts". The error for the published autumn forecast of the PSBR in 1985-86 as a percentage of GDP should have been minus not plus 0.6. This does not affect calculation of the average absolute errors but the bias should be as follows:

	% of GDP
Whole Period	-0.2
Last 10 years	-0.1
Last 5 years	-0.2

Colin Mowl

C MOWL

CONFIDENTIAL

FROM: P N SEDGWICK
DATE: 14 OCTOBER 1987

CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
PCC
MEG
Mr Bottrill
Mr S J Davies
Mr Grice
Mr Matthews
Mr Melliss
Mr Mowl
Miss O'Mara
Mr Riley
Mr Cropper
Mr Tyrie
Mr Call

TREASURY ECONOMIC FORECAST

Mr Allan's minute to me of October 12 passed on your request for further information on a number of points on the forecast which I circulated on 9 October. These points are covered in order below. Ms Ryding's note to Mr Mowl of October 12 asked whether the RPI figure for September 1988 which affects social security uprating was sensible or desirable. This note deals with this point at the end. (The Chancellor's question on CYMS and the reserves are dealt with in separate submissions.) I am indebted to Messrs Davies, Bottrill, Mowl and Dolphin for the material below.

(i) Changes in the PSBR

You asked when there was last a year-on-year change in the PSBR of 1.2 per cent of GDP. The table below gives the figures since the early 1970s. The PSBR fell by 1.5 per cent in 1985-86 but this was largely due to the recovery from the coal strike. Prior to that it fell by 2.1 per cent in 1981-82. There were however very large year to year changes in the 1970s.

	Changes in PSBR from previous year (% of money GDP)
1970-71	+2.7
1971-72	+0.1
1972-73	+2.0
1973-74	+2.2
1974-75	+3.2
1975-76	+0.3
1976-77	-2.9
1977-78	-2.8
1978-79	+1.7
1979-80	-0.5
1980-81	+0.6
1981-82	-2.1
1982-83	-0.2
1983-84	+0.1
1984-85	-0.1
1985-86	-1.5
1986-87	-0.7
1987-88 (Forecast)	-1.2

(ii) General Government deficits in the G5

You asked for individual countries' general government fiscal deficits as a share of GNP. These are shown below.

General government fiscal deficit(per cent of GDP)

	1979-85	1986	1987	1988	1989
US	2.1	3.5	2.5	2.5	2.3
Japan	3.4	0.6	1.5	1.5	1.0
Germany	2.6	1.2	1.6	1.8	1.5
France	2.0	2.9	2.7	2.3	2.1
UK	3.1	2.6	1.8	1.1	0.6

(iii) Errors on forecasts of the current balance

You asked about the average margin of error on forecasts of the current balance. The average absolute error on forecasts for the following year made in the autumn has been ¼ per cent of GDP, which is equivalent to £3bn. in 1988.

(iv) The outlook for trade in financial services

You asked for additional information on the outlook for financial services so far this year. It is not possible to provide a breakdown of the forecast for trade in services to distinguish financial services, although we look at recent developments in individual components in forming a judgment about the prospects for services earnings as a whole. The financial sector's net earnings rose by more than 20 per cent in 1986 to almost £5 billion or a fifth of the UK's total exports of services. In the first half of 1987, growth is estimated to have been slower with net earnings about 10 per cent higher than a year earlier.

The Bank of England estimates that earnings of foreign exchange dealers rose strongly in the first half-year, but that banks' earnings were estimated to be flat reflecting pressure on margins and the weakness in international bond markets. No information on securities dealers' earnings is available. Lloyds underwriters reported no further growth in earnings after last year's very steep rise when premium income increased sharply. Insurance brokers reported modest earnings growth.

The increased internationalisation of capital markets should offer increased opportunities for London-based financial institutions, but greater competition is likely to continue to pare margins and fees. The projected fall in bond markets as long rates rise and slower rise in equity markets, however, could also limit the growth in activity and earnings growth. Anecdotal evidence of the profits squeeze on a number of securities dealers and banks could be consistent with this. We expect insurance earnings to be constrained as claims rise to match the recent increase in premium income. On balance, the financial sector's earnings should continue to grow, but not at the same hectic pace as the last two years.

(v) Errors in PSBR forecasts

You wondered whether it is still true that the average absolute error in PSBR forecasts made at this time of year is around 0.8 per cent of GDP (£3 billion). This is the average error made in forecasts over the last eleven years. The first forecast included, that made in autumn 1976, had an extremely large error of over 2 per cent of money GDP. If this is excluded by looking at the last ten years only - the period we now quote in published forecasts - the average error drops to 0.7 per cent, and errors made over the last five years are lower still at 0.6 per cent (£2½ billion). Table A show further detail both for internal and published Autumn Forecasts.

TABLE A : ERRORS IN PSBR FORECASTS

(i) INTERNAL AUTUMN FORECASTS FOR PSBR (£bn)

Year		Forecast	Outturn	Error	Error as % of GDP
1976-77		11.2	8.5	-2.7	-2.1
1977-78		7.1	5.6	-1.5	-1.0
1978-79		8.1	9.2	1.1	0.7
1979-80		8.7	10.1	1.5	0.7
1980-81		10.7	13.3	2.7	1.1
1981-82		10.7	9.0	-1.7	-0.7
1982-83		8.0	9.4	1.3	0.5
1983-84		10.9	10.2	-0.7	-0.2
1984-85		9.7	10.2	0.5	0.2
1985-86		8.4	5.8	-2.6	-0.7
1986-87		8.4	3.5	-5.0	-1.3
AVERAGE ABSOLUTE ERRORS	WHOLE PERIOD			1.9	0.8
	LAST 10 YEARS			1.9	0.7
	LAST 5 YEARS			2.0	0.6
BIAS	WHOLE PERIOD			-0.6	-0.3
	LAST 10 YEARS			-0.4	0.2
	LAST 5 YEARS			-1.3	-0.3

(ii) PUBLISHED AUTUMN FORECASTS OF PSBR (£bn)

Year		Forecast	Outturn	Error	Error as % of GDP
1976-77		11.0	8.5	-2.5	-1.9
1977-78		7.5	5.6	-1.9	-1.3
1978-79		8.0	9.2	1.2	0.7
1979-80		8.3	10.1	1.8	0.8
1980-81		11.5	13.3	1.8	0.7
1981-82		10.5	9.0	-1.5	-0.7
1982-83		9.0	9.4	0.4	0.1
1983-84		10.0	10.2	0.2	-
1984-85		8.5	10.2	1.7	0.5
1985-86		8.0	5.8	-2.2	0.6
1986-87		7.1	3.5	-3.6	-0.9
AVERAGE ABSOLUTE ERRORS	WHOLE PERIOD			1.7	0.7
	LAST 10 YEARS			1.6	0.6
	LAST 5 YEARS			1.6	0.4
BIAS	WHOLE PERIOD			-0.4	-0.1
	LAST 10 YEARS			-0.2	0.1
	LAST 5 YEARS			-0.7	0.1

(vi) Growth in GGE

You asked for figures showing the real growth in GGE for each year between 1984-85 and 1987-88.

GGE IN REAL TERMS per cent change

	1984-85	1985-86	1986-87	1987-88
Including privatisation proceeds	2.7	-0.6	1.3	-0.2
Excluding privatisation proceeds	3.3	-0.3	2.2	0.2

(vii) Domestic demand in 1988

You asked for an explanation of the upward revision in the forecast for domestic demand in 1988.

Growth in consumers' expenditure, fixed investment, and stockbuilding have all been revised up for 1988 since the June forecast. Consumers' expenditure growth has been revised up by about ½ percentage point since June. This reflects higher forecast growth in real personal disposable income over 1987 and 1988 (an upward revision since June of around 1½ percentage points in total over the two years). This higher growth in real personal disposable income is in turn attributable to:

(a) faster growth in output and productivity (the forecast for non-North Sea productivity growth has been revised up by about ½ percentage point in 1988, partly because we have reconsidered the evidence of recent productivity performance);

(b) lower than expected consumer price inflation so far in 1987;

(c) a slightly bigger tax cut in the 1988 Budget than assumed in June (the increase is worth about an extra 0.1 per cent on personal disposable income in 1988).

We now think that manufacturing investment will rise significantly faster than in the June DTI survey: the latest quarterly investment figures, the responses in the last CBI quarterly survey, recent fast growth in manufacturing output, and the relatively high level of capacity utilisation in manufacturing all suggest that a big upward swing in manufacturing investment could be underway.

Once June the forecast for the increase in stockbuilding between 1987 and 1988 has changed for two main reasons:

(a) stockbuilding has been more negative in 1987 so far than expected;

(b) firms have stopped telling the CBI that (on balance) they hold more than adequate stocks - for the first time this decade.

These developments mean that it is more likely that stockbuilding will make a small positive contribution to growth in 1988 - something we did not allow for in June.

(viii) Construction output and prices

You asked about prospects for housing and construction output and prices. It is perhaps a little disappointing that housing starts have fallen back since the start of 1987, though with housing investment still likely to rise by about 10 per cent this year and 6 per cent next year, the immediate prospects are not particularly gloomy. Total construction output is forecast to rise by 7 per cent this year and 4½ per cent next year, with growth probably concentrated on the south east (this concentration being exacerbated by the Channel Tunnel and Canary Wharf projects).

There has in the past been a lag of a year or so between sharp movements in construction output and in national accounts construction output prices (because demand conditions first affect tender prices, and then output prices later on). There is now some evidence of tender prices rising fast in the south east (see Financial Times, 12 October, front page - copy attached). These price increases will probably show up in the GDP deflator next year rather than this. The effect on prices of any subsequent slowing in construction output will probably not show up in the GDP deflator until 1989.

(ix) Manufacturing productivity

You asked for year-by year forecast increases in manufacturing productivity. These are:

1986	3.2
1987	6.7
1988	3.9
1989	4.5

Following two years of growth at just over 3 per cent, manufacturing productivity has grown twice as fast this year. While we have raised (again) our estimate of underlying productivity growth -

from [redacted]4 to 4¼ per cent - much of this year's acceleration in productivity is attributable to the acceleration in manufacturing output (up from growth of 1 per cent last year to 5 per cent this). As manufacturing output growth reverts in 1988 and 1989 to close to its post 1981 trend, so we would expect productivity growth to revert to a note closer to its recent trend. Should we get another year of 5 per cent growth in manufacturing output, we would expect a continuation of an above trend rise in productivity. Note also that the reduction in productivity growth does not feed fully through into faster growth in unit labour costs as the forecast allows for an offset to the lower productivity growth in the form of lower wage drift.

(x) Nationalised industry prices

You were puzzled by the different figures for increases in nationalised industry prices in the main forecast and in the Public Finances Forecast. The figures were as follows

REAL NI PRICES - ANNUAL % INCREASES

Main Report		Public Finances Report		
			As circulated	Corrected
1987 Q4	-1.6	1987-88	-1.2	-2.3
1988 Q4	+1.0	1988-89	-0.6	-0.6

The figure for 1987-88 in Table XII of the public finances report for total NIs was unfortunately wrong. The correct figure of -2.3 per cent was in fact in Table XIII. The correct figure is shown above along with the figure as circulated.

The differences between the two sets of figures arise for two reasons:

(a) they refer to different time periods - Q4 in the main report as part of the explanation of changes in the RPI to the fourth quarter of each year, and financial year averages in the public finances report as part of the explanation of PCs trading surpluses and borrowing in financial years;

(b) the main report refers only to those prices which are in the RPI and the public finances report relates to all NI prices, ie industrial as well as consumer prices. For 1988-89, we are forecasting a substantial gap between average domestic NI price increases (+6 per cent in nominal terms) and average industrial NI price increases (+3¾ per cent).

(xi) The RPI and pay

You asked for a comparison of the effect of the RPI path on pay

settlements in 1985 with that postulated for 1988. Chart E on page 25 of the forecast report suggests some relationship between fluctuations in RPI inflation and private sector wage settlements since the end of 1984. Settlements reached a temporary trough at the end of 1984 and then picked up until around May 1985 (as inflation rose from under 5 per cent to 7 per cent). From around October 1985 to the beginning of 1987 pay settlements were either flat or declining (as RPI inflation declined almost without a break from July 1985 to August 1986); since the beginning of 1987 the pick up in RPI inflation has been accompanied by a renewed rise in pay settlements.

(xi) GGE ratios

You asked for the 1984-85 figure for the ratio of GGE excluding privatisation proceeds to money GDP. This is given in the revised version of table 34 below.

TABLE 34 : RATIO OF GGE EXCLUDING PRIVATISATION PROCEEDS TO MONEY GDP

per cent

	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90
1987 PEWP	46¼	44¾	44½	44	42¾	42¼
1987 FSBR	46¼	44¾	44¼	43½	42½	41¾
Oct forecast	46¼	44½	44	42½	41¾	41¼

(xii) The 1988 uprating factor

You also asked (Ms Ryding's minute to Mr Mowl of 12 October) whether the 5½ per cent RPI increase forecast for the year to September 1988 (the period relevant to the 1989 uprating) was "sensible or desirable". For the purpose of the published public expenditure assumptions, Mr Davies in his minute of 2 October proposed adopting a 5 per cent figure - which is what would be obtained by taking out the mortgage interest increase assumed in the forecast. The increase in the RPI over the year to September reflects the full impact of the main factors pushing up inflation next year: the rise in rates and specific duties (effective from April), the rise in electricity prices (feeding through to the RPI during the second quarter) and the rise in gas prices (feeding through to the RPI during the third quarter).

SJD p.p.

P N SEDGWICK

Construction costs gap widens

BY ANDREW TAYLOR

PRICES CHARGED by building contractors in the surging private construction market of south-east England, now Western Europe's busiest, are rising five times faster than in the rest of the UK.

Figures from the Building Cost Information Service of the Royal Institution of Chartered Surveyors show construction tender prices rose by 20 per cent in the south-east in the two years to March, compared with a 4 per cent rise in the rest of the country over the period.

The gap has widened as order-books in the south-east have continued to grow. For example, building prices in the region rose by 15 per cent in the 12 months to March, compared with a rise of 5 per cent in the preceding 12 months.

The survey covered tender prices accepted from contractors for about 180 different building types. It defined the south-east as an area enclosed by the counties of Norfolk, Cambridgeshire, Bedfordshire, Buckinghamshire, Oxfordshire, Wiltshire, Avon and Hampshire, easily the most prosperous region in the British Isles.

Order-books in the region have been fuelled by a massive rise in office building, particularly in the City of London, which accompanied the Big Bang deregulation of the London securities markets a year ago.

Demand for new sites for out-of-town shopping centres, encouraged by completion of the M25 orbital motorway around London, also boosted order-books in the region, as has a surge in private housebuilding in the last 18 months.

The number of new private homes started by developers in England and Wales this year is expected to be the highest for 15 years.

The pace of new building is such that many contractors in the south-east fear the market may be in danger of overheating. Skilled tradesmen remain scarce following the fall in construction which took place in the second half of the 1970s and early-1980s.

Some skilled tradesmen in central London are earning more than £100 a shift. Some were recruited from other regions where the construction recovery has been more limited or has still to bite.

Contractors also say construction specialists from the Irish Republic, where the building market is depressed, have established offices in London and the south-east, to take advantage of the upsurge.

The pace seems unlikely to slacken in the near future. Big projects under way or planned in the south-east include the Channel tunnel; a new Dartford crossing on the River Thames; completion of a large, new international terminal at London's third airport at Stansted, Essex; the massive Canary Wharf development in London's docklands; and further plans for the City and other parts of the docklands.

British and French contractors have established a skills-training centre at Ashford, Kent.

Figures available quarterly at £30, or by £100 annual subscription; Building Cost Information Service, 85-87 Clarence Street, Kingston upon Thames, Surrey.

[redacted] SECRET

D after use

FROM: A BOTTRILL

DATE: 12 October 1987

CHANCELLOR

cc:

Chief Secretary	Mr Sedgwick
Financial Secretary	Mr Grice
Paymaster General	Mr Matthews
Economic Secretary	Mr Melliss
PCC	Mr Mowl
MEG	Miss O'Mara
Mr Hawtin	Mr Riley
Mr Luce	Mr Cropper
Mr Moore	Mr Tyrie
Miss Peirson	Mr Call

TREASURY ECONOMIC FORECAST: FIXED £/DM VARIANT

You asked for a variant on the main forecast reported by Mr Sedgwick on 8 October which would assess the effects of assuming that the US dollar falls by 10 per cent over the next year and the DM/£ rate remains constant. This note discusses both the world and UK effects.

World economy

2. The variant assumes weaker confidence leads to a larger depreciation of the dollar and higher US interest rates.

(i) By the end of 1988 the dollar effective exchange rate is 10 per cent lower than in the past month and 6½ per cent lower than in the main forecast.

(ii) US interest rates rise by 2 percentage points over the next year, compared to 1 percentage point in the main forecast. Interest rates in other countries, which are broadly constant in the main forecast, fall by ½ percentage point in the variant, so the average world interest rate is unchanged.

(iii) The weaker EMS currencies which were assumed in the main forecast to realign against the DM and the Dutch guilder to maintain constant real bilateral exchange rates, depreciate in the variant by an additional 3 per cent.

3. The assumption that as US interest rates rise other countries' rates fall helps to ensure that growth and inflation in the major seven

economies as a whole remain broadly unchanged. World trade is also unchanged in 1988 but slightly lower in 1989. Within the G7 real GNP is lower and inflation higher in the US while the opposite is true after a lag for Germany and Japan. Lower US domestic demand reduces American imports by more than imports rise elsewhere helping to explain the decline in world trade. J-curve effects, however, delay any substantial benefits to the US current balance until 1990.

Table 1: Growth, inflation and trade
(Differences from base levels

	1988	1989	1990
Real GNP (%)			
Major 7	-0.1	-0.2	-0.1
US	-0.1	-0.2	-0.2
Japan	-0.2	-0.1	0.3
Germany	-0.1	0.0	0.1
Consumer prices (%)			
Major 7	-0.1	0.1	0.2
US	0.1	0.4	0.5
Japan	-0.2	-0.4	-0.3
Germany	-0.2	-0.4	-0.6
Current balances ($bn)			
US	-1	+4	+13
Japan	3	6	-2
Germany	5	4	-2
World trade volume (%)	-0.1	-0.4	-0.4

UK economy

4. The pressure on sterling against the DM might well be similar to that experienced by the weaker EMS currencies. This would tend to push the DM/£ rate, which was already projected in the main forecast to decline by around 2½ per cent a year, well below the bottom of the Louvre range by 1989. We have assumed instead, however, that the DM/£ rate remains at its recent average of 2.99.

Table 2: Exchange rates and interest rates

	Sterling exchange rate index			DM/£			3-month LIBOR	
	Oct	Variant	% change	Oct	Variant	% change	Oct	Variant
1987Q4	72.5	72.5	-	2.99	2.99	-	10.5	10.5
1988 av.	72.5	74.5	2.8	2.94	2.99	1.7	11.0	11.4
1989 av.	72.5	77.1	6.3	2.87	2.99	4.2	11.0	12.0

5. In order to maintain the DM/£ rate constant at this level, the effective exchange rate would therefore need to rise by almost 3 per cent in 1988 and 6 per cent in 1989 compared to the constant projected rate of 72½ in the main forecast. Even against a background of small reductions in other non dollar interest rates, the variant assumes that UK short rates would need to rise by ½ percentage point in 1988 to average 11½ per cent and by a further ½ percentage point in 1989 to average 12 per cent. These apparently steep interest rate increases reflect of course the arbitrary assumption that sterling remains at the top of its Louvre range against the DM and that none of any downward pressure on the pound is absorbed by a move within the Louvre margins.

Table 3: Money GDP, output and prices

(per cent change on previous year)

	Money GDP			Real GDP		GDP deflator	
	Oct	Variant	MTFS	Oct	Variant	Oct	Variant
1987-88	8.9	8.9	7½	4.2	4.2	4.6	4.6
1988-89	8.5	8.0	6½	2.8	2.4	5.4	5.4
1989-90	7.8	6.1	6	2.4	1.8	5.2	4.3

6. The tightening of monetary policy would reduce money GDP growth in 1988-89 by around ½ per cent compared to the October forecast and in 1989-90 the growth rate would be almost 2 per cent lower and close to the MTFS path. Most of the reduction in money GDP growth would reflect initially slower real GDP growth. Higher interest rates would tend to reduce domestic expenditure while the appreciation of sterling and slowdown in world trade would depress net exports. Output growth would slow from 4 per cent this year to 2½ per cent in 1988-89 and less than 2 per cent in 1989-90. The GDP deflator would still rise to around 5½ per cent next year, but would fall sharply to just over 4 per cent in 1989-90 in response to lower import costs and weaker demand.

Table 4: Earnings, competitiveness and the current balance

	Average earnings (per cent change on previous year)		Relative unit labour costs (1980=100)			Current balance (£ billion)	
	Oct	Variant	Oct	Variant	%change	Oct	Variant
1987	8.0	8.0	74.8	74.8	-	-2.4	-2.4
1988	8.0	8.0	76.7	78.6	2.5	-4.3	-3.7
1989	8.0	7.2	76.9	80.9	5.2	-5.6	-4.8

7. The reduction in domestic inflation would tend to reduce earnings growth in 1989 but this would offset only partly the effect of the

higher exchange rate on competitiveness. The current balance, however, would probably deteriorate less rapidly over the next two years than in the October forecast, as sterling's appreciation improves the terms of trade and tighter policies reduce domestic demand. This improvement in the current balance would probably not be sustained in later years once trade volumes responded more fully to the loss of competitiveness.

8. The effects of the variant on the PSBR are negligible in 1988-89, but by 1989-90 lower GDP and higher interest rates leads to an ex ante rise of around £1 billion in borrowing. This is assumed to reduce the scope for tax reductions in that year, with the PSBR ratio held constant at its projected 1988-89 level, as in the October forecast.

9. The variant shows that, in the absence of greater confidence in sterling, an attempt to maintain a fixed DM/£ rate could require higher interest rates and a fairly sharp slowdown in GDP growth. However inflation gains would in time be substantial. These results differ from the £/DM variant that we did in June mainly because then we assumed that improved confidence allowed the UK to have both a higher exchange rate and lower interest rates. This avoided the reduction in real GDP growth seen in the present variant. Inflation also benefited more.

A BOTTRILL

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COPY NO. OF 4.

FROM: A C S ALLAN
DATE: 12 October 1987

MR SEDGWICK

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
PCC
MEG
Mr Grice
Mr Matthews
Mr Melliss
Mr Mowl
Miss O'Mara
Mr Riley
Mr Cropper
Mr Tyrie
Mr Call

TREASURY ECONOMIC FORECAST

The Chancellor was most grateful for your minute of 9 October covering the main report of the recent forecasting exercise.

2. This is to be discussed at a meeting on Thursday, but the Chancellor would be grateful before then for further information on a few points:

(i) when was there last a year-on-year change in the PSBR of 1.2 per cent of GDP? (which is what is forecast for 1987-88 on 1986-87, as the PSBR moves from a deficit of 0.9 per cent of GDP to a surplus of 0.3 per cent);

(ii) Table 2 gives aggregate G7 figures for General Government Fiscal Deficits as a share of GDP over a run of years. The Chancellor would be grateful for the figures for the individual G5 countries;

(iii) what is the average margin of error on forecasts of the current balance?

(iv) Table 8 in paragraph 10 shows a breakdown of the invisibles balance. The Chancellor would be grateful for

a further breakdown of the services balance, in particular to distinguish financial services (to the extent that is possible);

(v) Table 29 in paragraph 63 shows figures for net external capital flows, including changes in official reserves. The Chancellor would be grateful for the figure for the change in official reserves for 1987 to date;

(vi) paragraph 64 says that the average absolute error in PSBR forecasts made at this time of year is around 0.8 per cent of GDP (£3 billion). The Chancellor wondered whether this was still true?;

(vii) he would be grateful for figures showing the real growth in GGE for each year between 1984-85 and 1987-88, both including and excluding privatisation proceeds?

(viii) The Chancellor would be grateful for some more explanation about what has led to the large upward revision in the forecast of domestic demand for 1988 (from 3.3 per cent in the summer forecast to 4.1 per cent in this forecast).

(ix) The forecast continues to stress the likely impact of the construction boom on the GDP deflator. But does the (perhaps surprisingly) gloomy outlook for housing have any offsetting effect?

(x) What are the year-by-year forecast increases in manufacturing productivity (from 1986 to 1989)? Is there any reason why productivity growth should revert quickly to its "estimated underlying rate of increase"?

(xii) The Chancellor was puzzled by the different figures for increases in nationalised industry prices in the main forecast and in the Public Finances forecast. The main forecast has nationalised industry prices rising 2.3 per cent in the year to 1987 Q4, and by 6.3 per cent in the year to 1988 Q4. The Public Finances forecast has

nationalised industry prices growing in real terms by -1.2 per cent in 1987-88 and -0.6 per cent in 1988-89. How are these reconciled?

(xiii) The Chancellor noted that in paragraph 46 the forecast assumes that pay settlements will rise when the RPI rises in mid-1988, but fall back as price inflation falls. How does this compare with experience in 1985, when there was a blip in the RPI?

(xiv) The Chancellor would be grateful for the 1984-85 figures for the ratio of GGE excluding privatisation proceeds to money GDP (as in table 34).

ACSA

A C S ALLAN

SECRET COPY NO. 67

d/cr

FROM: COLIN MOWL
DATE: 12 OCTOBER 1987

PPS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
PCC
MEG
Mr Hawtin
Mr Luce
Mr Moore
Miss Peirson
Mr Grice
Mr Matthews
Mr Melliss
Miss O'Mara
Mr Riley
Mr Cropper
Mr Tyrie
Mr Call

TREASURY ECONOMIC FORECAST: CORRIGENDA

There were some mistakes in the forecast reports circulated on 9 October.

Main Report

("Treasury Economic Forecast" - Mr Sedgwick's minute of 9 October)

P.5 Table 2 - the figures for the UK General Government Fiscal Deficit in 1987 and 1988 were wrong. The table should have read as follows:

TABLE 2 : GENERAL GOVERNMENT FISCAL DEFICITS AS A SHARE OF GDP (%)

	1979-85	1986	1987	1988	1989
UK	3.1	2.6	1.8	1.1	0.6
G7 (less UK)	3.1	3.1	2.8	2.7	2.7

P.24 Table 18 - the figure published last week for the increase in the RPI excluding mortgage interest payments was 3.5 per cent not 3.4 per cent.

P.34 Table 31 - the two columns of figures for the 4th and 6th rows (ie NICs and stamp duty) should be transposed as follows:

		Changes since	
		FSBR	June
-	higher NICs.....	-½	-
-	higher stamp duty	-½	-

Annex I - in para 2(i) the AEG percentage in 1988-89 should be 45 not 45¼.

Public Finances Report

("Treasury Economic Forecast, October 1987 : Public Finances - Mr Mowl's minute of 9 October).

P.2 Table II - the average increase in private sector average earnings in 1989-90 pay round is 7½ per cent not 8½ per cent.

P.5 Table V - the ROSSI uprating in the October Forecast for 1988-89 is 3.2 per cent not 3.6 per cent.

Colin Mowl

C MOWL

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COPY NO. 19

FROM: COLIN MOWL
DATE: 9 October 1987

CHANCELLOR cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
PCC members
Mr Sedgwick
Mr Hawtin
Mr Moore
Mr Odling-Smee
Mr Peretz
Mr Turnbull
Miss Peirson
Mr Luce
Mr Edwards
Mrs R Butler
Mr S Davies
Mr J Gieve
Mr Bottrill
Mr Pratt
Mrs Brown
Mr Potter
Mr McIntyre
Mr Riley
Miss Turk
Mr Ritchie
Mrs Todd
Mr Cropper
Mr Tyrie
Mr Call

TREASURY ECONOMIC FORECAST, OCTOBER 1987: PUBLIC FINANCES

I attach a copy of the report on the outlook for Public Sector Finances.

2. The report is a little shorter than previous ones as we have dropped the first two sections (the summary and discussion of the borrowing aggregates and fiscal adjustment) which largely duplicated the public finances section of the main forecast report. This report takes the latter as read and is mainly intended to provide more detailed explanation of the forecasts of expenditure and receipts. The public finances section of the main report is however attached at the beginning of this report for those who have not already seen it and at the end as an annex for others (to facilitate cross reference).

Colin Mowl

COLIN MOWL

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TREASURY ECONOMIC FORECAST

REPORT ON PUBLIC FINANCES

OCTOBER 1987

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TREASURY ECONOMIC FORECAST: PUBLIC SECTOR FINANCES

I PUBLIC EXPENDITURE

1. The forecast of expenditure relative to the plans in the 1987 PEWP is set out in table 32 of the main forecast report (see Annex to this report). The forecast for 1987-88 shows an underspend of the PEWP planning total excluding privatisation proceeds of £1.0 billion. By contrast currently published plans are forecast to be exceeded by substantial amounts in the following two years, by some £4 billion in 1988-89 and nearly £10 billion in 1989-90.

The Economic Background

2. The overspends should be interpreted in the light of the difference between the general economic prospect in this forecast and the economic assumptions used in the PEWP. Inflation is forecast to be higher than assumed in the PEWP throughout the forecast period and growth is projected to be higher than in the PEWP in 1987-88 and 1988-89. While higher than assumed inflation could be mainly reflected in a lower real level of public expenditure within year, it is likely to come through in large part as higher cash spending in future years and the effect will be bigger the further ahead one looks. A substantial proportion of spending is demand sensitive and therefore inversely related to the general level of economic activity. This is not only the case for about two-thirds of social security expenditure but also for central government subsidies, employment grants, regional assistance and some capital grants. Altogether, about a quarter of central government expenditure is likely to be significantly affected by the level of activity. Against this a buoyant economy may significantly increase the pressures for higher expenditure on non-demand sensitive elements, such as defence and health.

3. Table I compares the forecast with the economic assumptions used in the PEWP and FSBR.

TABLE I: GDP GROWTH AND INFLATION

	1986-87	1987-88	1988-89	1989-90
GDP growth				
PEWP 1987	2½	3¼	2½	2½
FSBR 1987	3	3	2½	2½
October Forecast	3¼	4	2¾	2½
GDP deflator				
PEWP 1987	3	3¾	3½	3
FSBR 1987	3	4½	4	3½
October Forecast	3	4½	5½	5¼

4. The following paragraphs consider each broad category of expenditure in turn, focusing attention on 1988-89 and 1989-90. The forecast is constructed in terms of economic categories rather than departmental programmes.

Central Government Pay

5. As in previous forecasts central government employment is assumed to remain broadly stable. The forecast of average earnings is built up from assumptions about each of the main groups (see table II). In the absence of complications introduced by staging, the outcome of the pay round beginning the previous September is the main determinant of earnings growth in each financial year. Central government earnings growth is assumed to be less than the private sector average in financial year 1988-89 and much the same in 1989-90; the civil service and non-Review Body groups are expected to do badly relative to the private sector in the 1987-88 pay round.

TABLE II: CENTRAL GOVERNMENT AVERAGE EARNINGS GROWTH

		Pay Rounds			Financial Years	
	(Weights)	1987-88	1988-89	1989-90	1988-89	1989-90
Review Body Groups (Nurses, Doctors, Armed Forces)	(51)	7½	8	7½	7½	8
Civil Service	(28)	6	8	7½	6	8
NHS non-Review Body	(17)	7	8	7½	7	8
Average CG	(100)	7	8	7½	7	8
Average Private Sector		8*	8½*	~~8½~~ 7½	8	7¾

* Underlying earnings growth

Mont 12.10

Other Central Government Current Expenditure on Goods and Services

6. This category comprises current expenditure on goods and services (CEGs) excluding pay: it includes MOD procurement. It accounts for nearly a fifth of the central government component of the planning total.

7. As table III shows, the forecast growth of other CEGS in real terms over the period to 1989-90 is somewhat below the average of the last five years. This is mainly because of a projected slowdown in the growth of real defence spending which is not, however, as marked as planned in the PEWP. The forecast for spending on both defence and health in 1988-89 and more particularly 1989-90 in real terms has been revised up since June in the light of the healthy outlook for public finances and the economy in general.

TABLE III: OTHER CENTRAL GOVERNMENT EXPENDITURE ON GOODS AND SERVICES (REAL TERMS, % GROWTH)

	Weight in 1986-87	Outturn Average 1981-82 to 1986-87	Forecast 1987-88	1988-89	1989-90
MOD	46	3¼	2¼	-	½
DHSS Health	28	3¼	5	2	3
Other	26	2¾	4¼	2	3
Total	100	3	3½	1	2

Social Security Expenditure

8. The forecast of social security expenditure for 1987-88 is in line with the figure produced in September by CYMS, the DHSS in-year monitoring system. The forecast of unemployment does not significantly diverge from the Treasury assumption used by DHSS.

9. There is some uncertainty over the CYMS forecast for 1987-88 in the light of recent low outturn data for certain types of benefit, mainly Unemployment and Supplementary Benefits. Currently DHSS have not allowed these outturns to exert their full influence on the CYMS forecast as the causes are still unclear and such outturn data would otherwise produce a large reduction in the in-year forecast. CYMS does not have a

sufficiently long track record to assess its performance adequately. The forecast has accepted the CYMS total for this year: there is however a downside risk.

10. For 1988-89 onwards, the PEWP plans have been adjusted for differences between the forecast for unemployment and upratings, and the corresponding assumptions underlying the PEWP. In addition upward adjustments were made to produce what is on the basis of past experience considered a central 'underlying' growth rate (ie the growth after allowing for the effects of upratings, changes in unemployment, changes in policy, demographic factors etc). This underlying growth can be seen as representing increases in benefit take-up or in the average levels of benefit payment.

11. Table IV shows the adjustments made to the plans in respect of changes to economic assumptions and the adoption of a higher underlying growth rate. The underlying growth rate is estimated to have risen from 3¼ per cent in 1986-87 to 4½ per cent in 1987-88, though the latter is still largely forecast. Uncertainty over the future path of underlying growth is exacerbated by the background of more buoyant economic activity than experienced in recent years, and the reforms due next April. The former could dampen underlying growth, the effect of the latter is uncertain. The forecast has discounted some of the projected increase in underlying growth in 1987-88 and put in lower figures for future years. Nevertheless large overspends of existing plans are forecast.

TABLE IV: EFFECTS OF ECONOMIC AND OTHER FACTORS ON THE SOCIAL SECURITY FORECAST

	£ billion		
	1987-88	**1988-89**	**1989-90**
Forecast overspend*	0.5	2.2	4.1
Due to:			
(a) Economic Assumptions:			
(i) Unemployment	- 0.7	- 1.2	- 1.3
(ii) Upratings	-	0.2	0.8
(b) More realistic underlying growth	1.2	3.3	4.6
MEMO:			
Underlying Growth Rate (%)	4.6	3.7	2.7

* relative to PEWP 1987 for 1987-88 and relative to PES baseline thereafter

12. Table V shows the economic assumptions used in the forecast and those underlying the PEWP. Unemployment is now forecast to be significantly lower than assumed in the PEWP whilst upratings are forecast to be higher. However the effects of these, partially offsetting, changes are smaller than the adjustment made to raise underlying growth.

TABLE V: ECONOMIC ASSUMPTIONS UNDERLYING THE FORECAST OF SOCIAL SECURITY EXPENDITURE

	1987-88	1988-89	1989-90
1. Unemployment (GB, million)			
PEWP 1987	3.05	3.05	3.05
October Forecast	2.7	2.5	2.5
2. Upratings (% pa)			
(i) RPI			
PEWP 1987	2.1	3.75	3.5
October Forecast	2.1	4.2	5.4
(ii) ROSSI*			
PEWP 1987	2.0	3.0	3.25
October Forecast	2.0	~~3.6~~ 3.2	4.4

* RPI less housing costs

The National Insurance Fund

13. Forecast earnings growth in the economy continues to drive National Insurance Contributions (NICs) up at a faster rate than benefit expenditure, producing flow surpluses on the National Insurance Fund (GB).

14. Given the prospect of large surpluses, the forecast assumes that the Treasury Supplement will be reduced by 2 percentage points per annum, the maximum reduction possible without primary legislation. Were the Treasury Supplement to be maintained at 7 per cent the flow surpluses would be £¾ billion and £1½ billion higher than forecast in 1988-89 and 1989-90 respectively. Table VI shows the surpluses and the Treasury Supplement.

TABLE VI: NATIONAL INSURANCE FUND (GB) SURPLUSES - £ billion

	1986-87	1987-88	1988-89	1989-90
Surplus: flow	0.4	1.0	2.1	1.5
: level end-year	5.7	6.7	8.8	10.3
Treasury Supplement	2.4	2.1	1.7	1.1
(rate %)	(9)	(7)	(5)	(3)

Net EC Contributions

15. Table VII shows the forecast of total net payments to EC institutions. It assumes an increase in the VAT ceiling for EC own resources from 1.4 to 1.6 per cent with effect from 1 January 1988.

TABLE VII: NET EC CONTRIBUTIONS (£bn)

	1987-88	1988-89	1989-90
PEWP 1987	0.9	0.4	1.1
Forecast	1.3	1.3 (1.0)	1.6 (1.9)

16. The projected overspend in 1987-88 compared with the PEWP is largely the result of the supplementary budget agreed in July. A large part of the forecast overspend in 1988-89 and 1989-90 is due to the assumed increase in the VAT ceiling. Higher than expected receipts of customs duties and agricultural levies this year have also led to an upward revision of our share of traditional own resources in 1987 and all forward years. In addition, the recent buoyancy of VAT receipts coupled with the strengthening of sterling against the ecu have led to an upward revision of our share of Community VAT contributions.

17. The forecast of the net EC contribution is however particularly uncertain. In view of this, and the possible distortion to public expenditure totals, the overall fiscal position, and the current account from the dip in the net contribution in 1988-89 and rebound in 1989-90, which has been a feature of most recent forecasts, including that in the PEWP, the path of the net contribution in this forecast was partially smoothed. The figures in brackets show what the forecast would have looked like had there been no smoothing - the 1988-89 dip is largely the result of the expected path of VAT abatements.

Other Central Government Expenditure

18. The most important components of this category are capital expenditure, current grants other than social security (including employment grants and overseas aid) and subsidies. Overspends totalling £1.4 billion and £1.9 billion are forecast for 1988-89 and 1989-90 respectively. The composition of this overspend is given in table VIII.

TABLE VIII: OVERSPENDS ON OTHER CG EXPENDITURE £ billion

	1987-88	1988-89	1989-90
GDFCF	0	0.1	0.2
Capital grants	0.2	0.3	0.4
Current grants other than social security and grants abroad	0.2	0.3	0.7
Subsidies	0.3	0.3	0.3
Other	0.2	0	0
TOTAL	0.8	1.0	1.5

19. The major contribution to the overspends comes from assuming that higher inflation than in the plans leads to additional cash spending. The growth of this category of expenditure in total is in real terms close to that implicit in the PEWP.

Local Authorities

20. Table IX summarises the forecast of local authorities finances.

TABLE IX: LOCAL AUTHORITY SUMMARY

	1986-87	1987-88	1988-89	1989-90
Total Current Expenditure (% increase)	8.4	10.0	7.9	9.3
LA Average Earnings (% increase)	8.7	9.1	8.2	9.0
LA Manpower (% increase)	2.2	1.1	1.1	1.1
Grant percentage (GB, accruals-% level)	46.3	45.8	44.9	44.6
Rate Poundage (% increase)	12.0	6.8	10.8	10.2
Gross Capital Spending In Real Terms (% increase)	1.3	- 1.4	0.6	1.1
Total Capital Receipts (£ billion)	2.6	3.5	3.7	3.9
LABR (£bn)	0.3	0.3	0.4	0.8

The forecast of current expenditure in 1987-88 is based on the authorities' budgets. Although authorities have spent slightly less than anticipated in their budgets in recent years, the forecast assumes that expenditure will turn out close to budgets in 1987-88 because the authorities appear to have made unduly low provision for pay increases.

21. The forecast for later years results from judgements about average earnings, manpower and levels of procurement. The forecasts for the growth of procurement volume and manpower are based on the averages of recent years, while the earnings forecast is built up from detailed assumptions about settlements in each group. Table X gives details of the earnings forecast.

TABLE X: LOCAL AUTHORITY AVERAGE EARNINGS GROWTH %

	Pay Rounds*	Financial Years**
1986-87	8 (7½)	8¾ (8¼)
1987-88	9½ (9)	9 (8)
1988-89	9 (8½)	8¼ (8)
1989-90	8½ (7¾)	9 (7¾)

* settlements in brackets
** private sector in brackets

High settlements for teachers, manual workers and construction workers are responsible for the generally positive differential with private sector earnings.

22. Table XI indicates that the forecast excess over provision for total local authority relevant public expenditure, which makes up about 95 per cent of total current expenditure, is not out of line with recent experience.

TABLE XI: LA RELEVANT PUBLIC EXPENDITURE

	% change	Overspend on provision*	
		£bn	%
1985-86	3.3	1.5	6
1986-87	8.2	2.6	9½
1987-88	9.8	1.2	4
1988-89	9.1	1.8	5½
1989-90	9.3		

* Baseline is PEWP provision in current year for years to 1987-88, and RSG provision for 1988-89.

23. The forecast indicates a much larger increase in rates in 1988-89 than in 1987-88, but a smaller increase than in 1986-87. This is partly due to larger grant underclaim in 1988-89 than in 1987-88 (reflected in the reduction in grant percentage) and partly due to the expectation that local authorities will

build up balances; Scottish local authorities are preparing for the community charge and local elections in England next year are confined to a few district councils.

24. A sharp rise in local authority capital receipts is forecast for 1987-88 (see table IX). This partly reflects an increase in the gross proceeds of council house sales, but is also due to, first, an increasing tendency for these sales to be financed by private sector as opposed to local authority mortgages and, secondly, the repayment of local authority mortgages taken out on council house sales in 1981 and 1982 - tenants who bought then are now free to sell and keep all the capital gain. Local authorities may also be raising more from sales of non-housing assets. The forecast assumes that authorities will have the scope and incentive to maintain in real terms the projected 1987-88 level of capital receipts.

25. Gross capital spending is expected to fall slightly in real terms in 1987-88. In 1988-89 and 1989-90 small real increases are forecast, implying substantial overspends in those years of £1-1½ billion on 1987 PEWP provision. But the higher forecast level of receipts results in only tiny overspends on net capital spending.

26. The local authority borrowing requirement (LABR) in the first five months of 1987-88 was much the same as in the equivalent period last year and the forecast assumes that this will also be true of the annual totals. The latest forecasts of local authority income and expenditure are broadly consistent with this pattern. The LABR forecast has not changed much since June but then the LA accounts could only be squared by assuming implausibly high unidentified receipts. The upward revision to capital receipts in this forecast - and a corresponding downward revision to unidentified receipts - makes the whole picture internally consistent and more plausible.

27. With capital receipts constant in real terms and some increase in gross capital spending in real terms, the LABR is forecast to rise gently in cash terms in 1988-89 and 1989-90.

Nationalised Industries and Other Public Corporations

28. Nationalised industries' output growth in 1987-88 is forecast to be higher than in any year since 1974-75 (in which year coal output rose strongly following the end of the 1973-74 strike). Indeed output growth in 1987-88 could be the highest ever achieved by the non-privatised industries (after adjusting for coal strike effects). British Steel output, in particular, is expected to increase rapidly this year, in response to increases in both manufacturing output and investment. Table XII shows some of the key features of the forecast.

TABLE XII: NATIONALISED INDUSTRY TRADING PERFORMANCE AND INVESTMENT*

	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90
Output (%)	0.7	3.4	0.9	3.6	1.6	1.4
Employment (%)	- 8.7	- 5.6	- 3.7	- 3.3	- 3.0	- 2.4
Productivity (%)	10.3	9.5	4.8	7.1	4.7	3.9
Real Prices (%)	- 0.7	- 1.8	- 1.1	- 1.2	- 0.6	- 0.1
Profits (%)**	32.0	16.0	21.0	26.0	8.5	10.1
Real Investment (%)	- 2.8	- 2.9	- 0.7	1.7	3.0	6.0

* The figures relate to the current composition of the NI Sector and adjust for coal strike effects.

** after stock appreciation

29. Buoyant output, together with continued high productivity growth, should produce healthy growth of profits in 1987-88 despite further real price falls. Some reduction in productivity growth is assumed in later years - the average for 1987-88 to 1989-90 is 5¼% compared with 7¼% in the period 1980-81 to 1986-87 - and output growth decelerates with that of the economy generally. But profits are forecast to rise in 1988-89 and 1989-90 at least as fast as money GDP, partly because the real prices are expected to fall less in 1988-89 and 1989-90 than the average of recent years (see table XIII for details).

TABLE XIII: NATIONALISED INDUSTRY PRICES IN REAL TERMS*
PERCENTAGE CHANGE IN FINANCIAL YEAR AVERAGE PRICES

	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90
British Coal	0.0	- 1.9	- 3.1	- 4.5	- 2.9	- 2.4
Electricity (E&W)	- 2.0	- 2.2	- 1.9	- 3.9	2.9	0.0
Water	1.0	4.7	4.4	1.7	1.4	2.0
British Rail	0.4	0.0	2.8	1.2	- 0.2	- 0.9
LRT	3.2	1.5	2.2	2.1	4.4	4.1
Post Office	- 1.5	- 4.2	- 2.0	- 0.8	- 0.4	- 1.0
British Steel	1.1	- 4.6	- 1.8	- 1.6	- 2.3	- 1.7
Average, All NIs	- 0.7	- 1.8	- 1.1	- 2.3	- 0.6	- 0.1
Memo: RPI	5.1	5.9	3.2	4.1	5.1	4.4

* Average of prices charged in both industrial and domestic markets. (Prices are relative to RPI).

30. The forecast for growth in real investment is somewhat higher than in recent forecasts. Weight has been given to previous experience which suggests that rapid increases in nationalised industry output tend to be accompanied by increases in their real investment. The forecast includes some large real investment increases for electricity, British Steel, LRT, British Rail, Water and the Post Office, offset by falls for Coal and British Shipbuilders.

31. Table XIV shows the forecast of external finance and the PCBR.

TABLE XIV: EXTERNAL FINANCE AND THE PCBR (£bn)

	1986-87	1987-88	1988-89	1989-90
External Finance				
PEWP Plans	0.3	0.7	0.3	- 0.1
Budget Forecast	0.4	0.8	*	*
October Forecast	0.4	0.6	0.7	0.6
PCBR				
Budget Forecast	- 1.4	- 0.9	*	*
October Forecast	- 1.4	- 1.1	- 1.2	- 1.2

* The Budget forecast is shown for 1986-87 and 1987-88 only - later years were constrained to plan figures and cannot therefore be considered genuine forecasts.

32. The forecast for 1987-88 shows a small undershoot on the external finance limit in the PEWP. In large part this is due to a buoyant profits outlook. The forecast is for external finance overshoots of £½ billion to £¾ billion in 1988-89 and 1989-90. These overshoots, which are somewhat lower than in previous forecasts, arise because fixed investment is higher and profits lower than those underlying the PEWP plans.

Debt Interest

33. Current projections of general government gross debt interest lie below those published in the PEWP and FSBR but slightly above those forecast in June for 1987-88 and 1988-89.

TABLE XV: GENERAL GOVERNMENT GROSS DEBT INTEREST PAYMENTS

£ billion

	1986-87	1987-88	1988-89	1989-90
PEWP	17.5	18.1	18.1	18.7
1987 FSBR	17.5	17.9	18.2	18.6
June Forecast	17.2	17.6	17.8	18.0
October Forecast	17.4	17.7	18.0	17.5

34. The single most important influence on this forecast is the significantly lower projections of government borrowing in all years. This is partially offset by higher interest rates. Compared to the FSBR higher inflation implies greater accrued interest on index-linked debt whilst the removal of presentational increases contained in the FSBR lowers gross payments.

II GENERAL GOVERNMENT RECEIPTS

35. Table XVI sets out details of the forecast of general government receipts in the format of FSBR Table 1.2. Comparisons are shown with the June Forecast and - for 1987-88 only - with the forecast published in the FSBR. All the figures in this section are before taking account of the fiscal adjustment.

36. In spite of the effect of the budget tax cuts general government receipts are forecast to rise by 8 per cent in 1987-88, only a little below the 9 per cent growth forecast for money GDP. Without the Budget tax cuts, growth of general government receipts would have been a little higher than money GDP. The forecast increase in taxes and royalties, at 10 per cent, is above GDP growth, despite the tax cuts. The main explanation is the exceptional buoyancy of a number of individual taxes - non-North Sea corporation tax, stamp duties and certain capital taxes - which boosted tax receipts last year, and which as yet shows no signs of abating. This buoyancy is now expected to continue into 1988-89; the forecast growth rates for general government receipts and taxes and royalties for that year, at 11 per cent and 12 per cent respectively, are substantially in excess of the 8½ per cent projected for money GDP. The forecast shows somewhat less tax buoyancy for 1989-90, with general government receipts growth, at 7½ per cent, just below that of money GDP and that of taxes and royalties slightly above it.

37. The forecast tax burden is summarised in paragraph 77 of the main report.

Income Tax

38. Income tax revenues are forecast to rise by only 5½ per cent this year, following the reduction of the basic rate in the Budget. This nevertheless represents an increase of £0.7 billion on the forecast made in June, nearly all of which is accounted for by PAYE. The upward revision to PAYE revenues is in line with the outturn to date, and for the most part reflects higher wages and salaries growth in the current forecast.

TABLE XVI

GENERAL GOVERNMENT RECEIPTS

£ billion (percentage changes on year earlier in brackets)

	Forecasts			Changes from June Forecast			Changes from FSBR
	1987-88	1988-89	1989-90	1987-88	1988-89	1989-90	1987-88
Income Tax	40.7 (+ 5½)	45.2 (+ 11)	49.4 (+ 9½)	+ 0.7	+ 1.1	+ 1.9	+ 0.7
Corporation Tax (excl. North Sea)	14.7 (+ 30½)	17.9 (+ 22)	19.0 (+ 6)	+ 0.6	+ 2.3	+ 1.3	+ 1.1
Capital Taxes	3.1 (+ 21)	4.2 (+ 34)	4.8 (+ 14)	- 0.1	- 0.1	- 0.3	- 0.1
Expenditure Taxes: VAT Receipts	23.8 (+ 10)	26.1 (+ 9½)	28.2 (+ 8)	+ 0.5	+ 0.4	+ 0.6	+ 0.5
Local Authority Rates	16.9 (+ 8½)	19.1 (+ 13)	21.2 (+ 11)	-	+ 0.7	+ 1.2	-
Stamp Duties	2.5 (+ 38½)	3.2 (+ 24)	3.7 (+ 17½)	+ 0.1	+ 0.2	+ 0.3	+ 0.4
Other	25.6 (+ 4½)	27.6 (+ 8)	29.7 (+ 7½)	- 0.3	+ 0.3	+ 0.8	+ 0.1
Total Expenditure Taxes	68.8 (+ 8½)	76.0 (+ 10½)	82.8 (+ 9)	+ 0.3	+ 1.6	+ 2.9	+ 1.1
North Sea Revenues	4.6 (- 4)	4.5 (- 2½)	4.5 (+ ½)	- 0.1	- 0.1	-	+ 0.7
Other Taxes	- 0.7	- 0.7	- 0.6	+ 0.1	-	-	+ 0.1
Total Taxes and Royalties	131.3 (+ 10)	147.1 (+ 12)	159.9 (+ 8½)	+ 1.4	+ 4.8	+ 6.1	+ 3.6
National Insurance and Other Contributions	29.1 (+ 9)	31.7 (+ 9)	34.3 (+ 8)	-	+ 0.3	+ 0.4	+ 0.6
Interest and Dividend Receipts	5.6 (- 8)	5.6 (+ 1)	5.4 (- 3½)	+ 0.2	+ 0.5	+ 0.5	- 0.1
Gross Trading Surplus and Rent	3.5	3.6	3.6	-	+ 0.1	+ 0.2	+ 0.2
Other Receipts	3.3	3.7	3.2	- 0.5	- 1.0	- 1.2	- 0.3
General Government Receipts	172.8 (+ 8)	191.7 (+ 11)	206.4 (+ 7½)	+ 1.1	+ 4.8	+ 5.8	+ 4.0

39. The forecasts for 1988-89 and 1989-90 assume annual indexation of allowances and thresholds in line with the RPI. With real incomes rising, the forecast shows real fiscal drag, with income tax revenues rising faster than incomes. Table XVII below, which sets out the forecast in terms of effective tax rates, illustrates this.

TABLE XVII: EFFECTIVE RATES OF INCOME TAX* (%)

	1985-86	1986-87	1987-88	1988-89	1989-90
PAYE	19.5	19.2	18.7	19.2	19.6
Total income tax	13.1	13.2	13.2	13.7	14.0

(* before taking account of fiscal adjustment)

Corporation Tax

40. Non-North Sea mainstream corporation tax (MCT) receipts increased by over 50 per cent (£2.2 billion) between 1985-86 and 1986-87. We are now forecasting a further increase for 1987-88 which, at approaching 40 per cent, is a little lower than last year's in percentage terms, but larger (£2.7 billion) in terms of absolute magnitude. These very substantial rises reflect both rapid profits growth during 1985 and 1986 (MCT received in 1987-88 will be in respect of company incomes in 1986 and earlier years) and a rising effective tax rate. The latter in turn reflects both the effect of several years of healthy profits growth in reducing the extent of tax exhaustion, and the phasing in - following the 1984 Budget reforms - of a new system of capital allowances, which has the effect of producing a temporary 'dip' in the amounts of allowances against tax during the transition period. The current forecast of MCT in 1987-88 is over £0.6 billion higher than that made at Budget time and £0.4 billion higher than the forecast made in June; this upward revision mainly reflects revisions to profits data for 1986. It should be stressed that, unlike most other taxes, monthly figures on outturn to date for MCT give little or no indication as to the likely outturn for the year; the vast bulk of MCT is paid in the second half of the financial year, mostly in October and January. In addition receipts in the first half of the year relate to company incomes in earlier years than

the year which will generate most of the second half receipts. In present circumstances, therefore the forecast of MCT is particularly uncertain.

41. The forecasts for future years show a further substantial rise in MCT receipts for 1988-89, but a much smaller rise for 1989-90. Table XVIII shows some details of the CT forecast, including effective tax rates (calculated on the basis of tax accruals and profits in the previous calendar year). The slow-down in 1989-90 reflects the lower profits growth forecast for 1988. The effective rate is expected to show a further significant rise for 1987-88 but to fall back a little in the following years, as the reduction in tax exhaustion slows and capital allowances under the new system begin to build up. As compared with the forecast made in June, MCT receipts are now expected to be £1.7 billion higher in 1988-89. This upward revision reflects the forecast higher level of profits in 1987, resulting from both higher profits growth than in June and upward revisions to profits data for 1986 and earlier years.

TABLE XVIII: CORPORATION TAX EFFECTIVE TAX RATES

Percentage Growth Rates for:-

	Revenue		**Tax determinants**		**Effective Rates (%)**	
	MCT Receipts	**ACT**	**Company Incomes (previous Calendar year)**	**Dividends (Calendar year)**	**MCT***	**ACT**
1985-86	+ 23	+ 21	+ 15	+ 24	11.0	59.3
1986-87	+ 55	+ 17	+ 26	+ 33	13.2	52.2
1987-88	+ 37	+ 17	+ 25	+ 28	15.2	47.7
1988-89	+ 21	+ 19	+ 19	+ 19	14.8	47.6
1989-90	+ 5	+ 11	+ 8	+ 10	14.5	47.8

[* numerator is tax accruals for previous year]

42. ACT receipts are now forecast to rise by 17 per cent (£0.7 billion) this year, despite the reduction in the income tax basic rate in the Budget, which has led to a reduction in the effective tax rate. This forecast has been revised upwards by £0.5 billion from Budget time, and by £0.2 billion since

June, in line with upward revisions to the forecast of dividends - which are now forecast to record a rise of nearly 30 per cent for the year, not much below last year's substantial increase. The forecast shows ACT receipts growing in line with dividends.

VAT

43. VAT receipts have been quite buoyant so far this year, but part of this buoyancy may be due to a further reduction in payment lags resulting from the Keith reforms to VAT collection procedures, and in particular to the default surcharge - introduced last October, but which only started to 'bite' (in the sense of penalties actually being levied on late-payers) in May. In the light of the evidence available so far - on penalties collected, and numbers of firms in arrears - we have tentatively revised our estimate of Keith effects for 1987-88 up from £0.2 billion to £0.4 billion.

44. The forecast for VAT is shown in Table XIX; the presentation here abstracts from 'special factors', such as Keith effects, in order to monitor 'underlying' VAT receipts. As compared with the forecast made in June, which was not significantly different from that in the FSBR, the forecast for 1987-88 has been revised upwards by £0.5 billion - nearly half of which is attributed to Keith effects. In the light of receipts to date, the forecast for 1987-88 as a whole could be termed cautious - even with our doubling our previous estimate of Keith effects. It nevertheless implies - on the basis of the present forecast of consumers' expenditure - a substantial rise in the effective tax rate, much larger than the rise which (following an upward revision to 1986 consumers expenditure data for this year's Blue Book) now appears to have taken place in 1986-87. It is quite possible therefore that - as happened last year - buoyant VAT receipts will turn out to be an indicator of higher than expected consumers' expenditure in total, rather than of a substantial shift in expenditure towards VATable goods and services.

TABLE XIX: VAT RECEIPTS FORECAST

	Percentage Growth Rates in:-		Forecast Levels (£bn)			
	VAT Receipts (Underlying)	Consumers Expenditure	Effective Tax Rate (Underlying)	Underlying Receipts	Special Factors*	Total Receipts
1985-86	13.7	9.1	9.09	19.4	+ 0.1	19.5
1986-87	10.0	9.6	9.13	21.4	+ 0.3	21.7
1987-88	9.1	7.6	9.25	23.3	+ 0.5	23.8
1988-89	10.1	9.4	9.32	25.7	+ 0.4	26.1
1989-90	8.4	8.0	9.36	27.8	+ 0.4	28.2

[* reduction of arrears from Keith report changes; 1987 Budget effects; repayment supplement resulting from strike earlier this year]

45. The forecasts for 1988-89 and 1989-90 assume some further growth in the effective tax rate. Real growth in consumers expenditure is forecast at 4½ per cent in 1988-89 and 3½ per cent in 1989-90.

North Sea Revenues

46. Government revenues from the North Sea in 1987-88 are projected at £4.6 billion, close to the June forecast but £0.7 billion above the FSBR forecast. Revenues have been boosted by a higher sterling oil price, reflecting a stronger dollar oil price only partly offset by a higher projected $/£ rate, and by the effect of lower than expected costs of drilling exploration and appraisal wells. Although total North Sea production in 1987 is turning out lower than expected at the time of the Budget, this has little effect on projected revenues because reductions are concentrated in non-PRT paying fields while production in some PRT paying fields has been revised up.

47. Despite the assumption of a constant $18 oil price in 1988 the sterling oil price is projected to weaken a little over the next year as a result of the projected depreciation of the dollar. With production also expected to fall, revenues are projected to decline slightly in 1988-89 but in 1989-90 the effect of a further decline in production is offset by the ending of APRT repayments.

ANNEX : EXTRACT FROM MAIN FORECAST REPORT

(8) PUBLIC FINANCES

64. Table 30 summarises the forecast and compares it with the numbers in the FSBR, and with the internal June forecast. The projections in the FSBR were on the basis of certain conventional assumptions and not a central forecast.

TABLE 30 : PUBLIC SECTOR EXPENDITURE, REVENUE, AND BORROWING
(£ billion)

	1986-87 Outturn	1987-88			1988-89			1989-90		
		FSBR	June Fore-cast	Oct. Fore-cast	FSBR	June Fore-cast	Oct. Fore-cast	FSBR	June Fore-cast	Oct Fore-cast
General Government Expenditure	165	174	173	172½	180	185	184	188	198	197
General Government receipts	160	169	172	173	178	187	192	187	201	206
Assumed cuts in personal taxes (cumulative)					3	3	4	5	5	6
GGBR	5	5	2	-½	5	2	-3	6	2	-4
Public corporations' overseas and market borrowing	-1½	-1	-1	-½	-1	-1	-2	-1	-1	-2
PSBR	3½	4	1	-1	4	1	-5	5	1	-5
(per cent of GDP) brackets)	(1)	(1)	(¼)	(-¼)	(1)	(¼)	(-1)	(1)	(¼)	(-1)

(a) 1987-88

65. The PSBR for 1987-88 is now forecast to be a surplus of £1b. The margins of error attached to PSBR forecasts made at this time of the year, whilst lower than those for the Budget forecast, are still very high. The average absolute error is around 0.8 per cent of GDP (£3b.).

66. The latest forecast represents an undershoot on the FSBR forecast of £5b., and a reduction of £2b. from the June forecast. Table 31 shows the main components of the £5b. reduction in the PSBR forecast since the Budget. Over three-quarters of the predicted undershoot of the FSBR forecast is accounted for by lower central government own account borrowing, with most of the remainder due to lower local authorities' borrowing. The forecast of public corporations' market and overseas borrowing is little changed. Looked at another way three-quarters of the downward revision to the forecast has been on general government receipts, and one-third to general government expenditure.

TABLE 31 : CONTRIBUTION TO THE CHANGE IN THE 1987 PSBR FORECAST SINCE JUNE AND THE FSBR

	£ billion Changes since	
	FSBR	June
- higher North Sea revenues from a higher North Sea oil price;	-¾	-
- higher non-North Sea corporation tax reflecting upward revisions to 1986 profits data and higher dividend payments (generating ACT) in 1987;	-1	-½
- higher income tax, in line with experience to date and mainly reflecting higher money incomes;	-¾	-¾
- higher national insurance contributions, reflecting higher money incomes;	-	-½
- higher VAT, in line with outturn to date, and reflecting buoyant expenditure and - we think - a larger than expected reduction in arrears as a result of the Keith reforms;	-½	-½
- higher stamp duty as a result of the buoyant housing and stock markets;	-	-½
- higher privatisation proceeds;	-¼	-¼
- a lower public expenditure planning total (excluding privatisation proceeds);	-1	-1¼
- offsetting increases, mainly lower 'other' receipts and higher national accounts adjustments	+¼	+1¼
TOTAL CHANGE IN PSBR FORECAST	-5	-2

67. Lower expenditure and higher receipts have contributed roughly equally to the £2b. reduction in the PSBR since June. The main upward revisions on the receipts side have been to income tax, non-North Sea corporation tax and VAT. On the expenditure side the main reduction is lower local authority net capital spending, reflecting higher capital receipts, but the forecasts of social security spending and nationalised industries' EFLs have also been reduced.

(b) Fiscal adjustment and PSBR in 1988-89 and 1989-90

68. The MTFS assumption of PSBRs of one per cent of GDP would, on present projections, imply a massive fiscal adjustment in 1988-89 of around £13½b., with a further annual fiscal adjustment of £3b. in 1989-90. The forecast makes the stylised assumption that higher than previously planned privatisation proceeds are used to reduce the PSBR and that one third of the remaining available fiscal adjustment for 1988-89, calculated on this

basis, reduces personal taxes, with the remaining two thirds reducing the PSBR to a surplus equivalent to about 1 per cent of GDP. The assumed cut in taxes is a little larger than in the June forecast. In 1989-90 the PSBR is maintained at the arbitrary surplus of 1 per cent of GDP, and there is scope for a further cut in personal taxes of £2b.

(c) Public expenditure

69. The forecast of the planning total excluding privatisation proceeds in 1987-88 has been revised down since June, and instead of a small overspend of the 1987 PEWP plans, a £1b. undershoot is now forecast. Substantial overspends of the PEWP totals are forecast for 1988-89 and 1989-90, only a little less than those forecast in June. The forecast for these years takes account both of the differences between the economic assumptions used in the PEWP and of the economic prospects in the forecast, together with other pressures on programmes which past experience suggests are likely. The forecast is in effect attempting to anticipate not only the final outcome of the current survey (and in the case of 1989-90 the next survey as well), but also any eventual over or underspend on the finally agreed planning totals. The forecast incorporates some modest additions to expenditure in 1989-90 following the buoyant performance of the economy in general and public finances in particular in 1987 and 1988. Privatisation proceeds of £5¼b. are assumed for 1987-88, in line with PE's latest assessment. Proceeds of £6b. a year are assumed for 1988-89 and 1989-90.

70. Table 32 sets out forecast increases in actual programme spending compared with the 1987 PEWP in terms of economic rather than departmental categories. About half the projected excess above current programme plans is accounted for by social security and local authority current expenditure. These are areas over which the Government has limited direct control.

TABLE 32 : FORECAST ADDITIONS TO PROGRAMME BASELINES

£ billion

	1987-88		1988-89		1989-90	
	PEWP 1987	Forecast Claims on Reserve	PES 1987 Base-line	Forecast additions to baseline	PES 1987 Base-line	Forecast additions to baseline
Allocated to programmes						
1. Social Security (including HB)	44.7	0.5	46.1	2.2	48.0	4.1
2. LA current (excluding HB)	32.5	1.1	33.7	2.9	34.6	5.2
3. CG pay	24.8	0.5	25.8	1.5	26.6	2.9
4. CG procurement	24.6	0.1	25.0	1.4	25.9	2.3
5. LA capital	4.3	-0.7	4.0	-0.2	4.1	0.0
6. EC	0.9	0.4	0.4	0.9	1.1	0.6
7. Nationalised industries	0.7	-0.1	0.3	0.3	-0.1	0.7
8. Other	17.8	0.6	18.3	0.9	18.8	1.5
9. Total programmes	150.1	2.5	153.7	9.9	9.0	17.3
10. Expenditure met from existing reserve						
(i) allocated to programme baseline	0.0	2.5	0.0	5.5	0.0	7.5
(ii) unallocated	3.5	0.0	5.5	0.0	7.5	0.0
11. Underspend (-) Addition to Reserve(+)	0.0	-1.0	0.0	4.4	0.0	9.8
12. PLANNING TOTAL excluding privatisation proceeds	153.6	-1.0	159.2	4.4	166.5	9.8

71. The forecast of social security spending assumes that the underlying growth in spending - ie the growth after allowing for the effects of changes in unemployment, upratings, policy changes, demographic factors etc - which is projected to have risen rapidly in 1987-88, falls back somewhat in 1988-89 and 1989-90. The forecast of local authority current spending, most of which is pay, assumes that numbers employed will rise at much the same average rate as in the last 2-3 years and that earnings increases will be somewhat above the private sector average (see para 48). This, together with the RSG settlements announced in July, implies average rates increases of about 11 per cent in 1988-89.

72. The forecast of central government pay assumes little change in numbers and earnings increases averaging below the private sector in 1988-89 and much the same as the private sector in 1989-90 (see para 49). The forecast of central government procurement assumes that non-defence spending will rise in real terms at much the same rate as over the past 5 years, and that defence spending will rise at ½ per cent a year in real terms. Local authority capital receipts and gross capital spending are assumed to be higher than in the 1987 PEWP, but by roughly equal amounts in 1988-89 and 1989-90. The forecast has partially smoothed out the projected dip in net EC contributions in 1988-89 and the rebound in 1989-90.

73. The large upward revision to the planning total forecasts for 1988-89 and 1989-90 since the Budget are largely matched by a higher inflation forecast. Consequently the increase in the planning total in real terms is less than the cash increase. In real terms the planning total and GGE (see table 33) are much the same as earlier internal forecasts. The forecast of GGE in real terms is almost identical to that made a year ago for 1988-89 and less than 1 per cent higher for 1989-90.

TABLE 33 PAST AND CURRENT FORECASTS OF GGE EXCLUDING PRIVATISATION PROCEEDS

£ billion

Forecast	1986-87		1987-88		1988-89		1989-90	
	Current prices	Real Terms*	Current Prices	Real Terms*	Current Prices	Real Terms*	Current Prices	Real Terms*
Jan 1986	169	169	176	169	186	169	-	-
June 1986	169	169	177	170	186	171	-	-
Oct 1986	170	170	178	171	188	172	200	173
Jan 1987	170	170	179	171	190	173	202	175
FSBR 1987	169	170	179	171	185	171	193	172
June 1987	169	169	179	170	190	171	203	174
Oct 1987	170	170	178	170	190	172	203	175

* in 1986-87 prices

74. The ratio of GGE (excluding privatisation proceeds) to money GDP is forecast to show a sharp fall in 1987-88 and more modest falls in 1988-89 and 1989-90. It is below the PEWP/MTFS paths in all three years.

TABLE 34 : RATIO OF GGE EXCLUDING PRIVATISATION PROCEEDS TO MONEY GDP

per cent

	1985-86	1986-87	1987-88	1988-89	1989-90
1987 PEWP	44¾	44½	44	42¾	42½
1987 FSBR	44¾	44¼	43½	42½	41¾
Oct forecast	44¾	44	42¼	41¾	41¼

(d) General Government Receipts

75. The recent history of forecasts of general government receipts has been a series of successive upward revisions. The current forecast continues this pattern, with substantial upward revisions to 1988-89 and 1989-90

compared the with June forecast. The upward revision since June to the forecast for 1987-88 has been smaller (about £1b.), though this still leaves the 1987-88 forecast of revenues £4b. higher than that in the FSBR.

76. Part of the upward revision to 1987-88 receipts since the FSBR can be attributed to higher economic activity, including stronger than expected stock and housing markets, which have boosted stamp duty receipts. Higher non-North Sea corporation tax for the most part reflects stronger than previously estimated activity and profits in 1986. Higher non-North Sea corporation tax is the most important single factor behind the higher total receipts now forecast for 1988-89 and 1989-90, accounting for around half of the revision since June to 1988-89 and one-third of the revision to 1989-90. The revision to the forecasts partly reflects higher profits growth for 1987 (and thus higher tax receipts for 1988-89). The remainder of the upward revision since June to the receipts forecasts for 1988-89 and 1989-90 are for the most part attributable to higher income and expenditure (income tax, VAT and NICs account for between one-third and half of the total upward revision in each year), but the forecast of local authorities rates has been raised by between £¾ to £1b. in each year.

TABLE 35: COMPARISON OF FORECASTS OF GENERAL GOVERNMENT RECEIPTS (PRE-FISCAL ADJUSTMENT FOR 1988-89 AND 1989-90)*

£ billion

Forecast:	1986-87		1987-88		1988-89		1989-90	
	Cash	Real Terms	Cash	Real Terms	Cash	Real Terms	Cash	Real Terms
January 1986	157	153	166	159	178	162	188	164
June 1986	156	156	164	158	179	164	188	166
October 1986	156	156	165	159	181	165	196	169
January 1987	158	158	169	162	184	168	197	171
FSBR 1987	159	159	169	162	178	164	187	167
June 1987	159	160	172	164	187	168	201	172
October 1987	160	160	173	165	192	174	206	178

* Forecasts made before this and last year's Budgets have been adjusted to be consistent with current tax rates and allowances. Real terms figures are at 1986-87 prices.

77. Table 36 shows non-oil taxes and national insurance contributions (NICs) as a percentage of non-oil GDP. The changes to the tax forecast since the FSBR mean that the forecast now shows a substantial rise in the pre-fiscal adjustment tax burden for 1988-89, but this is offset by the assumed cut in taxes. The projected rise for 1989-90 is smaller, and is

again offset by the assumed tax cut. Thus with the stylised assumption used here on the allocation of the fiscal adjustment, the tax burden for 1989-90 is the same as the level for 1987-88. With oil revenues as a percentage of GDP expected to be broadly flat at the projected 1987-88 level, the ratio of total taxes to money GDP is forecast to follow a similar pattern to the non-oil ratio.

TABLE 36: NON-OIL TAXES AND NICs AS A PERCENTAGE OF NON-OIL GDP

	1985-86	1986-87	1987-88	1988-89	1989-90
FSBR					
(a) pre-fiscal adjustment	37.2	37.3	37.8	37.9	37.7
(b) post fiscal adjustment	37.2	37.3	37.8	37.1	36.6
June Forecast					
(a) pre-fiscal adjustment	37.3	37.7	38.0	38.4	38.8
(b) post fiscal adjustment	37.3	37.7	38.0	37.5	37.9
October Forecast					
(a) pre-fiscal adjustment	37.0	37.5	38.0	39.1	39.4
(b) post-fiscal adjustment	37.0	37.5	38.0	38.0	38.0

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WORLD ECONOMIC PROSPECTS: OCTOBER 1987

SUMMARY

- The WEP assumes no major pressures develop in foreign exchange markets over the next year or so. The **dollar's nominal effective exchange rate** remains broadly unchanged over this period, and **US interest rates** rise only modestly. There is a risk though that much greater downward pressure on the dollar could develop, resulting in a combination of greater dollar depreciation and higher US interest rates.

- No major changes in announced **fiscal policies** in the major industrial countries are assumed.

- **Real GNP** in the major seven is picking up after some hesitation around the turn of the year. It is projected to grow by about 2½ per cent in 1987 and at a similar rate over the next few years, broadly in line with potential. Industrial production, which stagnated in several major countries in 1986, is forecast to grow by 3 per cent in 1987 and by over 4 per cent in 1988 and 1989.

- The volume of **World trade** in 1987 is expected to grow by around 3½ per cent, with world trade in manufactures growing slightly faster. In 1988 and 1989 the growth rate of total world trade is forecast to be around 4 per cent per annum.

- **Consumer price inflation** in the major seven has, as expected, risen to around 3 per cent, reflecting the recovery in oil and other commodity prices. Average inflation is forecast to stabilise at around this rate.

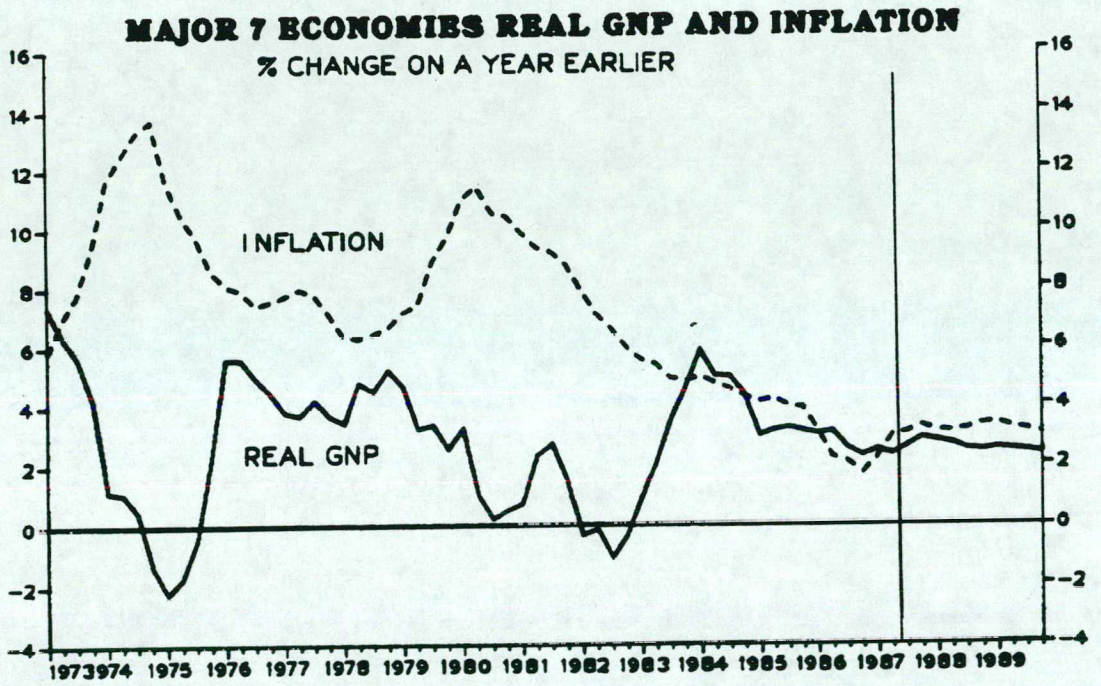
- The **oil price** (average North Sea price) is expected to remain around its current level, about $18 per barrel, until the end of 1988, and to remain constant in real terms thereafter. This is roughly consistent with OPEC's current target price.

- **Non-oil commodity prices** have recovered from their trough of last summer. Strengthening world industrial production should produce some further modest increases in the prices of industrial materials but they remain well below their historical average. No increase in real food prices is expected.

Table 1: Output, Inflation and Trade

Percentage change on year earlier	1985	1986	1987	1988	1989
Major 7 real GNP	3.1	2.7	2.6	2.6	2.4
Major 7 real domestic demand	3.2	3.8	2.7	2.7	2.6
Major 7 industrial production	2.8	0.9	3.0	4.3	4.2
Major 7 consumers' expenditure deflator	3.9	2.1	2.8	3.1	3.0
World trade					
- total	4.4	4.7	3.5	4.2	4.0
- manufactures	4.6	1.9	3.8	4.9	4.8

Chart 1 - Major Seven Growth and Inflation



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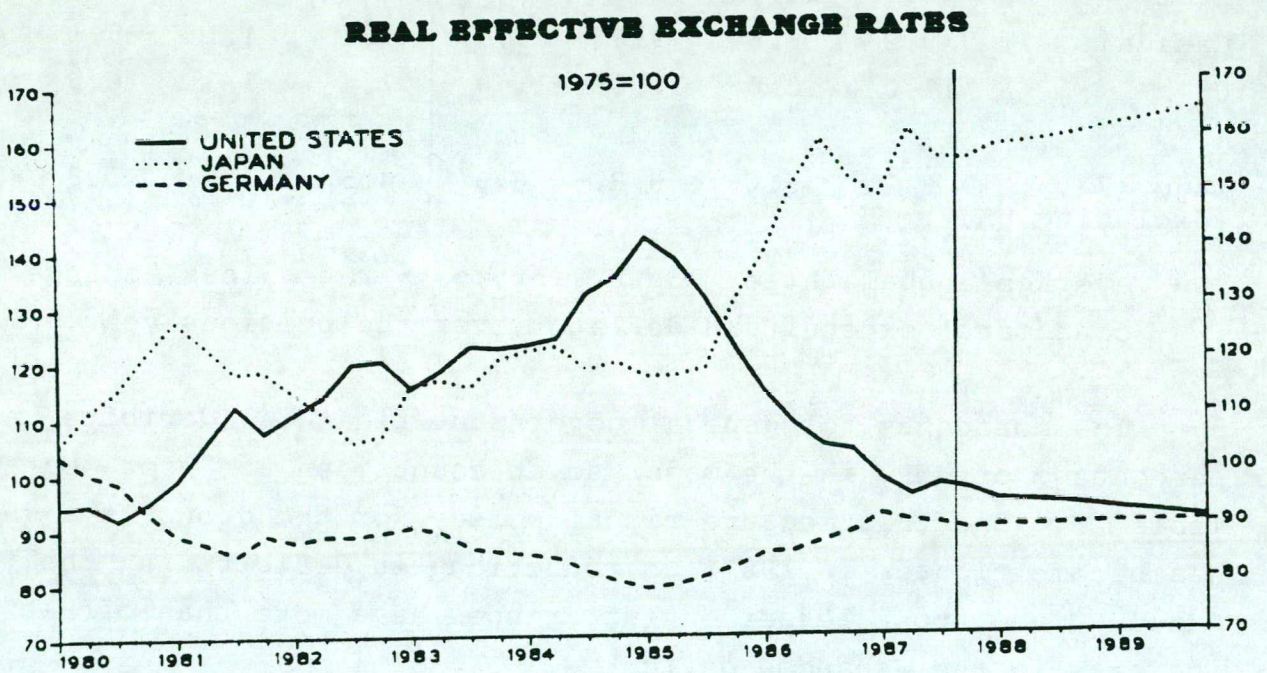
MONETARY AND FISCAL POLICIES IN THE MAJOR COUNTRIES

1. During the first half of 1987 nominal short-term interest rates rose by 1 percentage point in the United States and Canada and fell by ½ percentage point in Japan, Germany and France. These movements will have contributed to the relative stability of exchange rates since the Louvre Accord in February. More recently, interest rates have risen by a further ½ percentage point in the US, and market interest rates in Japan and Germany have also increased slightly.

2. One of the most important judgements made in this forecast is that the dollar does not come under significant downward pressure during the rest of the decade. We assume that the dollar's nominal depreciation is slightly more than the inflation differential between the US and Japan and Germany, and that US interest rates need to rise by only a further 1 per cent. This may be unduly optimistic in view of the prospects, on present policies, for current balances and net external asset positions of the three largest countries. There remains a significant risk that markets may become impatient with the speed of adjustment and much greater downward pressure on the dollar could develop.

Chart 2 - Real Effective Exchange Rates



3. As well as the desire not to see the dollar fall sharply, the Federal Reserve Board faces a number of conflicting domestic pressures in setting US monetary policy: continuing large Federal deficits, an inflation rate which has been creeping up, and political pressure not to raise interest rates to such an extent that real growth is weakened. On balance domestic considerations point to the trend in US interest rates remaining upward.

4. In Japan and Germany the monetary authorities are concerned about the rapid growth of their monetary aggregates and have only accepted this as a necessary price to prevent their currencies appreciating even more. They will be reluctant to let their interest rates fall while their exchange rates are not subject to strong upward pressure.

Table 2: Short-Term Interest Rates

	Nominal				Real*			
%	1986	1987	1988	1989	1986	1987	1988	1989
US	6.5	6.8	8.2	8.5	4.2	2.9	4.2	4.4
Japan	5.0	3.9	3.8	3.8	4.3	3.7	3.1	3.1
Germany	4.6	4.0	4.0	4.0	5.1	3.2	2.7	3.1
France	7.8	8.0	7.4	7.1	5.2	4.4	5.0	4.8
Italy	12.8	11.7	12.1	11.8	6.3	7.3	6.4	5.5
Canada	9.2	8.6	9.6	9.3	4.7	4.1	5.1	4.9
UK	11.0	10.0	11.0	11.0	7.4	7.3	6.5	6.7
Major 7 (excluding UK)	6.7	6.4	6.8	6.9	4.5	3.6	3.8	3.8

* Average annual three month interest rate less change in consumers' expenditure deflator over the previous year.

5. The forecasts for general government financial deficits, as a percentage of GNP, in the major seven countries are set out in Table 3. On this measure fiscal policy for the group as a whole has become tighter in 1987, as reductions in deficits in the US, Canada, and to a lesser extent France, have more than offset the increase in the Japanese deficit.

Table 3: General Government Financial Deficits

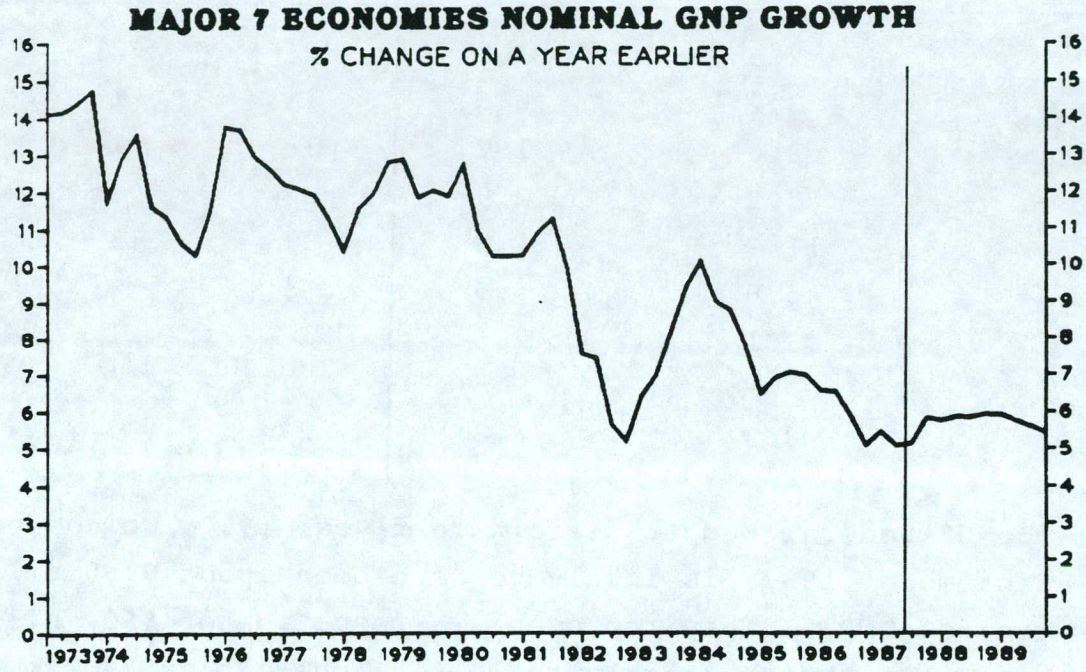
% of GNP	1980-85	1986	1987	1988	1989
US	2.6	3.5	2½	2½	2¼
Japan	3.2	0.6	1½	1½	1
Germany	2.6	1.2	1½	1¼	1½
France	2.2	2.9	2¼	2¼	2
Italy	11.9	11.2	11½	11	11
Canada	5.0	5.5	4½	4½	4½
UK	3.1	2.6	1	1	½
Major 7	3.3	3.3	2¾	2¾	2½

6. The US Federal budget deficit in fiscal 1987, which ended on 30 September 1987, is likely to have been about $160 billion (3½ per cent of GNP). This represents a reduction of $60 billion on the previous year, partly reflecting one-off gains from the tax reform package. The Congressional Budget Office estimate that, on a "current services" basis, the deficit will rise to over $180 billion in FY1988 and over $190 billion in FY1989. Despite the revamped Gramm-Rudman legislation, only modest reductions in the deficit from this baseline are likely until after next year's election, giving deficits of around $170 billion in both FY1988 and FY1989. This assessment is broadly in line with that of most other forecasters.

7. Elsewhere, the forecast assumes that fiscal measures already announced are implemented - in particular the Japanese package and cuts in tax rates in Germany from January 1988. Only about half of the Japanese package is assumed to be genuinely additional, but the fiscal stimulus nevertheless amounts to 1 per cent of GNP. After 1988 the Japanese Government is assumed to return to a policy of gradual fiscal consolidation. In Germany a further round of tax cuts is planned for 1990, but no changes are expected in 1989.

8. These policy assumptions are forecast to produce continued growth in aggregate money GDP in the major seven of around 5½ per cent a year - see chart 3.

Chart 3 - Nominal GNP in Major Seven



DEMAND AND OUTPUT

9. Data for the first half of 1987 show that domestic demand in the major seven as a whole slowed following rapid growth in 1986, when these countries experienced a large terms of trade gain. There are also signs that private investment was affected by exchange rate uncertainty around the turn of the year. Stockbuilding was particularly strong in the first half. The reasons for this are as yet unclear, but it was probably partly involuntary, and subsequent destocking could depress growth in the remainder of the year. However, other factors point to a modest recovery in domestic demand growth outside the United States and, on balance, domestic demand growth in the major seven is projected to grow at just over 2½ per cent per annum over the next few years.

Table 4: Domestic Demand Growth

Percentage change on year earlier	1986	1987	1988	1989
North America	3.9	2.0	1.8	1.6
Europe* and Japan	3.8	3.4	3.5	3.4
Major 7	3.8	2.7	2.7	2.5

* France, Germany, Italy and the UK.

10. The first half of 1987 also saw a slowdown in the growth of the major seven's imports and a pick up in their exports. If NODC's and OPEC's demand for imports recover as we expect, the gap between real domestic demand and GNP growth in the major seven will be reduced to less than ¼ per cent per year over the next couple of years compared with 1 per cent in 1986.

Chart 4 - Real GNP Growth in the Major Seven

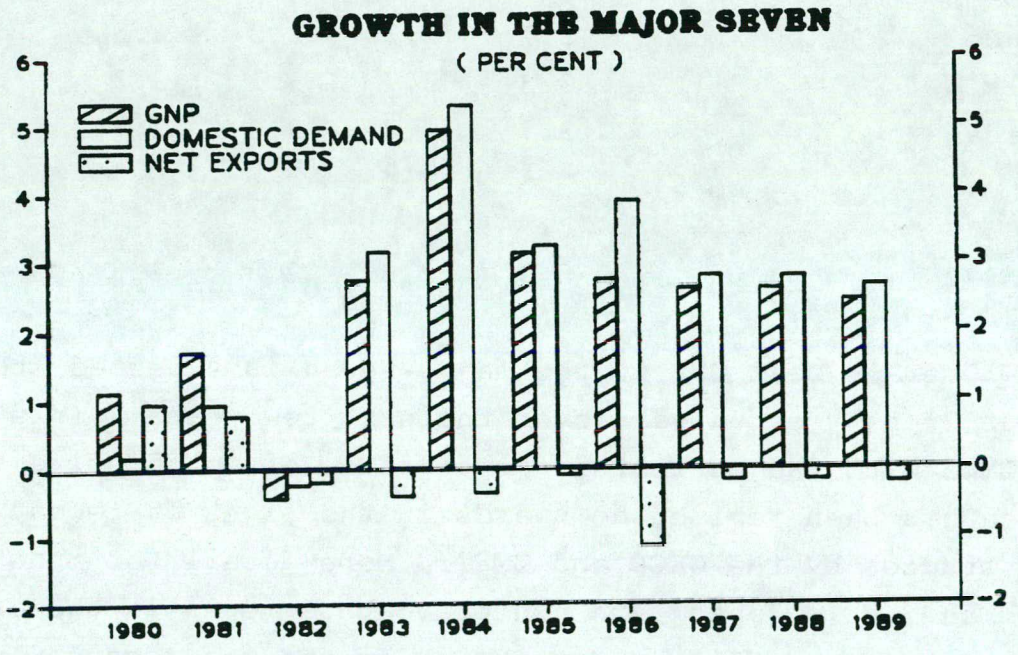


Table 5: Growth of Real GNP and Contribution of Domestic Demand

Percentage change on year earlier	GDP/GNP 1986	1987	1988	1989	Estimated Growth of Productive Potential
US	2.9	2.5	2.5	2.0	2½
Japan	2.5	3.2	3.5	3.6	3½
Germany	2.5	1.5	2.2	2.4	2¼
France	2.1	1.5	2.1	2.3	2¼
Italy	2.7	3.1	2.3	2.7	2½
Canada	3.3	3.4	2.4	2.1	2¾
UK	3.1	4.1	3.1	2.4	2½
Major 7	2.7	2.6	2.6	2.4	2½

Percentage change on year earlier	Domestic Demand Contribution 1986	1987	1988	1989
US	4.0	1.9	1.7 ↓	1.6
Japan	3.9	4.2	4.8 ↑	4.3
Germany	3.5	2.4	2.7 ↑	2.9
France	3.7	2.2	2.3	2.5
Italy	3.3	3.7	3.1	3.3
Canada	3.7	3.4	3.6	2.5
UK	4.3	4.5	4.7	3.4
Major 7	3.9	2.8	2.8	2.6

11. Overall real GNP in the major seven is expected to grow at about 2½ per cent a year over the next few years. This is broadly in line with the estimated growth rate of productive potential, which has been revised downwards in the light of recent experience and studies by the OECD and IMF. (More detail of the forecasts for the US, Japan and Europe can be found in the annex). The forecast recovery in export growth in the major seven contributes to a pick up in industrial production. This is normally more cyclical than real GNP, and 1987 and 1988 could see quite rapid growth perhaps averaging 4 per cent; in contrast to 1986 when production rose by less than 1 per cent.

WORLD TRADE

12. World import volumes grew by over 4½ per cent in 1986, with developed countries' imports rising by about 8 per cent. Much of this strong growth was caused by increased demand for oil (reflecting its low price in 1986) and strong domestic demand growth in the major industrial countries. On the other hand, OPEC imports are estimated to have fallen sharply and NODC's imports increased only slightly. Non-oil trade is estimated to have grown by less than 3 per cent, and trade in manufactures by only 2 per cent.

Table 6: World Import Growth

Percentage change on year earlier	1985	1986	1987	1988	1989
Total developed economies*	4½	8	4½	4	3½
of which:					
US	4½	12½	3½	-1	-½
Japan	0	13½	7	11½	8½
EC(6)**	5	6	5	4½	4
OPEC	-11	-20½	-10	0	2½
NODCs	5½	1	3½	5½	6
Total	4½	4½	3½	4	4
World imports of manufactures	4½	2	4	5	5
Main developed countries' exports of manufactures, weighted by UK market share	4	1½	2½	3½	4

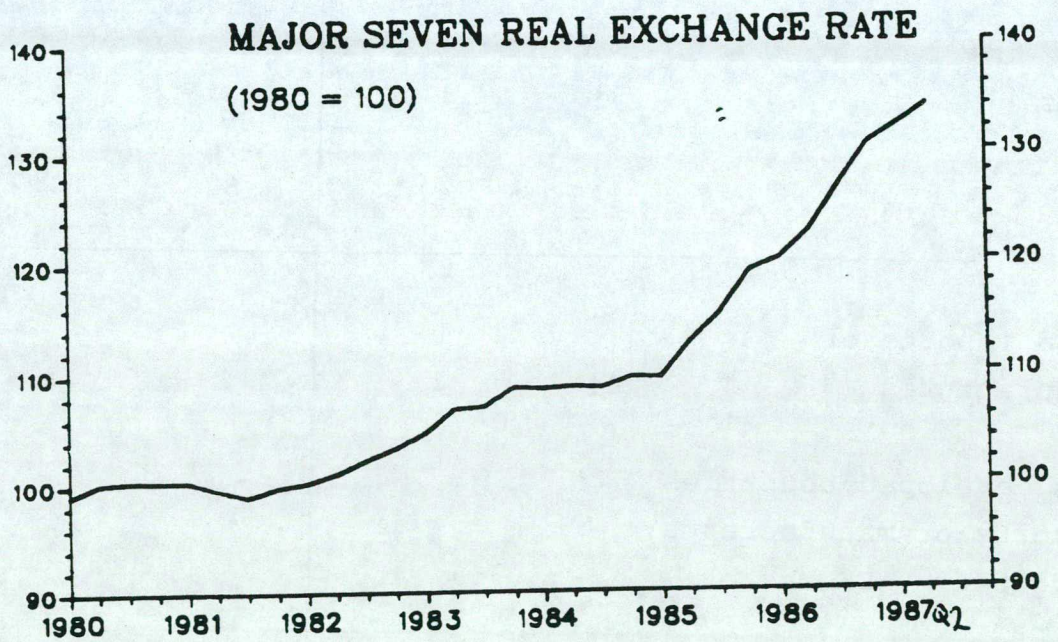
* OECD plus South Africa

** Belgium, France, Germany, Italy, Netherlands and UK.

13. The real exchange rate of the major seven as a group appreciated sharply from the beginning of 1985 because many developing countries depreciated their currencies in line with the dollar. (See Chart 5). This will have contributed to the rapid growth in developing countries' - particularly the NICs' - exports (and in major seven imports) last year and this. The appreciation of the G7 real effective exchange rate index has slowed since the Louvre Accord, but the pressure being put on the Pacific rim NICs to allow their exchange rates to rise to more realistic levels has not yet produced any reversal of the earlier rise in the index.

14. There is already evidence that an end to oil stockbuilding and a slowdown in domestic demand growth in industrial countries (particularly the United States) are producing slower growth in total world trade in 1987 - a rise of about 3½ per cent is expected. However, imports of manufactures should grow faster in 1987 than in 1986 helped by a recovery in NODCs' imports, and less of a cutback in OPEC imports. OPEC countries still account for a greater proportion of UK exports of manufactures than of world trade as a whole, so the continued cutbacks in OPEC imports mean that UK-weighted world trade in manufactures continue to grow more slowly than the total shown in Table 6.

Chart 5 - Major Seven Real Effective Exchange Rate



INFLATION

15. The average 12-month rate of inflation in the major seven countries has risen to 3 per cent as the effect of the oil price fall in 1986 has dropped out and as oil and other commodity prices have recovered. The forecast is for no further pick up in inflation. Earnings growth in many countries has slowed down, thereby reducing domestically-generated inflation and the appreciation of their effective exchange rates will keep import price rises low in Europe and Japan.

Table 7: Prices

	Consumers' Expenditure Deflator			
Percentage change on year earlier	1986	1987	1988	1989
US	2.2	3.8	3.8	3.9
Japan	0.6	0.1	0.7	0.7
Germany	-0.5	0.8	1.3	0.9
France	2.5	3.5	2.3	2.1
Italy	6.2	4.1	5.4	5.9
Canada	4.3	4.3	4.2	4.1
UK	3.6	2.7	4.5	4.3
Major 7	2.1	2.8	3.1	3.0

16. The main inflation risk is in the United States if the dollar falls sharply. Unemployment there has fallen below 6 per cent, around most people's estimates of the NAIRU and there is evidence of labour shortages in more prosperous areas. Higher import prices could be reflected in higher wage settlements. In any case, the differential between inflation in the United States and in Japan and Germany remains wide.

CURRENT BALANCES

17. Table 8 and Chart 6 show the forecast of current account balances. There is some evidence from monthly data that the

surpluses of Japan and Germany are already beginning gradually to decline as changes in trade volumes, shown by the trade ratios in Table 8, begin to offset improvements in terms of trade following the depreciation of the dollar. Our assumption of little further change in exchange rates allows some short-term reductions in imbalances, but - given our assumptions about macroeconomic policies and forecast of relative growth rates of domestic demand - limits adjustment in the long-term. However, as discrepancies produce a world current account deficit of $70 billion, which the IMF have been unable to allocate between countries, the magnitudes of present imbalances must be judged with care.

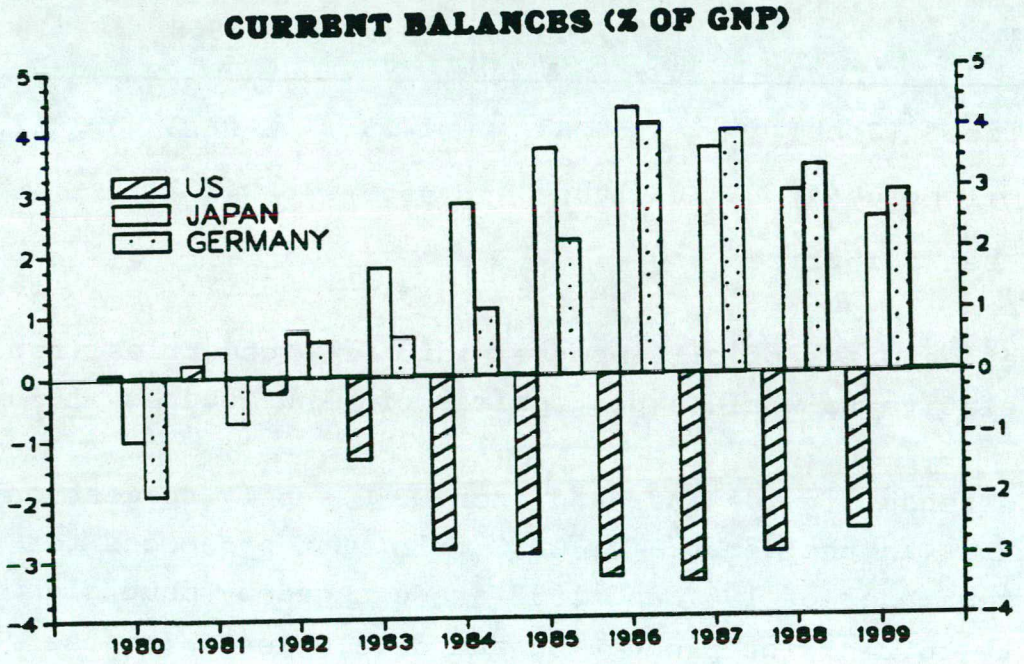
Table 8: External Balances, Trade Ratios and Net External Assets

	1986	1987	1988	1989	1990
Current balance ($bn)					
US	-141	-153	-140	-130	-121
Japan	85	85	77	73	68
Germany	37	44	40	39	37
NODCs	-2	-1	0	0	4
OPEC	-39	-30	-25	-21	-17
World imbalance	-70	-73	-74	-80	-77
Trade balance ($bn)					
US	-144	-153	-137	-125	-116
Japan	82	82	74	69	64
Germany	53	61	60	60	49
Trade ratio (exports/imports, volumes, 1980=100					
US	57	61	68	73	78
Japan	113	103	93	88	84
Germany	111	108	105	103	101
Net external assets ($bn, end of year)					
US	-264	-417	-557	-687	-808
Japan	180	265	342	415	483
Germany	94	138	178	217	254
Net external assets (% of GNP)					
US	-6	-9½	-11½	-13½	-15
Japan	9	11½	13	14½	15
Germany	10½	12½	15	16½	17½

18. Table 8 also shows estimates of the implications of these forecast current account balances for the net asset positions of the three largest economies. These figures are subject to a substantial margin of error - for instance, an attempt by Goldman Sachs, New York to adjust the official Department of Commerce figures to make the valuation of US assets less conservative gives an estimate of net external assets for the US at the end of 1986 of $200 billion, rather than net liabilities of $265 billion. Nonetheless, it is clear that if current account balances develop as expected the net external position of the United States will continue to deteriorate. There is a danger of a dollar "overhang" building up which could reinforce the risk of market impatience with the speed at which current imbalances were being reduced. This could point to much greater dollar weakness and/or higher US interest rates than assumed in the forecast.

19. Large current account imbalances are likely to mean that protectionist pressures remain strong in the US, though the recent recovery in industrial production and exports and continued employment growth should all strengthen the Administration's hand in resisting these pressures. Like its predecessors, this forecast assumes no more than a continuation of the recent trend of creeping protectionism in the world economy.

Chart 6 - Current Account Balances



THE OIL MARKET

20. OPEC have re-established some control over the oil market and Saudi Arabia is again in the position where it can, if it wishes, act as a swing producer. In the first half of 1987, total OPEC output was close to its agreed aggregate production limit - thanks to under production by Saudi Arabia - and oil prices were close to OPEC's target price, with the average OECD import price (fob) just under $17 per barrel. In the summer prices rose to over $20 per barrel for a short time (partly because of fears about an escalation of the Gulf War) before falling back again to around $17 per barrel following reports that several OPEC Members were breaching their production limits, and that Saudi Arabia was not making offsetting cuts in its production.

Table 9: The Oil Market

Millions of barrels per day	1980	1986	1987	1988	1989
Demand					
Consumption in OECD, OPEC and developing countries	49.8	46.9	47.4	48.1	49.0
Stockbuilding	0.6	1.1	0.0	0.3	0.4
Supply					
Non-OPEC	22.8	28.2	28.6	28.5	28.7
OPEC	27.6	19.8	18.8	19.9	20.7
Oil price* ($ pb)	30.3	14.3	17.2	17.5	18.1
Real oil price**	100	45.5	48.2	46.5	45.5
North sea oil price ($pb)	34.7	14.2	17.7	18.0	18.8

* Average price of oil imported into OECD countries (fob).

** (relative to world export prices of manufactures, 1980=100)

21. Trends in demand and non-OPEC supply suggest only modest increases in the demand for OPEC oil. But prospects for prices in the remainder of 1987 and 1988 are clouded by doubts about OPEC's ability to restrict production and developments in the Iran-Iraq

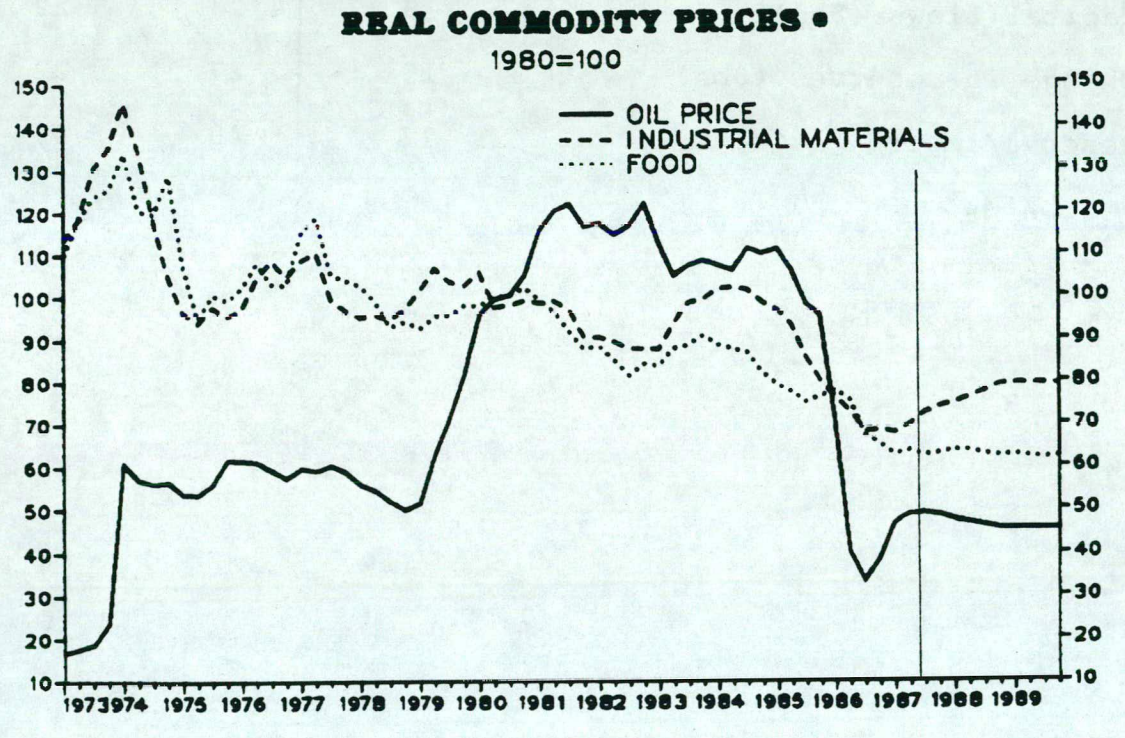
conflict. The forecast attempts to strike a balance by projecting the oil price (of OECD imports) remains around $17½ per barrel until the end of 1988. This is consistent with an average North Sea oil price of about $18 per barrel.

COMMODITY PRICES

22. Non-food commodity prices were driven to unsustainably low levels in 1986 by speculative influences in a general climate of low inflation and falling oil prices. Spot prices of non-food commodities rose sharply in the first seven or eight months of 1987, falling back slightly in recent weeks. Despite this reversal, average prices (in SDRs) are still about 30 per cent higher than a year ago.

23. Some further increases in real non-food commodity prices are possible over the next year or so, especially if industrial production in the major OECD countries grows reasonably strongly. But for most commodities relatively abundant supply points to only a modest rise. The continuing over-supply of many foodstuffs and lack of any real progress in cutting back production point to continued weakness in food prices, which are expected, at best, to level off in real terms.

Chart 7 - Real Commodity Prices



* IN RELATION TO PRICES OF MANUFACTURES

NON-OPEC DEVELOPING COUNTRIES

24. The forecast for non-OPEC developing countries is summarised in Table 10 (further detail is contained in the annex.) NODC exports are expected to continue to grow 1½ - 2 percentage points per year faster than their markets, allowing import growth to pick up and the reserve: import ratio to remain broadly unchanged. Within this overall picture, though, the performance of the NICs is much better than that of the major debtors.

Table 10: NODCs Current Account

	1985	1986	1987	1988	1989
Export markets growth (%)	3½	6	4	4½	4½
Export volume growth (%)	3½	7½	6	6	6
Import volume growth (%)	5½	1	3½	5½	6
Terms of trade (% change)	-1½	-1	-2	½	0
Current account ($bn)	-23	-2	-1	0	0
of which:					
Trade*	-2	13	18	25	27
Invisibles	-21	-15	-19	-25	-28
Capital flows ($bn)	22	18	23	22	22
Change in reserves ($bn)	2	15	27	22	21
Reserve/import ratio (%)	32	37	40	40	40

* fob/fob

ANNEX

1. This annex discusses the forecasts for each of the major countries, and for the NODCs, in greater detail.

United States

2. The Federal deficit is expected to have totalled around $160 billion in FY1987, which ended on 30 September. This is some $60 billion less than in FY1987, reflecting some genuine expenditure reductions but also one-off gains from tax reform measures and other one-off savings. The reduction in the underlying deficit is about half the total reduction. The Congressional Budget Office expect the deficit to rise over $180 billion in FY1988 and $190 billion in FY1989, on the basis of current services - partly because the tax reform is expected to be revenue-losing in these years. The OMB estimates are somewhat lower, largely because they take much more optimistic growth and interest rate assumptions.

Table A1: Federal deficit projections ($ billion)

Fiscal year	1987	1988	1989	1990
CBO Baseline deficit	157	183	192	176
OMB Current services deficit	159	161	166	147
WEP forecast deficit	160	170	170	170

The revamped Gramm-Rudman proposals set a fairly modest deficit reduction target of $23 billion from the so-called Gradison baseline (a special definition used in the GRH legislation) in FY1988. Measures to produce this reduction have to be agreed by 10 October or automatic expenditure cuts will be implemented. Some expenditure savings or tax increases are therefore expected, though it remains uncertain whether these will be agreed by the Administration and Congress or implemented automatically. The WEP assumes Federal deficits of $170 billion in both FY1988 and FY1989. For FY1988 this implies some slippage from the deficit of $160 billion that would be implied by a cut of $23 billion from the CBO baseline, because the WEP is less optimistic than the CBO about growth and interest rates.

3. Monetary policy is likely to be dominated by political considerations, but downward pressure on the dollar's exchange rate could lead to upward pressure on interest rates. Domestic considerations, including continuing large Federal deficits also point to higher rather than lower interest rates. The WEP, therefore, assumes a 1 percentage point rise by the end of 1988.

4. After growing at an annual rate of 4.4 per cent in the first quarter, real GNP grew by 2.3 per cent in 1987Q2. As expected stockbuilding fell back from the very high level seen in the first quarter and other forms of private domestic demand recovered following real falls in Q1. Private consumption, having grown at over 4 per cent annually since 1983, has only increased by 2¼ per cent over the last year, reflecting a slowdown in real disposable income growth. The personal saving ratio is still at historically low levels. Housing investment has been broadly unchanged over the last year, but the second quarter did see the first real increase in business investment since 1985Q4.

5. The prospects for the remainder of 1987 and 1988 are that domestic demand growth could slow a little further. Some pick up in earnings growth in response to higher inflation seems probable but RPDI is unlikely to accelerate much. On the other hand some recovery in the saving ratio is likely if, as we expect, inflation remains around 4 per cent and interest rates rise. Consumers' expenditure growth is, therefore, expected to continue to slow, though only gradually. Higher interest rates will also tend to depress housing investment - housing starts have been falling during 1987 - and business investment, though the latter could be boosted by a better net export performance. Finally, it is generally believed that car manufacturers in the US are only maintaining high stock levels until current wage contract negotiations are complete. If agreement is reached without a strike, the subsequent rundown of stocks is likely to prove a drag on domestic demand.

6. In 1987 the external sector is expected to make a positive contribution to growth for the first time since 1980. Export volumes began to grow strongly at the end of 1986 and have not slowed in 1987. Moderate growth of domestic expenditure and the

impact of the lower dollar have slowed import growth, though there was a surge in the second quarter, thought to be associated with high oil imports.

7. Overall we expect the external sector to contribute 0.6 per cent to GNP growth in 1987, rising to 0.8 per cent in 1988. However, this is offset by the slowdown in domestic demand and GNP growth is put at 2.5 per cent in both years.

8. Annual consumer price inflation has risen to 4.2 per cent, as the benefits from the fall in oil prices have dropped out, and exporters to the US have increased their dollar prices to reflect the dollar's depreciation. There is, however, little sign of an acceleration of domestic wage costs. But, with unemployment having fallen to close to most people's estimates of the NAIRU there is a fear that further increases in inflation via import prices could lead to higher wage increases.

Japan

9. Growth of real GNP, which since half-way through 1985 had been extremely slow by Japanese standards, seems to have quickened a little this year. Real GNP in the second quarter was 2.8 per cent up on a year earlier, while total domestic demand rose by 3.7 per cent. Industrial production was flat in the first five months of the year, but picked up sharply in June and July, while the trade surplus has declined reflecting, among other factors, an 8 per cent drop in export volumes between January and June. These developments seem to confirm that Japan is adjusting to growth led by domestic demand, albeit only gradually.

10. Domestic demand growth could reach over 4½ per cent in 1988. Consumers' expenditure might grow a little faster this year than in 1986 (2.7 per cent) but real personal disposable income growth has slowed sharply, so consumption growth in excess of 3½ per cent seems unlikely. A greater boost to growth should come from government and housing investment, reflecting the direct and indirect effects of the latest government economic package. The outlook for business investment looks less promising - all recent surveys point to very little growth.

11. Overall, with the external sector reducing growth by about 1 percentage point in 1987 and 1988, we expect GNP growth of 3 per cent this year and 3½ per cent next year. The latter, if achieved, would be broadly in line with productive potential growth.

12. Earnings in Japan have adjusted quickly to lower inflation. Initially the growth of bonus payments was cut sharply, and more recently pay settlements have moderated. This suggests that price inflation could remain at or under 1 per cent.

Germany

13. German growth continued to be sluggish in the second quarter. The main measure of GNP increased by 1 per cent, after falling in Q1, but this only left real GNP at the same level as in the third quarter of 1986. Of the components, in 1987Q2 investment and public consumption were especially weak whilst net exports declined slightly despite what were probably erratically strong gross exports. Falling industrial production figures and poor order book survey data corroborate the general assessment of weakness in economic activity.

14. The forecast assumes no change in announced German policy. Growth is forecast to pick up slightly from 1.5 per cent in 1987 to 2.2 per cent in 1988 led by consumption and business investment. The savings ratio has been assumed to fall in 1988 as real income gains of workers from the unanticipated fall in inflation become incorporated into permanent income by subsequent wage rounds. Investment is assumed to recover as the company sector finally turns into investment the profits from their share of the terms of trade improvement and the oil price gains. It must be admitted that neither of these trends is evident yet in the data. On the external side we see some improvement in the constant price trade balance, but less on the current price balance owing to J-curve effects.

15. On inflation we see some modest increase in 1988 owing to the passing through of recent wage settlements. In the later years consumer price inflation returns to a stable rate just under 1 per

cent per annum. We have assumed that the reduction of the working week in industry pressed for by the trades unions will follow the formula established by the major settlements up to now, resulting in reduced hours without loss of weekly earnings. This implicit increase in hourly rates has been treated as such in the forecast and passes into unit labour costs and hence into prices.

France

16. The behaviour of the French economy has provided us with something of a paradox: industrial production is still growing whilst on the expenditure side the only counterpart is increased stockbuilding. We had thought that the stockbuilding component might have included errors and omissions and that its strength may thus have reflected under-recording of other components of expenditure, however, the French themselves say that this is unlikely. The reported second quarter GDP expenditure figures were disappointing with consumption actually falling from its first quarter level and other components being weak.

17. The forecast sees growth picking up only slowly from 1.4 per cent in 1987 to 1.9 per cent in 1988 with no catching up of lost productive potential in the later years of the forecast. French monetary and fiscal policy is assumed to remain tight, partially constrained by sluggish growth in West Germany. The fiscal squeeze on personal disposable income, owing to the increases in social security contributions and the bias in tax reform towards the corporate sector results in slow consumption growth in 1987 and 1988. Business investment however is seen as recovering strongly owing to the tax reforms. The trade balance both current and constant priced deteriorates in the later years of the forecast.

18. Consumer price inflation has moderated in the later half of this year and the 1988 forecast is for 2.3 per cent against 3.5 per cent in 1987. Gross earnings in industry are not seen as likely to accelerate despite the household fiscal squeeze.

Non-OPEC Developing Countries

19. Aggregate NODC exports were strong in 1986 while imports almost stagnated. This general picture, however, conceals considerable divergence between different countries and regions as is illustrated in Table A1.

Table A1 Growth in NODC Trade Values ($) 1985-86

% change	Exports	Imports
Asian NICs[1]	+ 16.2	+ 8.2
China	+ 1.1	+ 1.5
Rest of Asia	- 0.8	- 2.0
Latin America[2]	- 14.0	- 3.1
Africa[3]	- 2.4	+ 8.7

[1] comprises Taiwan, South Korea, Hong Kong, and Singapore

[2] excluding Venezuela and Ecuador

[3] excluding Nigeria and South Africa. Figures given are those implicit in IMF WEO projection for Africa as a whole, owing to poor coverage of data.

Source: IFS Yearbook 1987 and Taiwan Yellow Book

20. The largest component of the export growth is attributable to the Asian NICs (except Singapore) who benefitted from their exchange rates depreciating with the dollar. Import growth has not been as fast, leading to the accumulation of large surpluses. Taiwan has used these to add to its reserves, while South Korea has started to repay debt. Elsewhere growth has been poor, with Latin America particularly badly hit. Both Brazil and Mexico have seen substantial reductions in their export values. Aggregate non-NIC imports stagnated or fell in 1986.

Table A2: NODCs Current Account

	1985	1986	1987	1988	1989
Export markets growth (%)	3½	6	4	4½	4½
Export volume growth (%)	3½	7½	6	6	6
Import volume growth (%)	5½	1	3½	5½	6
Terms of trade (% change)	- 1½	- 1	- 2	½	0
Trade Balance ($bn)[1]	- 2	13	18	25	27
Invisibles ($bn)	-21	-15	-19	-25	-28
Current Account ($bn)	-23	- 2	- 1	0	0
Capital flows ($bn)[2]	22	18	23	22	22
Change in reserves ($bn)	2	15	27	22	21
Reserve/import ratio (%)	32	37	40	40	40

[1] fob/fob

[2] defined as 'Capital Account' plus 'IMF Credit' plus 'exceptional financing' components in the Capital Account.

21. The forecast figures appear in table A2. Rapid growth in NIC's export volumes is likely to have continued into 1987. Latin American and African export volumes are forecast to have continued to be much less buoyant. Overall export volumes are seen as growing at 6%, some 2% ahead of markets. Owing to the low likelihood of immediate increases in absorption by the NICs and the continued financial constraints on other NODCs, import volumes in 1987 are seen as growing more slowly than exports, but somewhat faster than in 1986. After a further fall in early 1987 the terms of trade are forecast to stabilise.

22. For the later years, export volumes are seen as increasing at some 1½% ahead of markets as NIC exports moderate and other NODC exports begin to grow more quickly. Import volume growth picks up in line with exports, reflecting increased NIC absorption and the continuing availability of capital flows to other NODCs.

23. Table A3 provides a detailed breakdown of NODC current and capital account forecasts. The current balance is forecast to improve slightly, the improving trade balance being offset by a worsening balance of invisibles partially reflecting higher world interest rates.

Table A3: NODCs Current and Capital Accounts

$ billion	1985	1986	1987	1988	1989
Trade Balance	-2	13	18	25	27
Invisibles Balance	-21	-15	-19	-25	-28
Current Balance	-23	-2	-1	0	0
ODA	12	12	13	14	15
Other Official Lending[1]	9	8	9	10	11
Direct Investment	10	10	11	12	13
Bank Borrowing (net)	11	1	6	7	6
Bond Borrowing	7	4	4	5	5
Other Capital Flows	-31	-36	-36	-35	-36
Capital Account	-1	0	13	13	12
IMF Credit	1	-2	-3	-2	-1
Exceptional Financing[2]	22	20	18	11	10
Change in Reserves	2	15	28	22	21

Footnotes:

1 IBRD lending 5 4 5 6 6

2 Exceptional Financing includes payment arrears and reschedulings of official loans.

24. The divergent experiences of NODCs are also reflected in the capital account. For the poorer countries the forecast embodies some increases in ODA. World Bank lending expands as planned. After zero net lending by banks in 1986, bank credit is forecast to increase, with new money for Mexico, Argentina and Columbia in 1987 outweighing the $3½ billion repaid by S.

Korea and others. New money is assumed to be lent to Brazil in 1988, while S. Korea is assumed to continue to repay loans, perhaps as much again as in 1987. On official financing, exceptional financing is expected to be reduced in 1988 as a settlement with Brazil is reached. The substantial increase in the reserve figures is largely due to further increases in the Asian NICs reserves. These forecast reserve increases are fairly conservative given recent experience.

25. Table A4 shows the NODC debt indicators resulting from our forecasts. The aggregate figures show the indicators improving steadily but once again the overall figures conceal a far from comfortable position in a number of countries.

Table A4: NODC Debt Indicators

	1985	1986	1987	1988	1989
Growth in Gross Debt Stock (% change)					
Nominal	10½	1½	3½	4½	4½
Real	15	2	-6	-2	-2
Gross Debt/Export Ratio	1.7	1.7	1.5	1.4	1.3
Net Debt/Export Ratio	1.3	1.2	1.0	.9	.9
Gross Interest Service Ratio	.15	.13	.11	.11	.11
Net Interest Service Ratio	.10	.08	.07	.07	.06

SECRET

COPY No. 31

FROM: A BOTTRILL

DATE: 12 October 1987

ECONOMIC SECRETARY

cc: Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Sir Geoffrey Littler
Mr Cassell
Mr Monck
Mrs Lomax
Mr Odling-Smee
Mr Sedgwick
Mr Peretz
Mr Scholar
Mr Mowl
Mr S Davies
Mr Grice
Mr C W Kelly
Miss Noble
Mr Ilett
Mr Westaway
Mr Owen
Mr Courtney
Mr Pike
Mr Allum
Mr Lyon
Mr Dhar

FINANCIAL FORECAST

The attached note on the Autumn Financial Forecast complements that on the Treasury Economic Forecast circulated by Mr Sedgwick on 8 October. The forecast examines the prospects to the end of the financial year 1989-90.

A BOTTRILL

fcsts

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ASSUMPTIONS AND SUMMARY

The main policy assumptions underlying the forecast are:

- Interest rates are varied to achieve a stable sterling exchange rate index of 72½.
- The PSBR is fully funded each year by the non-bank private sector and the overseas sector.
- National Savings raise £2 billion this year and £1 billion a year in 1988-89 and 1989-90.
- Building societies' wholesale funding limit is unchanged.

Table 1: Summary of the forecast
(per cent change on previous year)

	3-month interest rate	Sterling index 1975=100	M0	M3	M4	Bank + B.Soc lending	Money GDP
1986-87	10.5	71.5	4.3	19.0	14.9	18.6	6.6
1987-88	10.1	72.6	5.1	20.4	14.9	17.8	8.9
1988-89	11.0	72.5	4.4	16.2	13.8	16.2	8.5
1989-90	11.0	72.5	3.4	13.0	12.7	15.7	7.8

2. The policy implications of maintaining a stable sterling effective exchange rate are complicated by the outlook for the US dollar. Against a background where the dollar is projected to fall further, the pound - along with the yen and the main continental European currencies - might face upward pressure. But we have given weight to the fact that the worsening UK current balance is likely to raise expectations of a sterling depreciation putting downward pressure on the pound. Money GDP is also growing faster than the MTFS objective. Both external and domestic circumstances, therefore, point to the need for higher interest rates to sustain the pound and restrain money GDP growth. The forecast includes a further 1 per cent rise in interest rates by early-1988 although this still leaves money GDP growth well above its target range.

3. Other monetary indicators also offer buoyant signals. M0 is rising rapidly and is forecast to breach its ceiling early in 1988 although higher interest rates and slower consumer spending growth should help keep it within its MTFS target range in the later part of the forecast. M3 which has also risen rapidly, may grow less quickly next year as companies' and financial institutions' deposits rise more slowly. This will tend to bring it more into line with M4. Lending to the private sector by banks and building societies, however, is forecast to slow only gradually, financed at least partly by both sterling and foreign currency external borrowing.

4. Particular issues in the forecast include:

- the readiness of the overseas sector to finance a growing UK current deficit at the projected interest rates

- the extent to which declining public sector borrowing needs will be offset by increased private sector borrowing and the net effect on real interest rates

- the extent to which the non-financial private sector will turn to liquid assets in the form of bank and building society deposits against a background where equity returns are likely to be less attractive than recently

- the balance that companies will strike between issuing securities and turning again to banks for their financing needs

- the effect on financial institutions' portfolios of the Government becoming a heavy net purchaser of gilts

- the increasing constraint placed on building societies by the limits on their access to wholesale funding.

THE EXCHANGE RATE AND INTEREST RATES

5. The sterling index which showed some weakness in the summer, has been generally firmer since the rise in UK interest rates in early-August. Sterling's latest firmness has occurred despite the poor August trade figures and has coincided with some renewed downward pressure on the dollar exchange rate and increases in US interest rates.

Table 2: Exchange rate and competitiveness

	Dollar effective rate 1975=100	Sterling effective rate 1975=100	£/$	£/DM	Relative unit labour costs (1980=100)
1986 Q4	110.5	68.2	1.43	2.87	71.5
1987 Q1	104.5	69.9	1.54	2.83	72.1
Q2	101.0	72.8	1.65	1.97	75.7
Q3	102.6	72.7	1.62	2.97	75.4
Q4	101.6	72.5	1.62	2.95	76.1
1988 Q4	96.8	72.5	1.70	2.89	76.8
1989 Q4	93.4	72.5	1.75	2.82	76.6

6. The dollar is assumed to depreciate by 4-5 per cent a year in effective terms in the next two years. US interest rates are assumed to rise further during 1988 and, with other countries' rates unchanged, the average world rate edges upwards.

Chart 1: The dollar and world interest rates

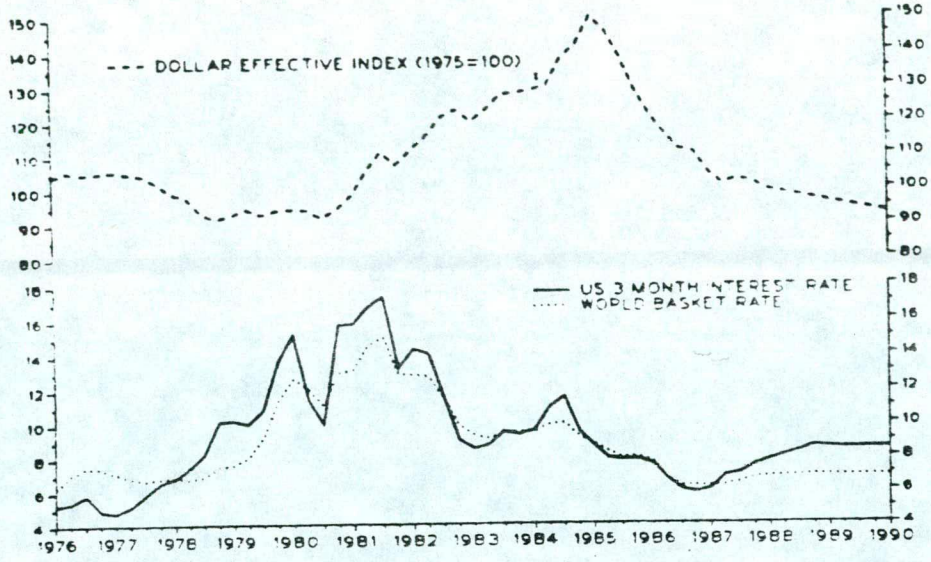
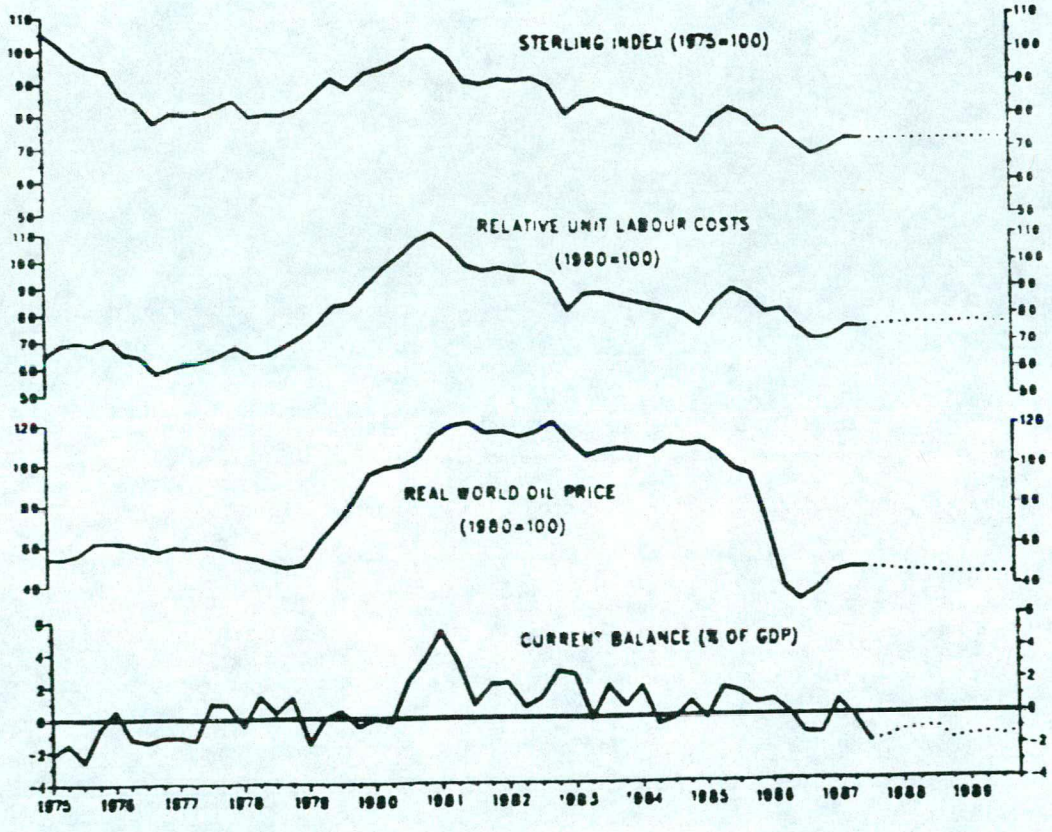
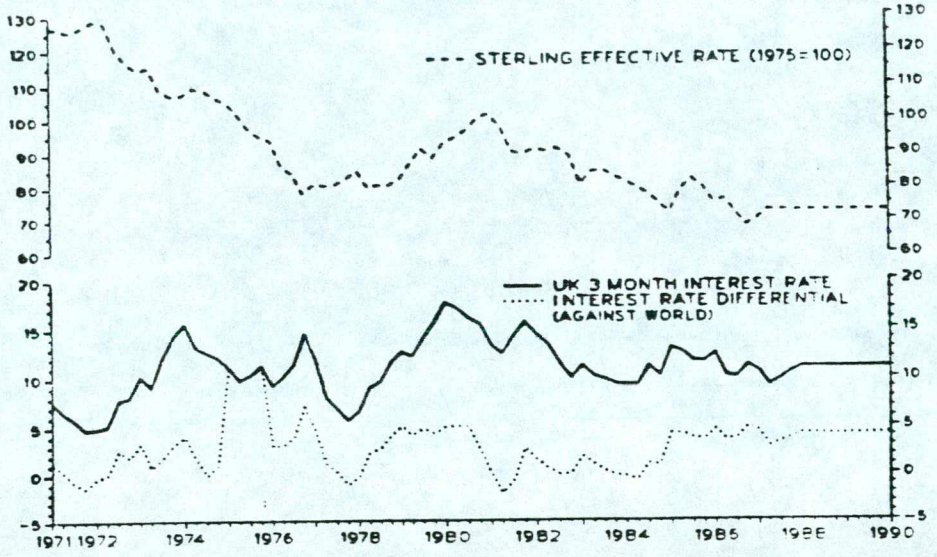


Chart 2: Influences on sterling



Against this background external pressures for sterling appreciation and lower UK interest rates might seem likely - other things equal. The forecast however, points to a further deterioration in the UK current account over the next two years. The forecast also shows a decline in the world real oil price next year which is not helpful to sterling. If this picture is correct there may well be a renewed exchange rate weakness and we have assumed that, in order to achieve the policy assumption of holding the sterling index constant at around 72½, short-term interest rates will need to rise to 11 per cent by the early part of next year. In addition we have assumed that £1 billion of the recent intervention is unwound before the end of the current financial year with a further £1 billion in 1988-89.

Chart 3: The pound and relative interest rates



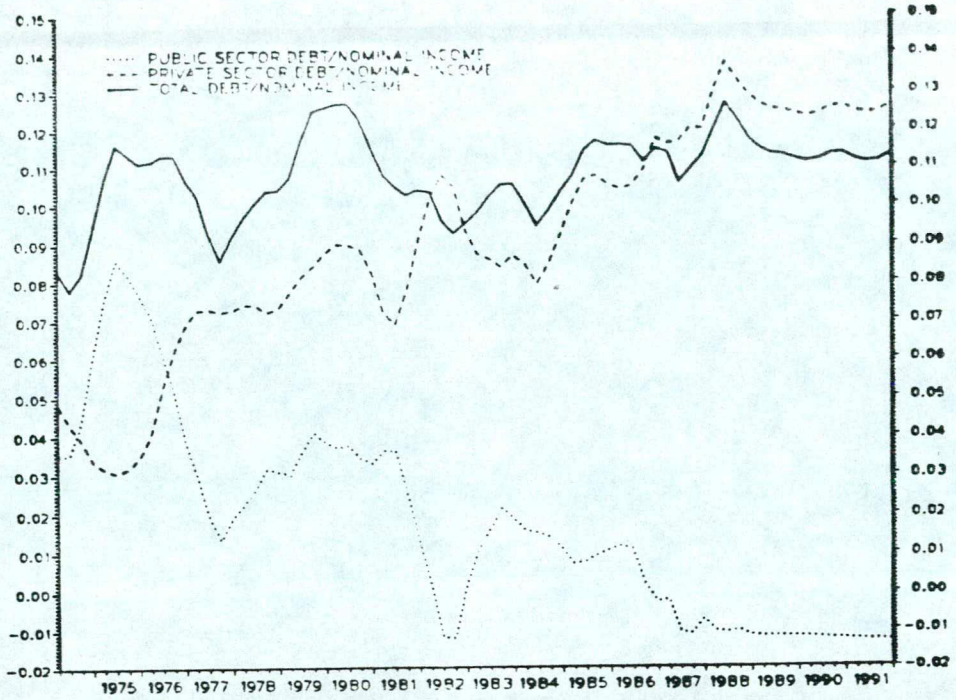
8. The assumption of a constant nominal exchange rate through the entire forecast period implies a steadily widening gap between the rate and the 'equilibrium' rate required to return the current account to balance. It is likely that a widening interest rate differential against the world would be required to sustain such a gap. The forecast rise of 1 percentage point in UK short rates returns the interest rate differential against the world basket to around 4 per cent from its present level of 3 per cent.

Table 3: Foreign and domestic interest rates

	3-month Eurodollar rate	G6 countries' average	UK 3-month LIBOR	Differential vis a vis G6 average	Memo 20-year gilts
1986-87	6.4	6.3	10.5	4.2	9.7
1987-88	7.5	6.6	10.1	3.5	10.1
1988-89	8.6	6.9	11.0	4.1	11.0
1989-90	8.7	6.9	11.0	4.2	11.0

The present flat yield curve is projected to persist. The prospect of significant net gilt purchases by the Government might be expected to put downward pressure on long rates but privatisation issues and heavy borrowing by the private sector, particularly companies, are forecast to offset this. Total borrowing relative to GDP remains at a high level. Rising domestic inflation and weakness in international bond markets may also affect sentiment adversely. In these circumstances we have assumed merely that UK long rates do not rise to restore a positive yield curve but remain broadly similar to short rates.

Chart 4: Public and private borrowing



10. Money GDP in the current financial year now seems likely to rise more rapidly than foreseen in the FSBR mainly because real growth is about 1 percentage point higher. The projected rise in interest rates should help to reduce money GDP growth in 1988-89 and 1989-90 but it still seems likely to exceed the MTFS path mainly as a result of higher inflation.

Table 4: Money GDP in the MTFS and forecast
(per cent changes on previous year)

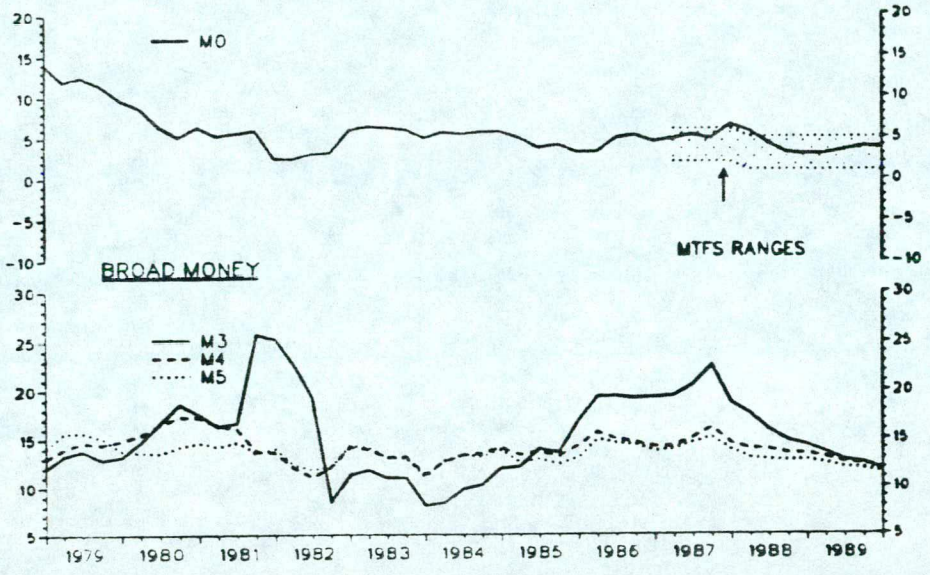
	GDP deflator		Real GDP		Money GDP	
	MTFS	Forecast	MTFS	Forecast	MTFS	Forecast
1986-87	3	3.0	3	3.5	6	6.6
1987-88	4½	4.6	3	4.1	7½	8.9
1988-89	4	5.4	2¾	2.9	6½	8.5
1989-90	3½	5.2	2¾	2.4	6	7.8

MONETARY AGGREGATES

Table 5: Monetary Aggregates
(per cent change over previous year)

	M0		NIBM1	M3	M4	M5
	MTFS Range	Outturn/ Forecast				
1986-87		4.3	11.0	19.0	14.9	14.3
1987-88	2-6	5.1	14.4	20.4	14.9	14.4
1988-89	1-5	4.4	2.7	16.2	13.8	13.0
1989-90	1-5	3.4	1.2	12.7	12.7	12.1

Chart 5: Monetary Aggregates (% change on year earlier)



Narrow money

11. In recent months, M0 has been rising rapidly in response to buoyant consumer spending and the fall in interest rates earlier in the year. In the three months to September, holdings of notes and coin have risen at an annualised rate of 8 per cent although the year on year figures for M0 growth have remained close to 5 per cent. This is in the upper part of the 1987-88 target range and despite some slowing down in the monthly growth rate, it is expected to breach its ceiling in the early months of 1988. Moreover, if the 1988-89 target range for M0 remains as published in the 1987 MTFS, then M0 will still be above its new lower ceiling of 5 per cent in the second quarter of 1988. The lagged effects of the recent rise in interest rates together with the further rise projected in the forecast and the slowdown in real consumer spending and later in consumer prices should bring M0 back within its target range by the middle of 1988.

12. NIBM1 growth is currently unusually high at 13½ per cent a year. Deposits have increased as a result of earlier interest rate cuts and oversubscriptions to capital issues and privatisations and are also possibly being held in anticipation of future issues, notably BP. Year on year growth is forecast to peak above 20 per cent later this year before falling sharply as privatisation effects unwind and the effect of higher interest rates coupled with increased use of interest-bearing current accounts attracts money away from idle balances. Unlike M0 which is a useful contemporaneous indicator, NIBM1 continues to give a noisy message which is difficult to interpret.

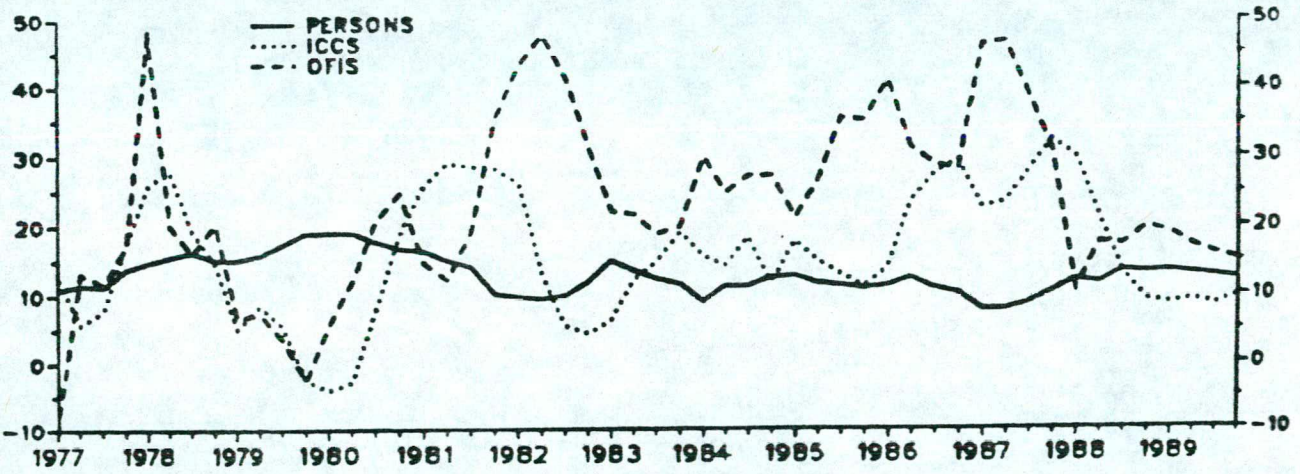
Broad money

13. Growth of the broader aggregate, M4, which includes private sector sterling deposits in both banks and building societies, is forecast to rise from its current level of 15 per cent a year to above 16 per cent a year by the beginning of next year before falling steadily to 12 per cent by the end of 1989-90. This reflects a fall in the growth of companies' and financial institutions' bank deposits. These form a larger proportion of M3 than of M4, and so the gap between M3 and M4 growth closes by 1990.

Table 6: Broad money by sector
(Per cent change on year earlier)

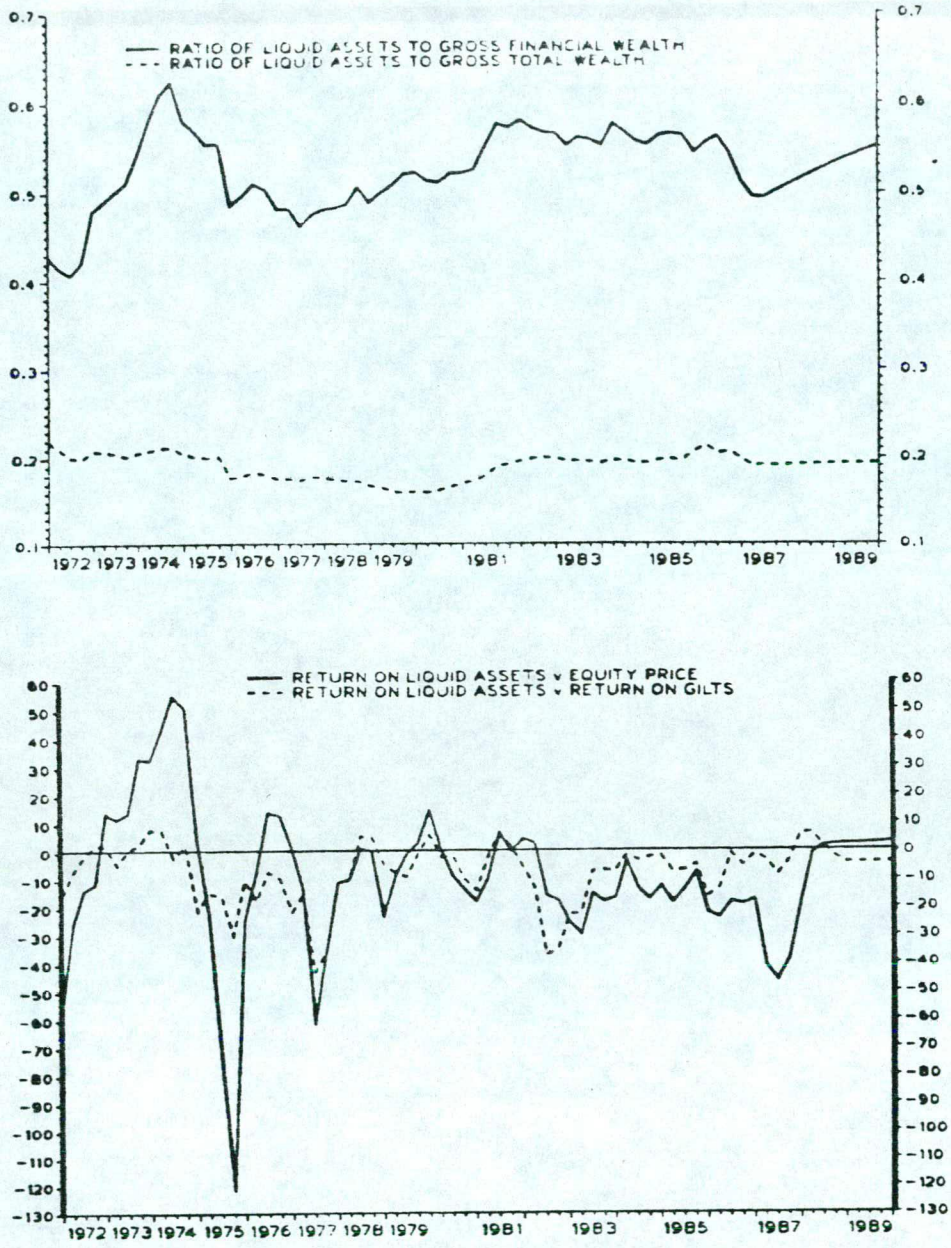
	M3 Persons	ICCs	B-Socs	Other OFIs	M3 Total	M4 Total
1986-87	11.8	24.6	56.2	25.3	19.0	
1987-88	11.3	27.4	47.6	31.0	20.4	14.9
1988-89	16.0	15.7	29.4	11.2	16.2	13.8
1989-90	13.5	9.1	24.6	11.2	13.0	12.7

Chart 6: Growth rates of M4 by sector



4. Personal sector liquid assets, which are defined to include bank deposits, building society deposits and national savings, are currently growing at 11 per cent and are expected to increase by more than 12 per cent in 1988-89 as personal disposable income rises strongly and some of the recent capital gains on equities are converted to liquid assets. Thereafter liquid assets grow faster than total financial assets as relative rates of return encourage a move from illiquid to liquid holdings. See Chart 7.

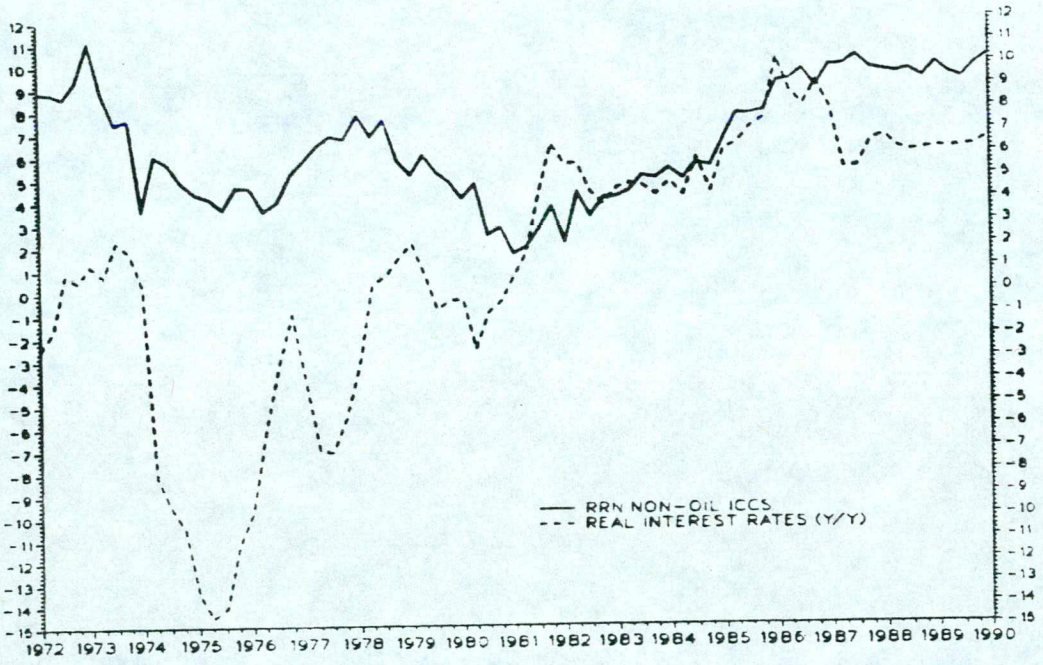
Chart 7: Household liquid asset ratio and relative rates of return



15. Within personal sector liquid assets, both bank and building society deposits gain share at the expense of National Savings, which by assumption attract considerably less funds than in recent years. In the short term, building societies are expected to lose more deposits than banks in the face of the BP issue. Banks are also assumed to gain competitiveness as they provide more high interest cheque accounts. In the medium term, however, building societies are assumed to gain non-price competitiveness with increased provision of 'banking' facilities.

16. The growth of industrial and commercial companies' banks deposits is forecast to fall sharply as growth of their total liquid assets slows. The slowdown in growth of ICCs' liquid assets is mainly explained by the resumption of company investment in real assets which, in contrast with recent years, is now expected to be more profitable relative to the return on liquid assets; see Chart 8.

Chart 8: Relative rates of return on ICCs' real investment and liquid assets



17. Growth of building societies' bank deposits is forecast to slow, but they continue to rise by 20-30 per cent a year as they run down the share of gilts in their liquid assets which grow in line with their balance sheets.

18. In the immediate future, growth of other financial institutions' bank deposits is expected to fall from above 40 per cent to below 10 per cent by the first quarter of next year. This reflects the glut of capital issues and privatisations in the second half of this year which reduces liquidity of institutions, particularly life assurance and pension funds'. Institutions' bank deposits are forecast to continue to grow only slowly as lower net inflows and sluggish equity prices cause their wealth to grow more slowly. The

effect of this on their bank deposit growth is offset only partly by the drastic curtailment of new gilt sales which limits one of the more normal uses of their funds.

Table 7: Counterparts analysis of broad money

£ billion	1985-86	1986-87	1987-88	1988-89	1989-90
Overfunding (-)	0.4	0.4	-0.4	0	0
£ bank lending to nbps	21.1	30.6	39.8	36.9	35.3
Banking external	0.5	0.8	-4.3	-3.9	-4.1
Increase (-) in net sterling non-deposit liabilities	-2.0	-4.6	-4.6	-5.7	-5.5
Change in M3	25.9	30.1	27.3	25.7	24.0
Memo items:					
Lending to non bank non building society private sector	35.2	48.0	54.2	54.8	55.9
Change in M4	29.7	33.6	39.3	41.6	42.0

19. We assume that the PSBR is fully funded on the M3 definition and the £0.4 billion underfund of 1986-87 is unwound this year. Credit to the private sector continues to rise rapidly but the need for external finance implies that the banking external is contractionary by approximately £4 billion a year. In addition, net non-deposit liabilities grow as banks increase capital issues to provide against their exposure to third world debtors. These contractionary net externals and non-deposit liabilities offset credit growth which is higher than that of both M3 and M4.

Table 8: Sterling lending by banks and building societies to private sector

	Bank + B.Soc lending		Bank lending		Bank lending by Sector Persons		% growth	
	£bn	% growth	£bn	% growth	House purchase	Other	ICCs	OFIs
1985-86	35.2	17.7	20.8	17.6	20.7	16.3	13.1	29.5
1986-87	48.0	18.5	31.2	19.2	24.1	13.4	11.1	43.4
1987-88	54.2	18.9	40.3	22.3	29.0	18.2	13.3	40.2
1988-89	54.8	17.2	36.9	20.0	22.4	18.9	14.3	28.0
1989-90	55.9	14.8	35.3	15.3	15.3	13.8	11.2	22.0

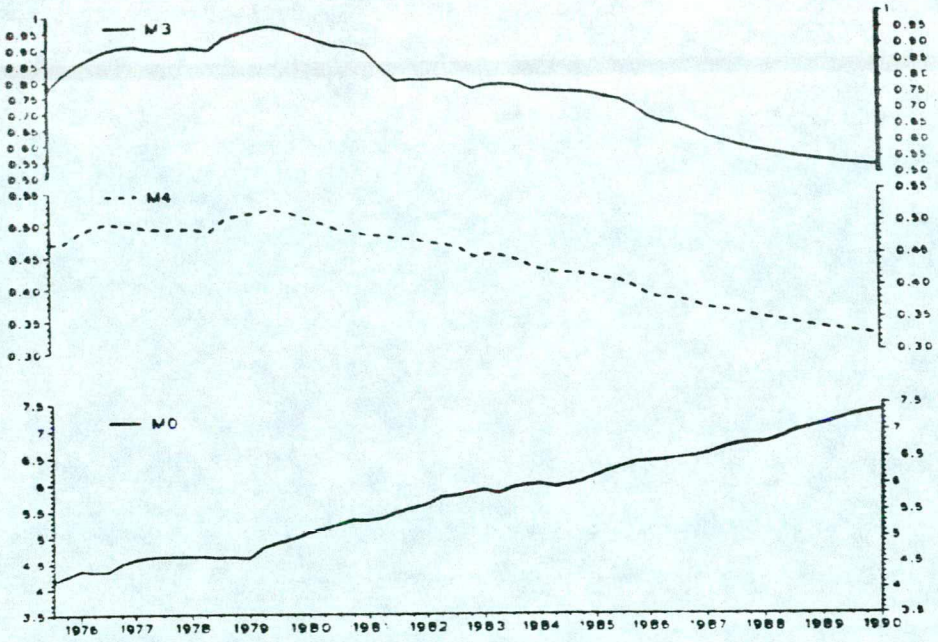
Velocity trends

20. The velocity of M0 rises relative to GDP over the forecast period reflecting higher interest rates and the continuing effects of financial innovation. The velocity of the broad aggregates is forecast to continue to fall - albeit at a slower pace than in the recent past.

Table 9: Income (GDP) velocity of money
(per cent changes on previous year

	M0	M3	M4
1986-87	2.3	-10.4	-7.2
1987-88	3.6	-9.5	-5.3
1988-89	3.9	-6.6	-4.7
1989-90	4.3	-4.6	-4.3

Chart 9: Monetary aggregates' velocity



FUNDING AND MONEY MARKET ASSISTANCE

21. In the current financial year, the negative PSBR of £1 billion still implies net gilt sales of £3½ billion to the private and overseas sectors to help offset the £3¾ billion of intervention which is assumed to occur by the end of the year and the £2¼ billion repayment of debt by local authorities. Most of these gilts have been bought by the overseas sector. In 1988-89 and 1989-90 the PSBR is expected to be much lower than previously foreseen at -£5 billion a year. Net Govenment purchases of gilts of £6 billion a year are required. This is assumed to be entirely from the domestic private sector. Gross gilt sales are forecast to fall from £9½ billion in the current financial year to £1¼ billion by 1989-90 despite the prospective large redemptions in the later years.

Table 10: PSBR and overfunding (£ billion)

	PSBR	Gilt sales to NBPS	National Savings	Other debt sales to NBPS	Overseas finance excl. reserves	Reserves	Wide over-funding
1986-87	2.1	1.5	3.4	-3.4	5.3	-3.8	-0.4
1987-88	-0.9	-0.2	2.0	-3.0	4.3	-3.7	0.4
1988-89	-5.0	-6.9	1.0	0.4	2.4	1.0	0.0
1989-90	-5.4	-6.5	1.0	0.4	0.5	0.0	0.0

Table 11: Sectoral gilt purchases (£ billion)

	Net sales							
	Persons	ICCs	OFIs*	Monetary Sector+	Over-seas	Total	Redemp-tions+	Gross sales
1984-85	3.7	-0.2	5.9	0.4	1.3	11.0	4.2	15.2
1985-86	0.4	-0.5	2.9	0.1	2.3	5.2	6.5	11.7
1986-87	2.4	-0.2	-0.7	1.4	2.8	5.8	8.8	14.6
1987-88	0.3	-0.4	0.0	-0.9	3.8	2.6	7.0	9.6
1988-89	-0.7	0.0	-6.2	0.0	0.0	-6.9	10.3	3.4
1989-90	-0.8	0.0	-5.7	0.0	0.0	-6.5	7.8	1.3

22. Money market influences are forecast to reduce the bill mountain. The stock of money market assistance outstanding falls from its current level of £6 billion to £7¼ billion by the end of this financial year and £3½ billion by the end of 1989-90. Under a regime of full funding and with zero net gilt purchases by banks, the contractionary effect of money market influences is explained by repayments of debt by local authorities to banks which is only partly offset by the growth of notes and coin.

Table 12: Money market influences and operations (£ billion)

	CGBR	Gilt sales (excl. REPOs)	CTDs & National Savings	Overseas and other finance	Money market influences
1985-86	11.0	-5.2	-2.3	0.3	3.7
1986-87	10.5	-5.8	-2.4	2.1	4.4
1987-88	3.3	-2.6	-1.3	4.1	3.5
1988-89	-2.3	6.9	-1.0	-1.4	2.3
1989-90	-3.0	6.5	-1.0	-0.4	2.0

	ID and BD commercial bills	REPOs /Other	Money market operations*	Changes in bankers' balances	Total assistance outstanding**
1985-86	-2.0	-1.7	-3.7	0.0	16.9 (12.1)
1986-87	-3.1	-1.2	-4.2	0.2	13.3 (10.1)
1987-88	0.2	-3.8	-3.6	-0.1	9.7 (7.1)
1988-89	-2.3	0.1	-2.2	0.1	7.7 (7.3)
1989-90	-2.0	0.1	-1.9	0.1	5.4 (5.0)

SECTORAL FLOW OF FUNDS

23. To an even greater extent than in recent forecasts, personal and company sector surpluses are forecast to fall from current levels, and this more than offsets the decline in the public sector deficit. As a result, the overseas sector moves into surplus reflecting the emerging balance of payments deficit.

Table 13: Sectoral financial surpluses and deficits (£ billion)

£bn	Private sector					Public	Overseas (1)	Residual
	Persons	Industrial and commercial companies		Financial companies	Total			
		Non-North Sea	North Sea					
1985-86	8.5	7.8	-0.7	1.5	17.1	-8.5	-3.8	4.8
1986-87	4.6	8.0	-0.4	4.7	16.7	-9.4	1.1	8.3
1987-88	2.1	6.9	1.0	3.8	13.8	-4.3	4.0	13.1
1988-89	2.3	3.5	0.4	4.9	11.1	-2.5	4.8	13.4
1989-90	0.8	4.6	0,3	4.4	10.2	-1.6	6.0	14.6

(1) Overseas sector surplus implies current account deficit.

Personal sector

24. Personal sector financial wealth is forecast to fall gradually as a proportion of disposable income mainly because wealth held in pension funds grows much more slowly partly as a result of contributions holidays. Households' gross wealth, however, is projected to grow broadly in line with income as households' saving ratio rises and offsets the fact that existing financial wealth grows only as a result of sluggish securities prices. Total household wealth, which includes the housing stock and consumer durables is also expected to rise in line with personal incomes in contrast to its faster growth of recent years, but remains high by recent standards.

Chart 10: Household wealth relative to income

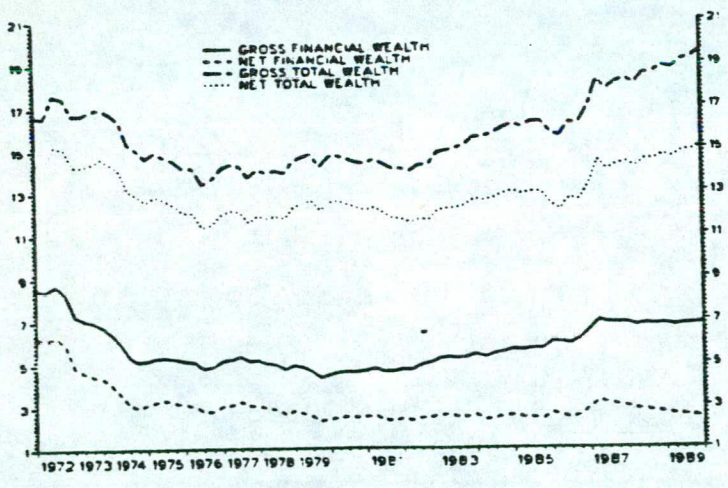
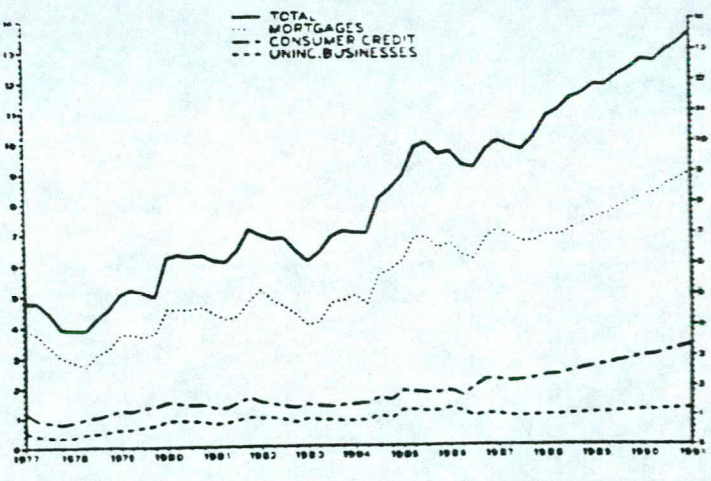


Chart 11: Personal sector income gearing



25. Total personal sector borrowing continues to rise strongly relative to personal incomes, but more than three quarters of this is accounted for by lending for house purchase. Thus, despite steep past and prospective rises in personal sector income gearing, most of this is accounted for by mortgage borrowing which has risen at least partly because of the rise in owner occupation.

Table 14: Flow of non-mortgage credit to personal sector (annual growth in stock outstanding in brackets)

£bn	Banks*	Other OFIs	o/w consumer credit	B.Socs	Total	Memo (Mort. equity withdrawal
1985-86	5.5 (16.3)	1.5 (9.1)	1.0 (13.8)	0.0	7.0 (14.1)	10.5
1986-87	5.0 (13.4)	1.4 (7.4)	1.1 (8.5)	0.1	6.5 (11.7)	15.1
1987-88	10.2 (18.2)	0.4 (9.4)	-0.3 (8.8)	0.5	11.1 (16.2)	14.5
1988-89	8.4 (18.9)	0.9 (4.5)	0.5 (4.6)	0.8	10.1 (16.0)	15.7
1989-90	8.2 (13.8)	0.9 (4.8)	0.5 (5.8)	0.9	10.0 (12.6)	16.5

* includes lending to unincorporated businesses

26. Interest payments on non-mortgage credit relative to personal income is rising to historically high levels but it is possible that these previous peaks will be scaled since credit was rationed in earlier periods. Given the above considerations, net financial wealth of the personal sector is expected to fall slightly.

27. Within personal sector asset portfolios, the fall in investment in life assurance and pension funds is mainly offset by a move into liquid assets. Persons' readiness to continue heavy buying of equities and unit trusts in limited by the forecast sluggish stock market.

Industrial and commercial companies

28. Companies' financial surplus in the present financial year seems likely to be little higher than last year as rising profits are used to finance higher real investment and stockbuilding. A sharp rise in cash spending on mergers and investment abroad, however, has raised companies' borrowing needs. These are being met by a large surge in capital issues. Bank borrowing remains modest by past standards.

Table 15: Selected financial transactions of ICCs

£bn	Financial surplus	Invest-(1) ment in company securities	Invest-ment abroad	Borrowing require-ment	Capital issues	Liquid assets(- indicates increase)	Bank borro-ing
1985-85	7.8	2.5	2.7	3.6	2.7	-2.9	8.0
1985-86	7.1	1.0	2.2	5.7	4.7	-5.3	6.9
1986-87	7.4	1.4	6.5	7.7	8.1	-10.8	5.8
1987-88	7.9	7.0	8.7	15.7	16.9	-11.4	5.9
1988-89	3.9	3.5	3.9	11.2	6.0	-8.5	9.6
1989-90	4.9	3.0	3.4	9.7	5.0	-8.6	8.9

(1) Cash expenditure on domestic mergers

29. The forecast is that companies' financial surplus will be substantially lower in the next two years as profits grow more slowly and investment continues to rise strongly. Merger activity and investment abroad are forecast to be lower but companies' borrowing needs will remain high by the standards of recent years. We have assumed that the absence of gilts will leave some room for corporate bond issues and that companies will also issue short-term securities. In the face of a less buoyant equity market, however, bank borrowing - both in sterling and foreign currencies - may play a larger role again. Companies' gross liquid asset ratio which has been rising steadily is forecast to increase further but the projected growth in bank borrowing and other short-term liabilities implies a small fall in the net liquidity ratio from its present high level.

Monetary sector

30. After a rapid expansion in 1986-87, attributable partly to Big Bang, monetary sector balance sheets seem likely to rise less rapidly this year and a further slowdown is forecast for 1988-89. Banks' claims on other financial institutions in particular are likely to grow more slowly. Overseas claims are also forecast to rise less rapidly reflecting at least partly banks' reluctance to increase exposure to troubled debtors. Lending to companies, however, may grow more rapidly to help meet their large financing needs - although companies' increasing reliance on security issues will push banks towards commission business rather than direct lending. Advances to persons is also forecast to rise rapidly although growth in mortgage lending may slacken from its recent hectic rate.

Table 16: Banks' balance sheet

£bn	Stock 1987Q1		Flows 1986-87	1987-88	1988-89	1989-90
Domestic						
£ assets	186.2		31.2	40.3	36.9	35.3
£ liabilities	153.4		25.9	29.1	26.9	25.1
f.c assets	51.0		13.2	8.2	7.5	9.0
f.c liabilities	28.7		8.1	5.2	5.0	5.0
Net deposit liabilities (1)	-55.1		-10.4	-14.2	-12.5	-14.2
Overseas						
£ assets	33.6		5.3	2.1	3.1	4.1
£ liabilities	42.0		4.2	5.2	5.7	6.6
f.c assets	430.1		52.5	45.1	42.6	47.4
f.c liabilities	438.3		59.9	47.8	45.3	51.6
Net deposit liabilities (1)	16.6		5.6	3.2	3.4	3.9
Net non deposit liabilities	38.6	£	4.7	5.0	5.7	5.5
	38.6	fc	-0.6	3.0	1.6	1.8
Memo item						
Net foreign currency position	14.1		-1.7	-2.6	-1.4	-2.0

(1) - indicates net assets

31. Banks are forecast to rely increasingly on attracting funds from overseas in the light of the slower projected growth of domestic

residents' deposits. Banks' liabilities in foreign currency seem likely to rise relatively rapidly, matched by increased foreign currency lending to domestic companies. Net non-deposit liabilities are projected to rise rapidly during the forecast period reflecting at least partly banks' increased provisions against their exposure to developing country debtors.

Building societies and the mortgage market

32. Building societies have lost share heavily in the market for new mortgages to banks and other lenders recently as slow growth in retail inflows, coupled with constraints on liquidity and wholesale funding, rendered them unable to increase their mortgage lending in line with demand. Over the forecast period, rising economy-wide interest rates and a sluggish equity market help to raise the societies' inflows (which are also aided by increased development of banking services). Mortgage demand also grows more slowly and the societies' market share recovers - albeit to a level well below that of the early 1980s.

Table 17: New mortgage advances by institution

	Building societies			Banks			Others (1)		
	£bn	%growth	share	£bn	%growth	share	£bn	%growth	share
1985-86	15.4	17.9	77.3	4.3	24.7	21.6	0.2	2.3	1.1
1986-87	18.7	18.4	69.3	5.5	25.2	20.3	2.8	29.9	10.4
1987-88	14.8	12.3	52.4	8.2	30.3	29.2	5.2	42.8	18.5
1988-89	19.2	14.2	61.6	6.0	16.9	19.3	6.0	34.3	19.1
1989-90	22.0	14.3	65.6	6.0	14.6	18.0	5.5	23.5	16.4

(1) Other OFIs plus public sector (mainly local authorities)

33. Societies are forecast to maintain the differential between mortgage rates and base rates at its present level of 1¼ per cent, and to cope with any shortfall by increasing wholesale funding until, by the end of the forecast period all societies are at or near the current limit. (In the short run there is also a small risk that some societies may rise rates in response to pressures resulting from the BP privatisation, although they can probably take the burden on liquidity, as in the past.)

Table 18: Building societies summary table

	Interest rate differentials			% growth in retail inflows	%growth in mortgage demand	liquidity ratio	wholesale ratio
	mortgage less gross share rate	mortgage less base rate	net share less net bank deposit rate				
1985-86	1.12	1.20	1.43	15.4	16.3	17.1	4.9
1986-87	1.35	1.17	1.28	10.9	18.5	15.3	8.6
1987-88	1.26	1.47	1.58	10.6	16.3	15.2	10.4
1988-89	1.14	1.25	1.49	12.4	15.3	15.9	12.5
1989-90	1.10	1.25	1.46	12.1	14.2	16.2	14.6

34. Over the medium term, several societies are likely to choose incorporation, either directly or as a prelude to an agreed bank takeover, as a solution to their funding problems. This has not been allowed for in the forecast since to do so would artificially distort the underlying picture. The tendency for mergers between societies is likely to continue, but has little effect on the overall picture.

Life assurance and pensions funds (LAPFs)

35. LAPFs inflows fall from £21 billion this year to £18 billion by 1989-90 because of contributions holidays. This reduces the growth of their bank deposits. The dearth of net gilt sales causes them to run down their £70 billion outstanding stock of gilts by £5 billion a year. But take-up of UK company securities including privatisations and overseas securities is at a higher level. Taking these effects together, the growth of their bank deposits is low by recent standards.

Other OFIs

36. Inflows to unit trusts have been extremely buoyant in recent quarters, partly boosted by the increase in take-up of linked life assurance schemes by LAPFs. Over the forecast period, the weakening stock market causes unit trust inflows to fall back below current high levels.

37. **Securities dealers** are assumed to reduce in importance over the immediate future as the shake out from the Big Bang continues and equity markets become more sluggish. Increases in stress lending by banks to this sector may occur.

38. **New mortgage lenders** are forecast to make considerable inroads into the market for new advances, their share increasing to around 20 per cent by the end of 1989-90. These institutions' financing requirements are expected to rely less on bank advances and increasingly on securitised mortgages, although to the extent that these will be bought by banks, recorded bank lending to the sector will remain high.

Capital markets

39. Total issues of domestic securities by all sectors, that is gilts, privatisations and corporate capital issues seem likely to rise from £21 billion last year to £29 billion this before falling sharply in 1989-89 and 1989-90.

Table 19: Issues of domestic securities by all sectors

	Net gilt issues	Capital issues	Privatisation issues	Total	Memo items: Overseas securities	Memo items: Equity price growth
1986-87	1.5	15.8	3.9	21.2	24.6	23.9
1987-88	-0.2	23.7	5.5	29.0	12.9	21.2
1988-89	-6.9	17.5	6.2	16.8	12.0	4.5
1989-90	-6.5	18.8	6.2	18.5	12.3	3.9

40. The main features of the forecast are heavy continued corporate issues. The large fall in issues of gilts is only partly offset by the rise in privatisations. With equity prices sluggish and government fixed term securities in short supply, corporate issues may at least partly take the form of fixed rate bond issues but if international interest rate uncertainties remain then greater reliance may need to be placed on short-term securities.

Overseas sector capital account

41. The need to finance a widening current account deficit and continued investment abroad by companies and financial institutions is forecast to be met by a mixture of corporate capital issues and increased bank borrowing from overseas.

Table 20: Overseas sector capital account

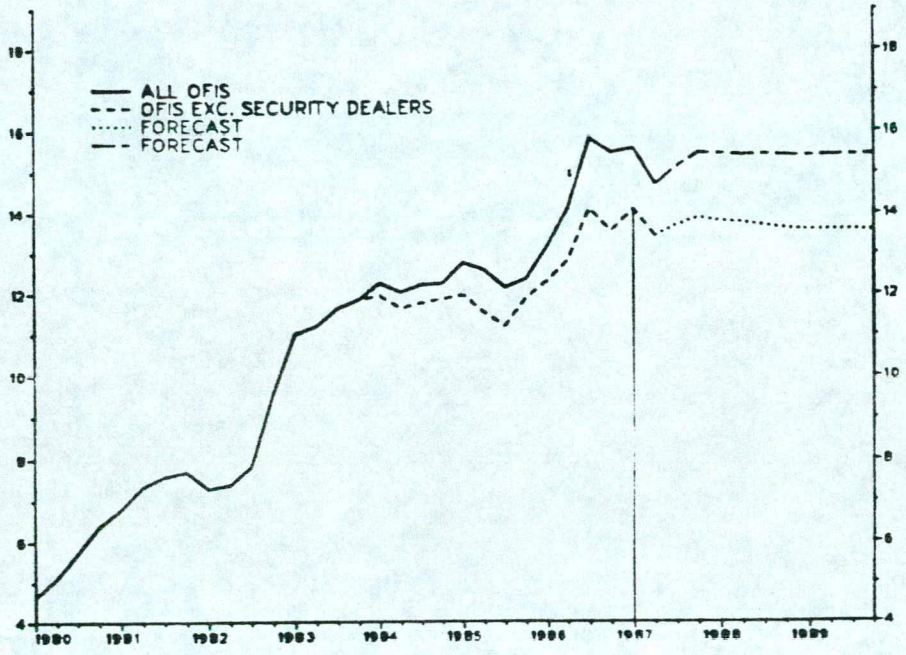
£ BILLION

	1985	1986	1987	1988	1989
DIRECT INVESTMENT					
Inward	4.4	5.4	4.3	5.1	5.2
Outward	-8.8	-11.4	-14.3	-10.4	-10.7
Net	-4.4	-6.0	-10.0	-5.3	-5.5
NON BANK PRIVATE					
Inward	6.8	8.6	12.2	10.2	11.5
Outward	-7.8	-16.0	-6.5	-6.6	-7.4
o.w of is portfolio	-5.1	-13.8	-2.8	-4.1	-4.6
Net	-1.1	-7.4	5.7	3.6	4.0
BANKS					
Inward					
£	4.1	5.6	6.5	5.2	6.2
f.c	25.3	58.4	46.2	43.2	51.6
Outward					
£	-1.6	-6.0	-2.7	-3.0	-4.0
f.c	-20.4	-47.9	-39.9	-36.0	-44.0
portfolio	-10.1	-7.6	-.1	-3.0	-3.4
Net	-2.7	2.6	10.0	4.4	6.4
GENERAL GOVERNMENT					
Inward	3.4	3.5	4.9	.2	-
o.w gilts	2.9	2.1	4.4	.2	-
Outward	-.7	-.5	-.8	-.7	-.7
Net	2.7	2.9	4.2	-.5	-.7
NET CAPITAL FLOWS	-5.5	-7.8	10.0	2.1	4.3
BALANCING ITEM	4.5	11.7	-1.8	1.0	1.0
RESERVES	-1.8	-2.9	-5.7	1.3	.3
CURRENT ACCOUNT	2.9	-1.0	-2.4	-4.3	-5.6

42. Direct investment abroad by UK companies which has been exceptionally large in 1986 and 1987 partly as a result of take-over activity, is forecast to fall as companies' ability to raise new equity finance is limited and subsidiaries' overseas profits rise less rapidly. Even with steady investment into the UK, however, net direct investment outflows seem likely to be about £5 billion a year.

43. Portfolio investment abroad by UK financial institutions which was boosted in 1986 by an exceptional £9 billion in purchases by securities dealers, has been lower so far in 1987 as this has unwound. In the absence of sharp movements in exchange rates, interest differentials and relative equity prices, security dealers' purchases of overseas assets are forecast to be less erratic. Other UK financial institutions are assumed to invest abroad a slightly higher proportion of their new inflows than in the recent past to keep the share of overseas assets in their total portfolios close to 15 per cent. Total portfolio outflows seem likely to be around £4 billion a year.

Chart 12: OFIs' overseas assets as a share of total assets.



44. Overseas investors seem likely to purchase a significant share of the unprecedented volume of UK companies' capital issues this year, and we forecast that this will continue - albeit at a lower rate. Banks are assumed to increase their net foreign currency borrowing by some £3-4 billion a year for on-lending to domestic companies. The early projected improvement in the sterling interest differential against the world average also allows them to attract net sterling deposits from overseas of about £2 billion a year.

45. Gilt sales to the overseas sector, however, which have been particularly strong in 1987, are projected to fall to zero from mid-1988 onwards given the modest full fund requirements. Around half the £4½ billion build up in reserves recorded in the second quarter of 1987 is expected to be unwound by end 1988-89. Thereafter the conventional zero intervention projection is retained.

Net overseas assets

46. The UK's net overseas assets which rose by £36 billion during 1986 to £114 billion, may show a small further rise this year despite the need to finance the current deficit. The relatively strong rise in securities markets abroad has increased the UK overseas assets more than the pound's appreciation has reduced their value in sterling terms. Valuation effects are forecast to be small in future with UK and overseas securities markets moving broadly in line and the sterling exchange rate constant. The widening current deficit, however, implies a gradual decline in net overseas assets.

Table 21: Changes in UK net overseas assets (£ billion)

Gross assets	**1986**	**1987**	**1988**	**1989**
Capital flows	+92	+70	+60	+70
$ revaluation	-9	-35	-19	-15
Non $ revaluation	+42	-10	+5	+3
Market revaluation	+20	+19	+2	+3
Unexplained	-9	+9	0	0
Change in stock	+136	+53	+48	+61
Stock level (end year)	731	784	832	893
Gross liabilities				
Capital flows	+82	+74	+64	+75
$ revaluation	-8	-29	-15	-12
Non $ revaluation	+23	-5	+2	+2
Market revaluation	+4	+9	+1	+2
Unexplained	-1	-1	0	0
Change in stock	+100	+48	+51	+66
Stock level (end year)	617	665	716	782
Net assets				
Change in net asset position	+36	+5	-3	-5
Net asset position (end year)	114	119	116	111

RA8.94

[redacted]

FROM: A C S ALLAN
DATE: 10 October 1986

CHANCELLOR

cc PS/Minister of State

REPLACEMENT OF CCTA TELEPHONE EXCHANGE: GEC AND NORTHERN TELECOM

Jim Prior rang just before lunch to try to speak to you. He said he had meant to have a word with you last night about this order. GEC were very concerned about it and very keen to do everything possible to win the deal.

2. I held off his bid to ring you in Bournemouth. But he said he was keen for you to 'phone him tonight if there was anything that GEC could do to help. I can't imagine you will want to, but if you do he will be in Suffolk (0502-79278) this evening.

A C S ALLAN

RJ11.64

UNCLASSIFIED

FROM: N G FRAY
DATE: 12 October 1987

MR S PRICE

THE SEPTEMBER RPI

The Chancellor has seen and was grateful for your minute of 8 October.

N G FRAY

PERSONAL AND CONFIDENTIAL

FROM: S PRICE
DATE: 8 OCTOBER 1987

1. MR S J DAVIES
2. CHANCELLOR OF THE EXCHEQUER

cc: PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr F Cassell
Mr Kemp
Mr N Monck
Mr Odling-Smee
Mr Scholar
Mr Sedgwick
Mr Bottrill
Mr Davies
Mr Culpin
Mr Gilhooly
Mr Mowl
Miss O'Mara
Mr Pickford
Mr de Berker
Mr Patterson
Mr Cropper
Mr Tyrie
Mr Call

THE SEPTEMBER RPI (to be published at 11.30 am on Friday 9 October)

The level of the RPI rose from 102.1 to 102.4 between August and September. The twelve-month rate of inflation was 4.2 per cent in September, a fall from 4.4 per cent in August. Excluding mortgage interest payments, the September twelve-month rate of inflation was 3.5 per cent, 0.2 per cent lower than in August.

2. About half of the rise in the index between August and September was accounted for by higher prices for clothing, mainly reflecting the arrival of the new season's stocks. Other notable increases were for household goods, beer and motor vehicles. Food prices fell in spite of the bad weather. The fall in the twelve-month rate of inflation reflected the 0.5 per cent increase in the index recorded between August and September last year, when there was a sharp increase in petrol prices.

3. The September RPI is used to determine the 1988 social security uprating. The 4.2 per cent increase in the all items index is the same as the internal assumption given last month to DHSS. The RPI excluding housing (the Rossi index), which is used to uprate about a third of the social security programme, increased by 3.2 per cent (0.1 per cent more than the assumption issued last month).

4. The current forecast is that inflation will rise slightly next month (to 4.3 or possibly 4.4 per cent), before falling below 4 per cent in November and December.

5. In the City there is broad agreement about the expected change in prices between August and September 1987. Phillips and Drew, James Capel, Wood Mackenzie, Alexander Laing and Cruickshank and Warburg Securities all expect +0.3 per cent; the Nomura Research Institute expects a rise of 0.2 per cent. The correct figure is +0.3 per cent.

Simon Price

S PRICE
EA1 DIVISION
x 5388

063600
MDHIAN 3168

CONFIDENTIAL
FM WASHINGTON
TO IMMEDIATE FCO
TELNO 2317
OF 281636Z OCTOBER 87
INFO PRIORITY EC POSTS, UKDEL NATO, TOKYO, MOSCOW
INFO SAVING CONSULS GENERAL IN USA

US INTERNAL: THE STATE OF THE PRESIDENCY

SUMMARY

1. PRESIDENT REAGAN HAS HAD A WEEK OF SETBACKS. DEVELOPMENTS ON WALL STREET, A STINGING DOMESTIC DEFEAT OVER THE BORK NOMINATION, A FOREIGN POLICY DISAPPOINTMENT OVER GORBACHEV'S DELAY IN SETTING A SUMMIT DATE, AND RISING CONCERN OVER THE ESCALATION OF INCIDENTS IN THE GULF. ALL THIS AT A TIME WHEN HE HAS BEEN DISTRACTED BY PERSONAL WORRIES. THE PRESIDENT'S RESILIENCE SHOULD NOT BE UNDERESTIMATED. BUT LITTLE SIGN OF CALMER WATERS AHEAD: AND THE 1988 ELECTIONS ARE INCREASINGLY CASTING THEIR SHADOW FORWARD.

DETAIL

2. POLITICAL COMMENTATORS HERE AGREE THAT THE PRESIDENT IS GOING THROUGH ONE OF HIS ROUGHEST PATCHES SO FAR. THE STOCK MARKET CRASH CAME IN THE SAME WEEK THAT THE SENATE FINALLY VOTED BY 58-42 TO REJECT JUDGE BORK. ALTHOUGH THIS DEFEAT HAD BEEN A VIRTUAL CERTAINTY FOR SOME TIME (OUR TELNO 2128), THE MARGIN WAS EVEN GREATER THAN FORECAST. IT WAS THE BIGGEST DEFEAT EVER OF A NOMINEE FOR THE SUPREME COURT. ON AN ISSUE ON WHICH THE PRESIDENT HAD PUT HIS OWN PRESTIGE ON THE LINE, AND WHICH HE HAD DESCRIBED AS THE MOST IMPORTANT ITEM ON HIS DOMESTIC AGENDA, HE WAS UNABLE TO HOLD THE SUPPORT EVEN OF THE SENATORS OF HIS OWN PARTY (SIX OF WHOM VOTED AGAINST BORK).

3. THE EXPECTATION IS THAT THE NEXT NOMINEE WHOM THE PRESIDENT PUTS FORWARD (SEVERAL NAMES ARE NOW BEING CANVASSED INFORMALLY WITH THE SENATE LEADERSHIP) WILL BE CONFIRMED WITHOUT TOO MUCH DIFFICULTY EVEN IF HE (OR SHE) IS AS JUDICIALLY CONSERVATIVE AS JUDGE BORK. BUT THE FACT THAT CONSERVATIVE SOUTHERN DEMOCRATIC SENATORS, IN RESPONSE TO AN ORGANISED CAMPAIGN OF PRESSURE FROM THEIR ELECTORS, AND PARTICULARLY FROM BLACKS, UNEXPECTEDLY CAME OUT ALMOST UNANIMOUSLY AGAINST BORK IS AN OMINOUS REMINDER TO THE REPUBLICANS, ONE YEAR OUT FROM THE ELECTIONS, OF THE POLITICAL STRENGTH OF THE DEMOCRATS IN THE SOUTH. THE DEMOCRATS HAVE CORRESPONDINGLY TAKEN HEART FROM THE DEFEAT OF BORK, WHICH THEY SEE AS A FURTHER STEP, FOLLOWING THE CAPTURE OF FIVE SOUTHERN

REPUBLICAN SENATE SEATS LAST YEAR, TOWARDS A POSSIBLE ELECTION VICTORY IN 1988 BASED ON SUCCESS IN THE SOUTH.

4. IN PURELY ELECTORAL TERMS, THE STOCK MARKET COLLAPSE IS ALSO HELPFUL TO THE DEMOCRATS. GIVEN THAT ELECTIONS HERE ARE WON AND LOST ESSENTIALLY ON POCKET BOOK ISSUES, THE REPUBLICANS HAVE RECENTLY BEEN MAKING GREAT PLAY OF THE 59 MONTHS OF UNINTERRUPTED GROWTH IN THE ECONOMY. WHILE NO DEMOCRAT LEADER CAN AFFORD TO SAY SO PUBLICLY, ANY DOWNTURN IN THE ECONOMY WOULD SIGNIFICANTLY BOOST DEMOCRATIC ELECTORAL CHANCES. FOR THE ADMINISTRATION, BY CONTRAST LAST WEEK'S EVENTS HAVE BEEN A DAMAGING SETBACK. THE PRESIDENT HAS BEEN OBLIGED TO BACK OFF, ALBEIT GRUDGINGLY, FROM HIS HITHERTO FIRMLY STATED OPPOSITION TO TAX INCREASES. MOREOVER HE HAS NOT - AT LEAST SO FAR - BEEN SEEN BY THE MARKETS TO HAVE EXERCISED THE LEADERSHIP NECESSARY TO STOP THE SLIDE. COMMENTATORS HAVE EXPRESSED WIDESPREAD CONCERN AT HIS APPARENT FAILURE TO APPRECIATE THE SERIOUSNESS OF THE PROBLEM.

5. WHILE THE PRESIDENT'S WILLINGNESS TO START DEFICIT REDUCTION NEGOTIATIONS WITH CONGRESS HAS HAD SOME POSITIVE PSYCHOLOGICAL EFFECT (OUR TELNO 2301), THERE IS CLEARLY A RISK OF OVER-HIGH EXPECTATIONS BEING GENERATED. IN PRACTICE THE FIRST ROUND BETWEEN THE PRESIDENT AND CONGRESSIONAL LEADER, WHICH TOOK PLACE ON 26 OCTOBER, WAS NO MORE THAN A FORMAL OPENING SESSION. THE DETAILED DISCUSSIONS (WHICH ARE BEING CONDUCTED FOR THE ADMINISTRATION BY THE TWO BAKERS AND BUDGET DIRECTOR MILLER, AND BY THE BIPARTISAN LEADERS OF BOTH HOUSES ON THE CONGRESSIONAL SIDE) ONLY STARTED ON 27 OCTOBER, AND ARE NOT EXPECTED TO PRODUCE RESULTS FOR SEVERAL DAYS. CONGRESSIONAL LEADERS WERE NOTABLY CAUTIOUS WITH THE PRESS AFTER THE OPENING SESSION. THE EXPECTATION IS THAT AGREEMENT CAN AT LEAST BE REACHED ON A DOLLARS 23 BILLION PACKAGE BY 20 NOVEMBER (THEREBY AVERTING THE GRAMM-RUDMAN AXE). BUT IT REMAINS TO BE SEEN WHETHER THIS WILL SATISFY THE MARKETS, OR WHETHER A LARGER, POSSIBLY MULTI-YEAR, PACKAGE WILL BE NECESSARY, AND IF SO, ACHIEVABLE.

6. ON THE FOREIGN POLICY FRONT, THE NEWS OF SHEVARDNADZE'S FORTHCOMING VISIT TO WASHINGTON HAS COME AS A WELCOME RELIEF TO THE ADMINISTRATION AFTER THE SETBACK LAST WEEK OF GORBACHEV'S APPARENT REFUSAL TO SET A DATE FOR A SUMMIT. THE PRESIDENT CAN STILL HOPE TO BOLSTER HIS POSITION IN THE COUNTRY WITH AN INF AGREEMENT, THOUGH THERE MAY YET BE SIGNIFICANT DIFFICULTIES HERE OVER ITS RATIFICATION. BUT THERE ARE OTHER CLOUDS ON THE HORIZON: IN THE GULF, ANOTHER MAJOR INCIDENT WOULD FACE THE ADMINISTRATION WITH SOME AWKWARD DECISIONS. CONGRESS IS PRESSING THE ADMINISTRATION OVER THE WAR POWERS ACT (OUR TELNO 2283). A SERIOUS ESCALATION IN THE GULF COULD MAKE A PRESIDENTIAL VETO ON THIS

ISSUE VULNERABLE TO AN OVERRIDE IN THE SENATE. IRANGATE WILL ALSO RETURN TO PUBLIC ATTENTION SHORTLY WHEN THE HOUSE AND SENATE SPECIAL COMMITTEES ISSUE THEIR REPORT (EXPECTED EARLY NEXT MONTH) AND THE INDEPENDENT COUNSEL ANNOUNCES WHAT PROSECUTIONS HE INTENDS TO BRING, THEREBY POSSIBLY FACING THE PRESIDENT WITH SOME DIFFICULT DECISIONS OVER PRESIDENTIAL PARDONS. AND APART FROM BATTLES WITH CONGRESS OVER THE DEFENCE BUDGET AND ARMS CONTROL, THE PRESIDENT IS LIKELY TO HAVE ANOTHER BRUISING FIGHT ON THE HILL NEXT MONTH WHEN HE SUBMITS HIS NEW REQUEST FOR AID TO THE CONTRAS.

7. AS THE ADMINISTRATION APPROACHES ITS FINAL YEAR, THERE ARE ALSO RUMOURS OF IMPENDING RESIGNATIONS (EVEN WEINBERGER HAS BEEN MENTIONED RECENTLY). MRS DOLE AND BROCK HAVE ALREADY GONE (BOTH TO THE DOLE CAMPAIGN), AND THERE IS A STEADY OUTFLOW AT LOWER LEVELS. HOWARD BAKER SHOWS NO SIGN OF LEAVING, BUT HAS BEEN STRONGLY CRITICISED BY SOME RIGHT WING REPUBLICANS AND HAS NOT HANDLED RELATIONS WITH THE HILL AS SKILFULLY AS EXPECTED. ALL THIS, TOGETHER WITH THE STRING OF POLICY SETBACKS, MUST HAVE A DAMAGING EFFECT ON MORALE IN THE WHITE HOUSE. AND OF COURSE IT COMES AT A TIME WHEN THE PRESIDENT HAS BEEN PARTICULARLY DISTRACTED BY PERSONAL WORRIES (HIS WIFE'S ILLNESS AND NOW HER MOTHER'S DEATH).

COMMENT

8. THE POLITICAL SCENE CHANGES RAPIDLY HERE AND A NUMBER OF THESE FACTORS COULD SWING TO THE ADVANTAGE OF THE PRESIDENT (THE SHEVARDNADZE VISIT, FOR EXAMPLE). BUT THE ACCUMULATION OF NEGATIVE FACTORS IS STRIKING. THE MEDIA ARE ONCE AGAIN OPENLY EXPRESSING DOUBTS ABOUT THE PRESIDENT'S LEADERSHIP, AND THE BORK EPISODE HAS SHOWN THAT HE CAN NO LONGER APPEAL TO THE COUNTRY OVER THE HEADS OF CONGRESS. THE STOCK MARKET FALL, AND PRESSURE FOR NEW TAXES, REMAINS THE MAJOR HEADACHE. IT IS BAD NEWS FOR OJBUSH TOO (SINCE BUSH HAD JUST GONE ON RECORD AS UNEQUIVOCALLY AGAINST TAX INCREASES). IN SHORT, THE PRESIDENT AND HIS ADMINISTRATION HAVE BEEN THROWN ON THE ~~DEFENSIIJAHSSHIS~~ DEFENSIVE. HIS PERSONAL APPROVAL RATINGS REMAIN HIGH, BUT WITH BOTH HOUSES OF CONGRESS AGAINST HIM, THE PRESIDENT IS SUFFERING A DECLINE IN INFLUENCE WHICH, AS THE 1988 ELECTIONS CAST THEIR SHADOW FORWARD, IT WILL BE DIFFICULT FOR HIM TO REVERSE.

9. FCO PLEASE ADVANCE TO PS/MRS CHALKER (FOR SIR A ACLAND).

JENKINS

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Chancellor 12/2 A, B, C

U.S. JOINED DOLLAR INTERVENTION - JAPAN OFFICIAL NRJA

BY RICH MILLER

TOKYO, SEPT 2 - THE U.S. JOINED IN RECENT COORDINATED INTERVENTION TO SUPPORT THE DOLLAR, JAPANESE VICE FINANCE MINISTER FOR INTERNATIONAL AFFAIRS TOYOO GYOHTEN SAID.

HE ALSO DISMISSED MARKET TALK THAT MAJOR NATIONS WERE ONLY HALF-HEARTEDLY ACTING TO BUTTRESS THE CURRENCY AND SAID THEY STAND READY TO TAKE STRONG ACTION IF NEEDED TO ACHIEVE EXCHANGE RATE STABILITY.

"IF THERE IS UNEXPECTED STRONG PRESSURE AGAIN HAPPENING IN THE MARKET, THE AUTHORITIES' REACTION WILL ALSO BE A VERY DETERMINED AND STRONG ONE," HE TOLD REUTERS IN AN INTERVIEW.

02-SEP-1028 MON449 MONG

CONTINUED ON - NRJB

P

NRJB

U.S. JOINED =2 TOKYO

GYOHTEN SAID HE SAW NO FUNDAMENTAL REASON FOR THE DOLLAR TO BREAK OUT OF THE BROAD 140 TO 160 YEN TRADING RANGE IT HAS EXPERIENCED OVER THE LAST YEAR.

THE AUTHORITIES HERE WILL ACT TO ENSURE THAT THE DOLLAR REMAINS RELATIVELY STABLE IN THAT RANGE FOR AS LONG AS ECONOMIC FUNDAMENTALS WARRANT, HE ADDED.

BUT HE EMPHASISED THAT MAJOR NATIONS ARE NOT ADOPTING A FIXED RATE SYSTEM. "THERE IS NO EXPLICT COMMITMENT THAT EXCHANGE RATES SHOULD BE KEPT AT CERTAIN ABSOLUTE LEVELS," HE SAID. "YOU HAVE TO JUDGE THE MOMENTUM OF THE PRESSURE, THE SPEED OF THE MOVE AND THE MAGNITUDE OF THE CHANGE."

02-SEP-1033 MON466 MONG

CONTINUED FROM - NRJA

CONTINUED ON - NRJC

P

NRJC

U.S. JOINED =3 TOKYO

GYOHTEN ATTRIBUTED THE DOLLAR'S STABILITY BETWEEN 140 AND 160 YEN OVER THE PAST 12 MONTHS TO THREE MAJOR FACTORS - THE MARKET COMFORT WITH THAT RANGE, MAJOR NATIONS' AGREEMENT ON THE NEED FOR CURRENCY STABILITY, AND IMPROVING ECONOMIC FUNDAMENTALS.

"THE MAJORITY VIEW (IN THE MARKET) IS THAT EXCHANGE RATE RELATIONSHIPS HAVE MORE OR LESS ARRIVED AT A COMFORTABLE RANGE," HE SAID.

ADDITIONALLY, MAJOR NATIONS ARE NOW ALL AGREED THAT FURTHER MAJOR CHANGES IN EXCHANGE RATES MIGHT BE HARMFUL, HE SAID.

02-SEP-1040 MON474 MONG

CONTINUED FROM - NRJB

CONTINUED ON - NRJD

P

U.S. JOINED =4 TOKYO

"UNTIL LAST SUMMER, THERE WERE DIFFERENCES AMONG MONETARY AUTHORITIES OVER THE DIRECTION OF THE DOLLAR," GYOHTEN SAID. "BUT NOW THERE IS A FAIRLY UNANIMOUS FEELING THAT ANY FURTHER MAJOR CHANGE IN EXCHANGE RATE RELATIONSSHIPS MIGHT BE HARMFUL.

"MONETARY AUTHORITIES ARE DEMONSTRATING THAT CONSENSUS, BY TAKING ACTIONS IN THE MARKET, INCLUDING THIS RECENT INTERVENTION," HE ADDED.

THE OFFICIAL SAID MAJOR NATIONS ARE KEEPING IN VERY CLOSE TOUCH WITH EACH OTHER IN ORDER TO FORSTALL ANY DISRUPTION TO CURRENCY STABILITY.

02-SEP-1047 MON487 MONG

CONTINUED FROM - NRJC

CONTINUED ON - NRJE

P

U.S. JOINED =5 TOKYO

IMPROVING ECONOMIC FUNDAMENTALS HAVE ALSO CONTRIBUTED TO CURRENCY MARKET STABILITY, GYOHTEN SAID.

"THE EXCHANGE RATE CHANGE THAT TOOK PLACE SO FAR IS CLEARLY SHOWING ITS VERY STRONG AND LASTING IMPACT ON THE TRADE PERFORMANCE," HE SAID.

ALTHOUGH TRADE IMBALANCES WORLDWIDE ARE STILL LARGE, THEY ARE BEGINNING TO BE REDUCED, THANKS TO THE DOLLAR'S 40 PCT FALL OVER THE PAST 2-1/2 YEARS.

THIS ADJUSTMENT IN TRADE IS EVEN BEING SEEN IN THE U.S., ALTHOUGH AMERICA HAS RECENTLY DEVELOPED A NEW TRADE PROBLEM WITH NEWLY INDUSTRIALIZING COUNTRIES, GYOHTEN SAID.

02-SEP-1048 MON489 MONG

CONTINUED FROM - NRJD

CONTINUED ON - NRJN

P

U.S. JOINED =6 TOKYO NRJN

"ALTHOUGH THE JUNE U.S. TRADE FIGURE WAS NOT VERY ENCOURAGING AND JULY WILL NOT BE EITHER, AMERICAN EXPORTS ARE DEFINITELY DOING MUCH BETTER NOW," GYOHTEN SAID.

HE STATED, HOWEVER, THAT THE CURRENT SITUATION WAS A DELICATE ONE. "THAT MAKES CLOSER CONSULTATION AND BETTER POLICY COORDINATION ALL THE MORE IMPORTANT," HE SAID.

MONETARY AUTHORITIES, FOR EXAMPLE, ARE FACED WITH HARD CHOICES. JAPANESE MONETARY POLICY IS VERY EASY, BUT THERE ARE SOME WORRYING SIGNS OF RENEWED INFLATION, HE SAID.

02-SEP-1051 MON492 MONG
CONTINUED FROM - NRJE CONTINUED ON - NRJO
P

REUTER MONITOR 0910

U.S. JOINED =7 TOKYO NRJO

THE U.S., ON THE OTHER HAND, MIGHT WANT TO KEEP INTEREST RATES AT A RELATIVELY HIGH LEVEL IF ITS PRIMARY OBJECTIVE IS EXCHANGE RATE STABILITY, GYOHTEN SAID.

"BUT THE REALITY IS NOT THAT SIMPLE," HE SAID. "THEY HAVE TO ALSO TAKE THE DOMESTIC ECONOMIC SITUATION INTO CONSIDERATION."

ASKED WHETHER THE ONLY SOLUTION TO SUCH A POLICY IMPASSE WAS A LOWER DOLLAR, GYOHTEN REPLIED, "THAT SOLUTION IS CERTAINLY NOT DESIRABLE FOR ANYBODY."

02-SEP-1052 MON494 MONG
CONTINUED FROM - NRJN REUTER
P

REUTER MONITOR 0910

PH1/188

STATEMENT BY CHANCELLOR ON US BUDGET AGREEMENT

I welcome the news that agreement in principle has been reached on a package of measures to reduce the US budget deficit.

As I have all along made plain, this is an essential element both in the correction of the imbalances that have been plaguing the world economy, and in the restoration of confidence in the financial markets.

Other major nations, particularly the surplus countries, will now need to prepare an appropriate response, with a view to a meeting as soon as practicable after the Congress has approved the package, so that a successful co-operative approach to current economic difficulties can be agreed.

SECRET COPY NO. 1

FROM: P N SEDGWICK
DATE: 12 OCTOBER 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
PCC
MEG
Mr Edwards
Mrs Lomax
Mr Luce
Mr Moore
Miss Peirson
Mr S Davies
Mr Grice
Mr Hibberd
Mr Matthews
Mr Melliss
Mr Mowl
Mr O'Donnell
Mr Pickford
Mr Riley
Mr Owen
Mr Tyrie
Mr Call

TREASURY ECONOMIC FORECAST

I attach a copy of the main report of the recent forecasting exercise, which reflects judgements taken at a series of meetings with Sir T Burns.

2. The other detailed reports on this exercise to be circulated by the end of this week are

World Economic Prospects	Mr Matthews
Public Finances	Mr Mowl
The Financial Prospect	Mr O'Donnell

3. Our work during the forecasting exercise has produced four other notes on topics of current interest that will be circulated by the end of the week. These are

The effects of higher interest rates in the forecast	Mr O'Donnell
Capacity utilisation in manufacturing	Mr O'Donnell
Post-mortem on the FSBR forecast	Mr Owen
The effects of the Piper Alpha disaster	Mr O'Donnell

P.N.S

P N SEDGWICK

OCTOBER FORECAST

SECRET

TREASURY ECONOMIC FORECASTING EXERCISE

OCTOBER 1988

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TREASURY ECONOMIC FORECASTING EXERCISE

The forecast covers the period to 1990 (1990-91 for public finances). It embraces two of the three years for which the Autumn Statement will include revised public expenditure plans. Table 1 summarises the results and compares them with earlier forecasts and the current average of City forecasts.

(i) In 1988 growth of **real GDP** is likely to be just over 4 per cent (nearly 5 per cent excluding oil) and growth of **money GDP** to be about 11 per cent. Both are growing much more rapidly than expected at budget time. Official statistics probably underestimate growth.

(ii) **Domestic demand** growth is estimated to be 6 per cent in 1988. Domestic demand decelerates sharply from 1989 as the investment boom eases off, and as sustained high short term interest rates exert a sharp squeeze on personal sector finances. With growth of domestic demand slowing down, **GDP growth** falls to a little below potential during 1989 and 1990, even though the contribution of net trade to growth is once again positive.

(iii) **The current account deficit** for 1988 is likely to be about £14bn. The current account may not change significantly in 1989 because slower domestic demand growth is likely to be partly offset by a slowdown in the world economy. It should, however, fall in 1990.

(iv) **RPI** inflation, boosted by recent mortgage rate increase, reaches 6¼ per cent in 1988Q4, peaks at 7¼ per cent in the middle of 1989, and falls back thereafter. Less distorted measures of inflation - such as producer prices and the RPI less mortgage interest payments - are forecast to be over 5 per cent in 1989 and to fall slowly thereafter. The **GDP deflator** is likely to grow by just under 7 per cent in 1988-89 as a result of fast rising investment prices, high public sector earnings growth, and an improvement in the terms of trade. It is forecast to grow by 6 per cent in 1989-90.

(v) The **PSDR** (public sector debt repayment) is forecast to be £11¾bn. in 1988-89, almost 2½ per cent of GDP. On the working assumption that the PSDR excluding privatisation proceeds stays at its projected 1988-89 level, there is scope for modest cuts in personal taxes in the 1989 and 1990 budgets.

TABLE 1 : SUMMARY OF FORECAST

	FSBR 1988	JUNE 1988	OCTOBER 1988	AVERAGE OF CITY FORECASTS
A THE WORLD ECONOMY				
1. GNP (MAJOR 7 EXCLUDING UK) (per cent change on a year earlier)				
1987	2.8	2.9	3.2	
1988	2.5	4.0	4.1	
1989	2.1	2.8	3.0	
1990	2.7	2.7	2.3	
2. DOMESTIC DEMAND (MAJOR 7 EXCLUDING UK) (per cent change on a year earlier)				
1987	3.1	3.1	3.6	
1988	2.5	4.0	4.2	
1989	2.1	2.7	3.1	
1990	2.8	2.6	2.4	
3. WORLD TRADE IN MANUFACTURES (per cent change on a year earlier)				
1987	5.5	6.0	5.4	
1988	4.9	10.0	8.7	
1989	4.3	5.0	7.3	
1990	6.6	5.2	4.9	
B UK ACTIVITY AND DEMAND				
4. GDP VOLUME (non-North Sea in brackets) (per cent change on a year earlier)				
1987	4.3(4.7)	4.3(4.7)	4.2(4.6)	
1988	3.2(4.3)	3.9(4.3)	4.2(4.8)	3.6
1989	2.6(3.0)	2.9(3.2)	2.7(3.0)	2.1
1990	2.5(3.0)	2.0(2.3)	2.3(2.6)	
5. VOLUME OF DOMESTIC DEMAND (per cent change on a year earlier)				
1987	4.2	4.1	4.3	
1988	4.2	5.8	6.0	
1989	3.3	3.1	2.6	
1990	3.1	1.6	1.6	
6. UNEMPLOYMENT (UK S.A. EXCLUDING SCHOOL LEAVERS million)				
1987 Q4	2.66	2.64	2.66	
1988 Q4	2.41	2.32	2.10	2.19
1989 Q4	2.41	2.24	1.88	2.19
1990Q4	2.45	2.32	1.85	

NO! (3.6)?

1989-90

1.915

	FSBR 1988	JUNE 1988	OCTOBER 1988	AVERAGE OF CITY FORECASTS
C INFLATION AND MONEY GDP				
7. MONEY GDP (MARKET PRICES) (per cent change on a year earlier)				
1987-88	9¾	9.8	10.0	
1988-89	7½	10.0	11.1	
1989-90	6½	7.9	8.7	
1990-91	6	6.1	7.3	
8. RPI (excluding mortgage interest payments in brackets) (per cent change on a year earlier)				
1987 Q4	4.1(4.0)	4.1(4.0)	4.1(4.0)	
1988 Q4	4.0(3.9)	5.0(4.5)	6.2(5.0)	5.9
1989 Q4	3.0(2.7)	5.6(4.5)	5.9(5.5)	4.5
1990 Q4	3.4(3.5)	4.1(3.6)	4.9(4.8)	
9. GDP market price deflator (per cent change on a year earlier)				
1987-88	5	5.1	5.3	
1988-89	4½	5.7	6.8	
1989-90	4	5.2	6.0	
1990-91	3½	4.0	5.1	
D PUBLIC FINANCES				
10. PSBR - £ billion				
1987-88	-3.1	-3.5	-3.5	
1988-89	-3.2	-7.3	-11.8	-8.1
1989-90	0	-7.3	-11.3	-8.1
1990-91	0	-7.4	-12.2	
11. PSBR - % OF GDP				
1987-88	-¾	-¾	-¾	
1988-89	-¾	-1½	-2½	
1989-90	0	-1½	-2¼	
1990-91	0	-1½	-2¼	
12. ANNUAL FISCAL ADJUSTMENT - £ billion				
1988-89				
1989-90	3¾	2¾	2	
1990-91	¾	¾	1¼	-

	FSBR 1988	JUNE 1988	OCTOBER 1988	AVERAGE OF CITY FORECASTS
E MONETARY CONDITIONS				
13. SHORT TERM INTEREST RATES (per cent))				
1987 Q4	9.2	9.2	**9.2**	
1988 Q4	9.0	9.5	**12.0** //	11.5
1989 Q4	8.8	10.5	**12.0**	9.5
1990 Q4	8.4	10.5	**11.0**	
14. MO (per cent change on a year earlier)				
1987-88	5	4.9	**4.9**	
1988-89	1-5	5.1	**7.1** //	
1989-90	1-5	1.9	**2.8**	
1990-91	0-4	0.9	**3.4**	
15. STERLING INDEX (1975=100)				
1987 Q4	74.9	74.9	**74.9**	
1988 Q4	75.5	76.7	**75.0**	75.3
1989 Q4	74.4	74.3	**73.2**	73.7
1990 Q4	74.1	72.9	**71.0**	
16. £/DM EXCHANGE RATE				
1987 Q4	2.94	2.94	**2.94**	
1988 Q4	3.00	3.08	**3.10**	
1989 Q4	2.97	2.96	**3.03**	
1990 Q4	2.91	2.84	**2.90**	
17. RELATIVE UNIT LABOUR COSTS (1980=100)				
1987	76.5	76.7	**75.5**	
1988	79.5	82.1	**79.1**	
1989	80.4	80.8	**79.2**	
1990	80.7	80.1	**77.9**	
F TRADE AND CURRENT ACCOUNT				
18. VOLUME OF NON-OIL EXPORTS OF GOODS AND SERVICES (per cent change on a year earlier)				
1987	6.8	6.7	**6.5**	
1988	4.2	2.8	**2.9**	
1989	3.6	6.5	**6.6**	
1990	5.4	5.0	**4.6**	
19. VOLUME OF NON-OIL IMPORTS OF GOODS AND SERVICES (per cent change on a year earlier)				
1987	8.5	8.4	**8.1**	
1988	6.4	9.5	**12.7**	
1989	4.4	6.1	**4.4**	
1990	4.9	3.2	**1.9**	
20. CURRENT BALANCE £ billion				
1987	-1.7	-1.6	**-2.5**	
1988	-3.9	-9.3	**-13.8**	-12.5
1989	-4.6	-10.1	**-14.0**	-11.8
1990	-4.3	-9.0	**-12.9**	

(1) MAIN ISSUES

The world economy

3. GNP in the major industrialised countries and world trade in manufactures have grown strongly over the past year. The growth rate of real GNP in the major seven may now be moderating and is forecast to be in line with potential in 1989. Average consumer price inflation in the major seven has so far remained around 3 per cent, but a slight pick up in 1989 is forecast as a result of demand pressures, particularly in the US. The Fed is assumed to respond by some further tightening of monetary policy in 1989. Forecast growth of world trade in manufactures is still relatively high at 7¼ per cent in 1989 and 5 per cent in 1990. This favourable world background assumes that the further modest reductions in the external imbalances of the three large economies occur without major implications for exchange rates or interest rates.

UK demand and output

4. Interpretation of recent developments and assessment of prospects are hampered by huge discrepancies in the national and sectoral accounts, which are in a greater state of disarray than previously experienced. Growth of the expenditure measure of GDP is almost certainly under-recorded over the past three years, particularly in the first half of 1988. (The "compromise adjustment" accounts for 1¾ per cent of GDP growth in 1988, more than the overshoot of the FSBR forecast.) It is impossible to assess the financial position of the personal or corporate sectors with precision.

5. The personal sector has become a net payer of interest in 1988. With its very high gross debt/income ratio and record level of income gearing, it is now much more vulnerable to rises in short term interest rates than in the past. Sharp rises in the value of equities (until 1987) and housing wealth have allowed the personal sector to continue borrowing while maintaining a strong financial position. Consumers' expenditure has risen rapidly and the savings ratio has fallen. But following the recent rise in base rates personal sector net interest payments will rise sharply. In addition the forecast marked deceleration in house prices in 1989 will act as a brake on personal sector wealth and therefore consumption. In this less favourable financial climate the need to save will be greater. The saving ratio should therefore, after a short lag, rise a little from its current low level. This will involve a sharp deceleration in consumers' expenditure, though forecast growth in 1989 is - at 3 per cent - respectable by any standards except those of the last three years.

6. There is an enormous balancing item in the personal sector accounts - equal to about 8 per cent of personal disposable income. (The likelihood is that both personal income and expenditure are under-recorded, though the former by more than the latter.) This suggests that the savings ratio could be higher than the official figures suggest. If this were the case the deceleration in consumers' expenditure could be less marked than forecast. But even allowing for some under-recording of income, the savings ratio has fallen to historically low levels, and some rise is very likely.

7. The strong rise in **fixed investment** during 1988 should moderate in 1989. The effects on investment in 1989 of higher than expected growth in 1988 and the recent rise in base rates will probably more or less offset each other.

8. The slowdown in both consumption and investment during 1989 should ensure that year on year **GDP growth** falls back close to the growth of potential. But with so many difficulties in assessing what has happened so far this year, the timing of the moderation of growth is extremely difficult to predict. It is conceivable that there may not be firm evidence of the deceleration of consumers' expenditure until well into the first half of 1989, and later still for fixed investment.

The balance of payments

9. The recorded deterioration in the current account has occurred despite fast growth of world trade and of UK exports of manufactures. The rapid growth of domestic demand has led to a historically very high growth in the volume of imports of goods and services.

10. The loss of labour cost competitiveness in 1987 and capacity constraints in certain industries have probably contributed to the deterioration in the current account. The problem may, however, be worse than survey evidence suggests. With highly competitive and - in the EC - closely integrated and geographically close markets for manufactures it may well be more difficult directly to observe capacity constraints than in the past. Shortages of materials and parts or production bottlenecks may not be as visible because it is easier than in the 1960s or early 1970s to obtain supplies from abroad at short notice. The continuation of the rise in profit margins on manufactured exports during 1988, in spite of a worsening of measured competitiveness, is further evidence of capacity constraints that have almost certainly contributed to the sharp acceleration in imports. Capacity constraints may also have held down export growth as exporters have switched production to satisfy buoyant

domestic demand. One of the principal difficulties in the forecast is to assess the extent and speed with which adverse capacity effects on the current account will be reversed. The forecasts for exports and imports do assume some reversal of such effects during 1989 and 1990.

11. Progress in reducing the current account deficit could be slow at first. Growth of visible exports, which has to be 2½ per cent more than import growth for the visible balance not to deteriorate, is likely to moderate as world growth eases. Domestic industry may continue working at high capacity utilisation rates for the next few quarters. Thereafter, with domestic demand decelerating, the current account deficit should begin to fall.

Inflation and money GDP

12. Short term movements in RPI inflation will be dominated by movements in the mortgage rate. If base and mortgage rates stay at current levels during 1989 the peak monthly inflation rate is forecast to be at 7¼ per cent in July 1989.

13. It is more difficult to assess the behaviour and prospects for underlying inflation. Both producer prices and the RPI excluding mortgage interest payments have been slowly accelerating through 1987 and 1988, with inflation rates at 5 per cent by the second half of 1988. This primarily reflects a continuation of the strong build up in profit margins over the past six years. The forecast is for a further rise in underlying inflation in the first half of 1989 to 5½ per cent. Thereafter inflation falls slowly as margins level off and earnings growth moderates.

14. Boosted by overtime payments, growth of private sector **average earnings** has risen slightly over the last year. Indeed the low level and very modest acceleration of wage settlements during two years of boom and gradually rising price inflation have been surprising features of recent economic performance. Because earnings and settlements have not been very sensitive to changes in activity recently, the forecast has a mild deceleration over the next two years.

15. Growth of the **GDP deflator** in 1988-89 is forecast to be above the conventional measures of underlying inflation. This is the result of fast rises in the prices of investment goods and in public sector consumption (the latter mainly reflecting growth of earnings) and an improvement in the terms of trade. **Money GDP** in 1988-89 rises at 11 per cent, compared with 10 per cent in the previous year. Growth of money GDP falls in both 1989-90 and 1990-91.

Financial conditions

16. The forecast has money GDP growth and underlying inflation above the 1988 MTFS paths. MO, however, comes back within its target range during 1989-90. The sterling index and important bilateral exchange rates fall a little from their present level during the forecast period. To achieve this degree of monetary tightness **short term interest rates** stay at 12 per cent until the end of 1989 and fall little thereafter.

17. There are great uncertainties attaching to any judgement on the appropriate level of short term interest rates necessary to achieve a particular degree of monetary tightness. The main risk in the short run is that short term interest rates may need to be higher than in the forecast to exert the necessary downward pressure on money GDP and inflation. In the absence of evidence of decelerating demand the exchange rate could come under significant pressure at a time when the current account is persistently in large deficit and UK inflation is above the G7 average - and indeed in 1989 above forecast inflation in every other G7 country.

Public finances

18. Public finances have continued to perform more strongly than expected, mainly as a result of higher activity and inflation. The buoyancy of the economy has probably contributed to the expected shortfall of public expenditure on plans in 1988-89, as well as boosted revenue. It could well be, however, that 1988-89 turns out to be the year in which the conjunctural position has been most beneficial for public finances. With slower growth it is much less likely that performance on public finances will continuously be better than expected as in the last two years.

19. There have been particular difficulties in producing the forecast for public expenditure. Inflation, as measured by the GDP deflator, is now estimated to have been a little higher in 1987-88 than assumed in the last PEWP and is forecast in 1988-89 to be over 2 percentage points higher than assumed in the PEWP. While this unanticipated inflation has been accompanied by some agreed rises in cash limits this year, spending has been squeezed in real terms. Inflation is forecast to be higher than currently assumed in the last PEWP and MTFS in each of the next two financial years. A key issue in the forecast is the extent to which there will be a further real squeeze on spending next year from unanticipated inflation and to what extent there will be overspending or future uplifting of cash plans. The forecast assumes that while the real terms squeezes of the past two years will intensify bids for more expenditure from 1989-90

onwards this will not be sufficient to offset fully the higher forecast inflation. The level of public expenditure in real terms in future years is lower than in recent forecasts.

20. The (pre-fiscal adjustment) forecast for taxes for 1989-90 benefits from a further large increase in onshore corporation tax following the large expected rise in profits for 1988. Nevertheless total taxes and NICs (before fiscal adjustment) are forecast to rise only slightly as a percentage of GDP in 1989-90. With the working assumption of a constant PSDR ratio (excluding privatisation proceeds) there is scope only for very modest cuts in personal tax cuts in the 1989 or 1990 budgets, which is more the result of a forecast fall in the GGE ratio than the small rise in the tax ratio.

21. The UK is now running a larger budget surplus - as measured by the general government financial balance - than any other G7 economy, including Japan, and is assumed to continue to do so.

TABLE 2 : GENERAL GOVERNMENT FINANCIAL DEFICITS (per cent of GDP)

	1986	1987	1988	1989	1990
UK*	2½	¾	-1	-1	-1
G7 (less UK)	3	2½	2¼	2¼	2

*Financial years.

(2) THE WORLD ECONOMY

22. There was a spurt in the growth of world trade and output in the second half of 1987 and in the first half of 1988. Real GNP in the major seven industrialised countries was 4¼ per cent higher in 1988Q2 than a year earlier. Over the same period total world trade and world trade in manufactures may both have risen by almost 10 per cent, reflecting the continued buoyancy of G7 imports and an acceleration in the imports of many developing countries. If achieved, G7 real GNP growth of 4 per cent in 1988 will only have been exceeded once in the last ten years (in 1984).

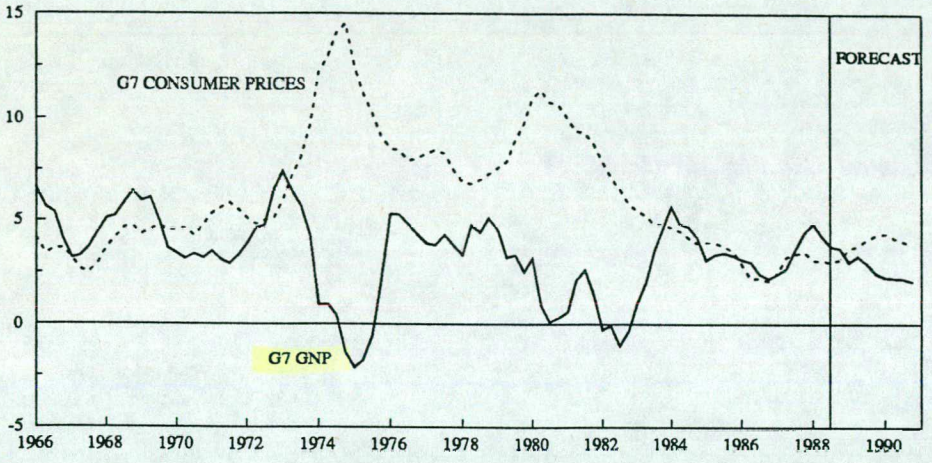
TABLE 3 : G7 (EXCLUDING UK) GROWTH AND INFLATION

Percentage changes on a year earlier	1987	1988	1989	1990
Real GNP	3.2	4.1(4.1)	3.0(3.0)	2.3
Domestic demand	3.6	4.2(4.2)	3.1(3.2)	2.4
Industrial production	3.1	5.6	4.4	2.3
Consumer prices	2.5	2.8(3.2)	3.6(3.5)	3.9

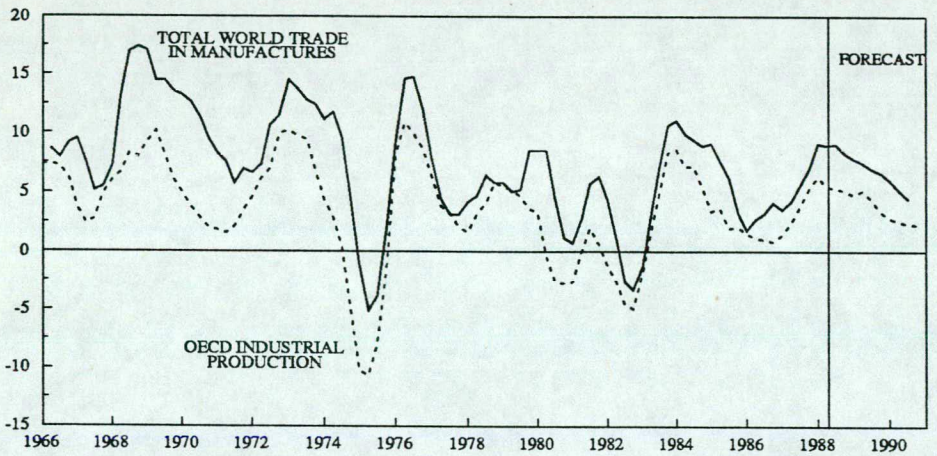
Note: Figures in brackets are IMF forecasts for G7 including UK.

23. G7 GNP and world trade are expected to grow slightly more slowly in the second half of 1988, and then to grow in line with potential in 1989. If real growth in 1989 is 3 per cent as forecast, the major seven will have experienced seven years of growth at an average rate of 3½ per cent.

CHART A : G7 GNP AND CONSUMER PRICES
(Percentage Change Over Year Earlier)



OECD INDUSTRIAL PRODUCTION AND WORLD TRADE
(Percentage Change Over Year Earlier)



24. Growth of world trade has been strong because not only the G7 but other countries have increased their imports rapidly. The four Asian NIEs have experienced particularly rapid import growth. But many other developing countries are now increasing their imports, in part because rises in commodity prices have improved their external position. Some slow down in the growth rate of world trade seems probable in 1989 as the spurt in demand and activity in the major countries starts to fade, though world trade in manufactures may still grow strongly at about 7 per cent. Other factors contributing to slower import growth are weak oil prices, which may cause OPEC and other oil producers to adjust more rapidly than the beneficiaries of lower prices, and higher interest rates, which will limit the capacity of heavily-indebted countries to increase imports.

TABLE 4 : THE VOLUME OF WORLD TRADE IN GOODS

Percentage changes on a year earlier	(Share of 1986 imports)	1987	1988	1989	1990
World trade (imports)	(100)	5	8¾	6½	4¾
of which:					
- Major seven	(54)	6	9¾	6½	4½
- Other developed	(26)	6¼	7	6½	5
- OPEC	(5)	-11	1¾	-4¾	-4½
- NICs	(5)	20¾	17	13¾	12
- Other developing	(10)	-1	7	6½	5
World trade in manufactures		5½	8¼	7¼	5

25. **Non-oil commodity prices** rose very rapidly during 1987 and the first half of 1988. Real industrial materials prices in 1988Q2 were some 20 per cent higher than a year earlier. Spot prices have since fallen back a little, but have maintained most of the earlier rise. Over the forecast period real commodity prices are expected to remain steady.

26. **Oil prices** have been very weak recently in spite of strong world activity because many OPEC members have expanded their output. The forecast assumes that OPEC will have limited success in reimposing quotas. Only a modest recovery in prices is expected, and the average North Sea price is projected to rise from its current level to $14 by the middle of 1989, and remain constant thereafter.

27. **Consumer price inflation** in the major industrial countries has been around 3 per cent for some time. There are some signs of inflationary pressures in countries where capacity utilisation is approaching previous peaks - especially the United States - and indirect tax increases are expected in Japan and Germany. Recent rises in interest rates in G7 countries should help limit the rise in inflation, but G7 inflation is forecast to rise to 4 per cent next year.

(3) INTEREST RATES, THE EXCHANGE RATE, AND COMPETITIVENESS

28. The forecast has a path for short term interest rates that, in the light of the rest of the forecast, is judged to be consistent with a gentle decline in the exchange rate. It does not bring the growth of money GDP close to the path in the 1988 MTFS, though MO does come within its target

range. The path for the exchange rate, together with forecasts of unit labour costs at home and abroad, imply little change from now on in the level of labour cost competitiveness.

TABLE 5 : EXCHANGE RATES AND COMPETITIVENESS

	Base rates	Sterling Index	$/£	Dm/£	Labour cost competitiveness*
1985	12.3	78.2	1.30	3.79	85.0
1986	10.9	72.8	1.47	3.19	77.4
1987	9.7	72.6	1.64	2.94	75.5
1988 Q1	8.8	75.1	1.79	3.01	77.5
Q2	8.2	77.8	1.85	3.14	80.4
Q3	10.8	75.9	1.70	3.16	79.2
(Oct 11)	12	76.4	1.72	3.18	
1988 Q4	12	75.0	1.68	3.10	79.1
1989 Q4	12	74.1	1.67	2.98	79.3
1990 Q4	11	71.0	1.65	2.85	77.9

* UK unit labour costs relative to those of trading partners. A fall implies an improvement in competitiveness.

29. It has been particularly difficult to form a judgement on the path of interest rates consistent with the exchange rate projection. The differential between UK short rates and eurodollar rates was around 3½ percentage points on average during 1985 to 1987. With UK base rates at 12 percent until the first quarter of 1990 the current differential of about 2½ percentage points with Eurodollar rates is maintained. Thereafter there is a small fall as UK rates fall by more than Eurodollar rates.

30. Interest rates have to stay at current levels for some time to slow down domestic demand and to attract the inflows necessary to finance the current account deficits expected over the next few years. Market analysts now expect large trade deficits to persist for a number of years and this does not seem to have had an adverse effect on confidence. It therefore seems likely that the predicted path of interest rates should be sufficient to attract the required foreign capital.

31. Table 6 shows the financing of the current account deficit. A large part of the finance comes from the balancing item. This item could, of course, reflect unrecorded earnings, implying that the current account is actually much smaller than the number published by the CSO. Irrespective of whether the balancing item reflects errors on the current or capital account, the forecast suggests that identified foreign capital inflows of between £4 and £5 billion will be needed each year from 1988 to 1990. The UK generally spends more on direct investment overseas than foreigners spend in the UK. This is likely to continue unless there is a big rush of

inward investment from outside the EC in the run-up to 1992. It has been assumed that the level of the net direct outflow continues at much the same rate as in the first half of 1988. The implication is that sterling inflows to banks - which are perhaps the most volatile form of finance - will need to average £10 billion per year between 1988 and 1990. There is a risk that foreigners' confidence could be upset by various factors such as temporary increases in the UK inflation rate. This would make it more difficult to achieve these inflows at the assumed level of interest rates.

TABLE 6 : FINANCING THE CURRENT ACCOUNT DEFICIT (£ BILLION)

	1988	1989	1990
Current Account	-13.8	-14.0	-12.9
Balancing Item	9.7	9.0	8.5
Required Identified Capital Inflows	4.1	5.0	4.4
of which:			
Net direct investment	-7.5	-7.2	-6.8
Net non-bank non-govt portfolio	-6.9	-3.4	-4.3
Net Banks £	12.6	8.8	8.8
FC	3.2	3.2	3.2
Net general government*	0.0	1.7	1.5
Other	2.7	2.0	2.0

* includes reserves

(4) TRADE AND THE BALANCE OF PAYMENTS

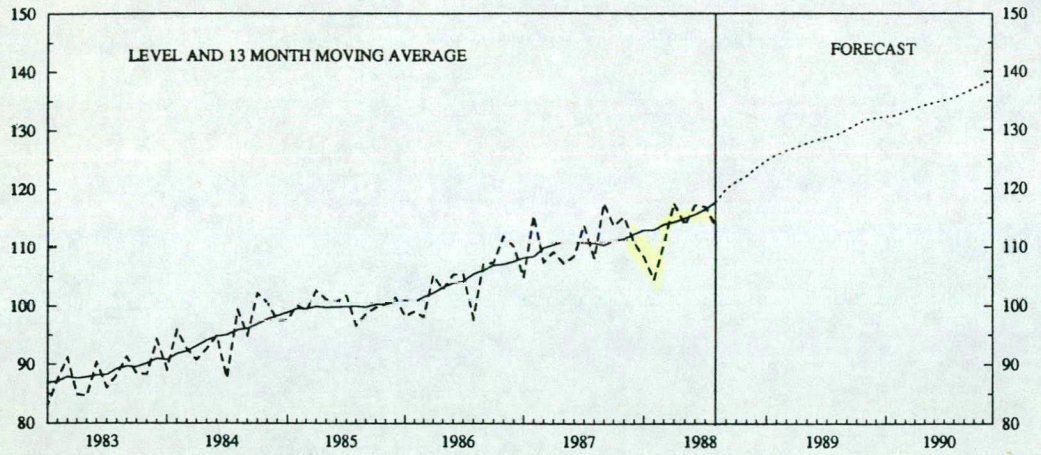
32. The latest estimates of the current account show a cumulative deficit of £9¼ billion for the first eight months of the year. This compares with a deficit of £2½ billion for the whole of 1987. The main contribution to this deterioration has come from the visible balance where the average monthly deficit in 1988 so far has been £¾ billion higher than in 1987. But there has also been a marked deterioration in the invisibles balance with the average monthly surplus being about £¼ billion lower than in 1987.

33. Chart B shows the underlying trends in import and export volumes. The recent deterioration in trade performance owes more to exceptional import growth than to poor export performance. This conclusion is strengthened by the suspicion that the 1988Q1 export figures in particular might still be subject to some under-recording as a result of the change in Customs procedures. While the published figures already incorporate some allowance for this, independent evidence on engineering export sales suggests that recorded exports might still be too low in 1988Q1. On the other hand, the latest survey by Customs and Excise for March of this year did not suggest

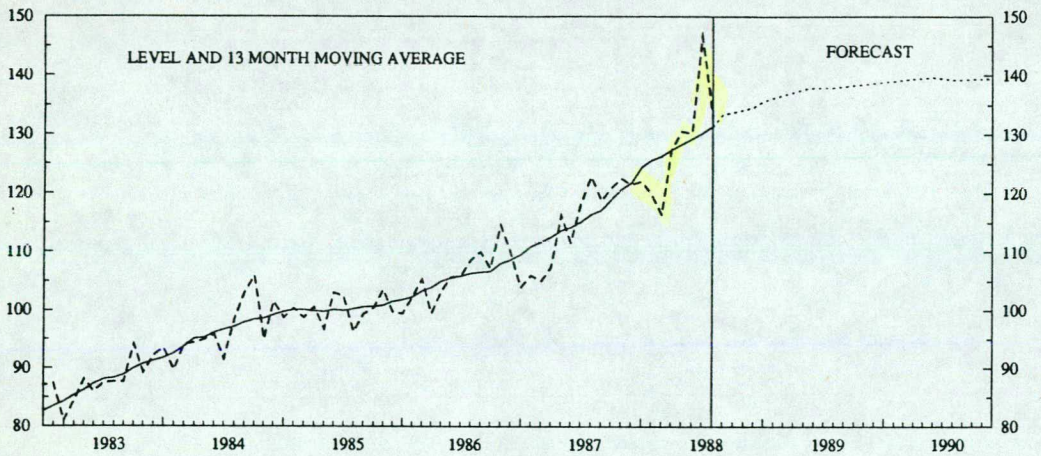
significant under-recording, and the data for manufacturing output and the CBI survey are consistent with some pause in export growth in 1988Q1.

CHART B: NON-OIL IMPORT AND EXPORT VOLUMES

NON-OIL EXPORT VOLUMES



NON-OIL IMPORT VOLUMES



34. In more recent months, the upward trend in non-oil exports has been resumed. Declining competitiveness and possibly also the effects of capacity constraints at home may have been restraining the growth of exports. In contrast, recent data on non-oil imports show a continuation of the strong upward trend.

35. Against a background of rapid UK domestic demand growth and the worsening in competitiveness since last year, a further deterioration in the **non-oil visible balance** is forecast through the rest of 1988. The oil surplus will be lower in the second half of the year than it was in the first, due to the combined effects of Piper Alpha and a lower sterling oil price. With the invisibles surplus also projected to decline, the current account deficit for 1988 is forecast to be £13.8 billion, 3 percent of GDP.

36. In 1989 the current account deficit is forecast to be virtually unchanged at £14.0bn. (nearly 3 per cent of GDP) despite the rapid slowdown in the growth of domestic demand. Three factors help to explain the delay in the turnaround of the current account:

(a) Imports of goods and services are now much higher than exports which implies that exports would have to grow significantly faster than imports in 1989, just to keep the deficit constant. So although the forecast shows exports of goods and services growing 1 percentage point faster than imports in 1989, this is consistent with a small deterioration in the balance on goods and services.

(b) World trade is projected to grow a little more slowly, following a rise of 8¾ per cent in 1988. This slowdown, combined with a slight deterioration in competitiveness, will limit the scope for a rapid improvement in exports.

(c) The surplus on trade in oil is likely to continue on its downward trend. The repercussions of Piper Alpha will be felt throughout the forecast period.

37. After 1989 the current account deficit falls as domestic demand slows significantly.

TABLE 7 : UK CURRENT ACCOUNT (£ billion)

	Visible Trade			Total	Invisibles	Current
	Manufactures	Oil	Other	Visibles		Balance
1986	-5.7	4.1	-7.1	-8.7	8.8	0.1
1987	-7.5	4.2	-6.9	-10.2	7.7	-2.5
1987 Q1	-0.9	1.2	-1.6	-1.3	2.1	0.8
Q2	-1.8	1.0	-1.6	-2.4	2.0	-0.4
Q3	-2.3	0.9	-1.9	-3.2	2.1	-1.1
Q4	-2.5	1.1	-1.8	-3.3	1.4	-1.9
1988 Q1	2.9	0.9	-2.0	-4.0	1.1	-2.8
Q2	-3.3	0.7	-1.8	-4.4	1.5	-2.9
Forecast						
1988	-14.2	2.3	-7.5	-19.4	5.6	-13.8
1989	-14.7	2.0	-7.4	-20.0	6.0	-14.0
1990	-14.0	1.8	-7.4	-19.6	6.7	-12.9

Non-oil visible trade

38. The volume of manufactured exports rose by 7½ percent in 1987 as the lagged benefits of improved competitiveness in 1986 helped UK manufacturers gain an increased share of world trade. However, exports of manufactures have failed to keep pace with world trade so far this year. While data for recent months show a strong recovery in exports of manufactures from the

poor performance in the first quarter, the growth rate for the year is forecast to be 5 per cent compared with world trade growth of 8¾ percent. Over the rest of the forecast the UK's share of world trade is expected to be little different from its average between 1984 and 1986, though to be a little lower than in 1987.

CHART C: THE UK'S SHARE OF WORLD TRADE IN MANUFACTURES

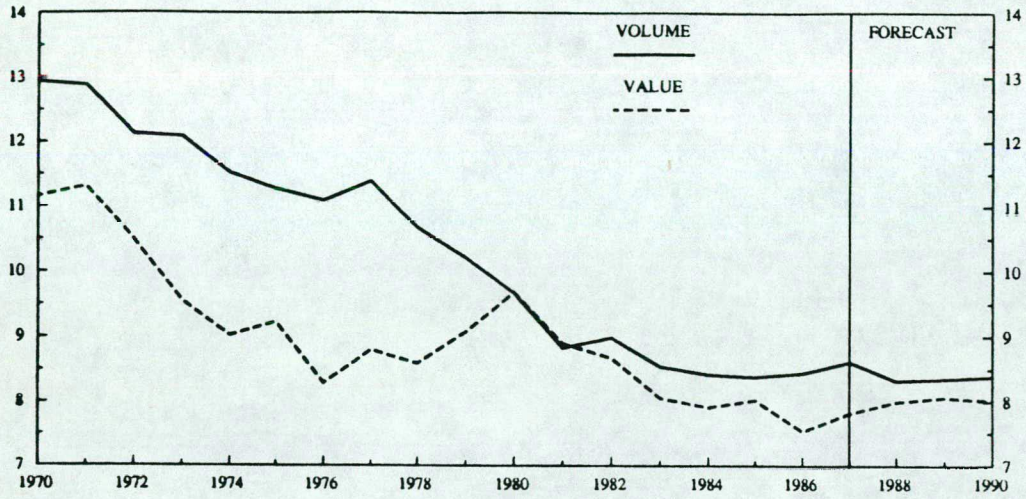


TABLE 8 : WORLD TRADE AND DOMESTIC DEMAND FOR MANUFACTURES AND COMPETITIVENESS

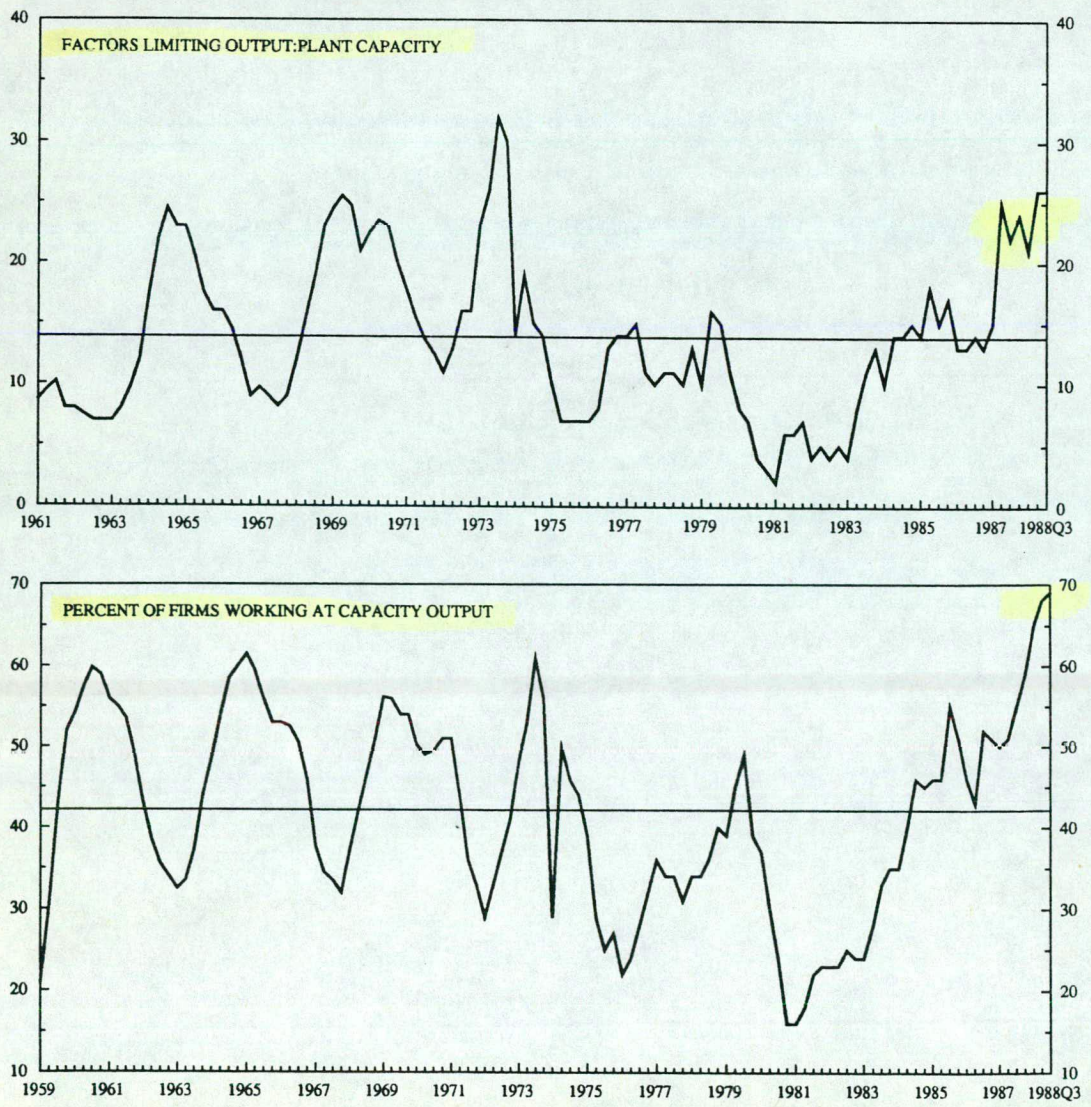
(per cent changes on a year earlier)

	World trade	Domestic demand for manufactures	Relative unit labour costs
1986	2.6	2.2	-9.0
1987	5.4	5.6	-2.3
1988	8.7	7.5	4.7
1989	7.3	3.6	0.2
1990	4.9	2.0	-1.7

39. The volume of imports of manufactures rose strongly in 1987 (particularly in the second half) and has grown even more strongly so far in 1988. This reflects very buoyant domestic demand, the worsening in competitiveness, and possibly also the effects of capacity shortages in some industries. The forecast is for imports of manufactures to grow by nearly 17 percent in 1988.

40. The performance of both imports and exports of manufactures in 1988 so far has been worse than expected. Part of the explanation is likely to be that capacity shortages in some industries are currently having an adverse effect. On the exports side, producers may have been diverting exports to the domestic market in response to capacity constraints; higher profit margins on domestic sales than on exports provides some supporting evidence for this hypothesis. There is growing evidence of capacity shortages in certain industries. The proportion of manufacturing firms reporting output below capacity in the most recent CBI survey has fallen to an all time low, and the proportion reporting capacity as an important constraint on output is at a very high level by historical standards. The industries which appear to be particularly constrained at present are metal manufacturing, chemicals, building materials, food, drink and tobacco and motor vehicles. These industries have tended to make an above average contribution to the worsening trade deficit in manufactures, and it is reasonable to attribute part of this to worsening capacity constraints.

CHART D: CBI INDICATORS OF CAPACITY UTILISATION IN MANUFACTURING



41. Some reversal of the adverse capacity effects of 1988 is likely in the later years of the forecast as constraints are eased by the slowdown in the growth of domestic demand and the increase in capacity following strong investment in 1988 and 1989. The forecast makes an allowance for this effect by projecting slightly more favourable rates of growth of imports and exports of manufactures than suggested by the paths of world trade, domestic demand and competitiveness.

TABLE 9 : TRADE IN MANUFACTURES
(per cent change on previous year)

	Volume		Value	
	Exports	**Imports**	**Exports**	**Imports**
1986	3.3	5.9	4.2	8.6
1987	7.6	9.6	11.4	13.3
1988	4.9	16.9	8.1	17.0
1989	7.7	6.1	12.7	11.1
1990	5.3	2.6	9.4	7.1

42. The terms of trade have improved in 1988 so far, helped by sterling's appreciation, and the latest monthly data suggests a further gain in the third quarter. The forecast assumes little further change from the 1988 level; export and import price inflation is predicted to remain close to 4 per cent.

43. The manufactures trade deficit is expected to widen to £14¼ billion in 1988 compared with £7½ billion in 1987 as the rapid growth of import volumes relative to export volumes more than offsets the improvement in the terms of trade. But with import growth slowing down substantially in later years and slowing well below the growth of exports, the manufactures deficit begins to fall in the second half of 1989.

44. 1988 is turning out to be a poor year for (non-oil) **non-manufacturing visible trade**. (Non-manufacturing exports account for about 12 per cent of total exports of goods.) Exports are expected to be unchanged on last year's level. Over the next few years non-manufactured exports should behave more like manufactured exports, so volume growth may be substantial next year. Imports of non-manufactures consist of food, drink and tobacco and basic materials. The former category has shown little growth during 1988 and imports from this sector are likely to fall in line with the slower growth rate of consumer spending. Basic materials imports have also increased surprisingly slowly. (It is worth noting that construction materials, like bricks, concrete and cement are classified as manufactured imports.)

Oil Trade

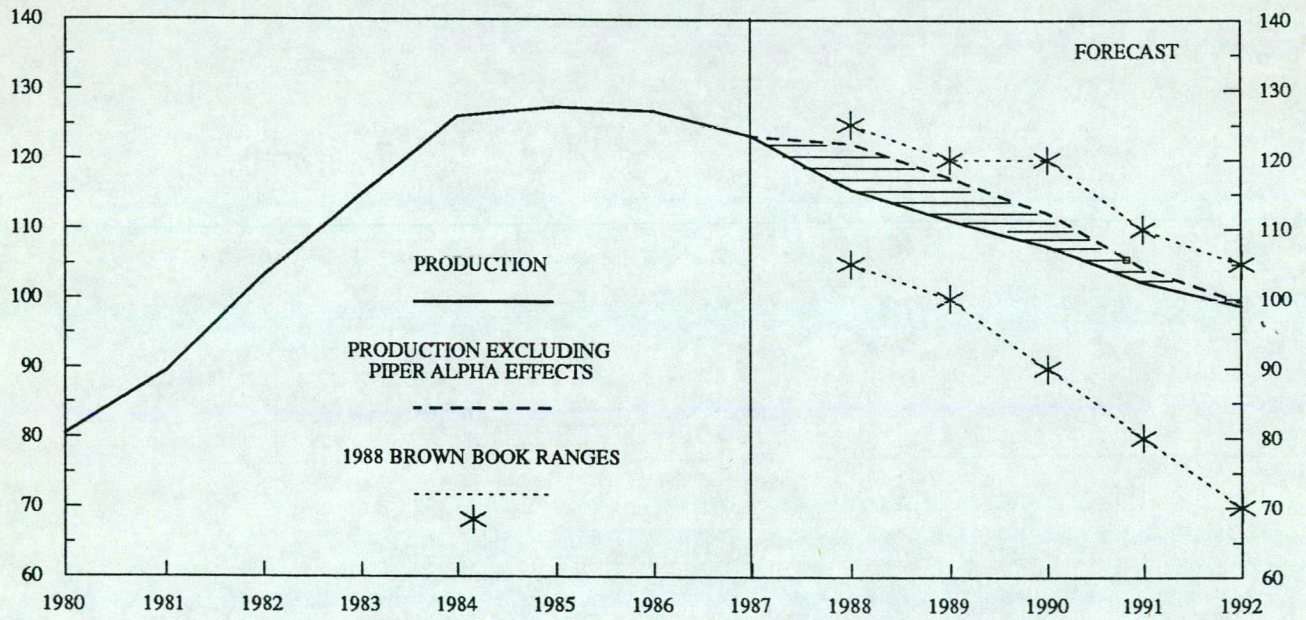
45. The oil trade surplus is expected to fall by almost £2 billion in 1988 for three reasons:

(i) a substantial fall in the sterling oil price;

(ii) a decline in production, mainly caused by the Piper Alpha disaster;

(iii) a recovery in UK demand for oil reflecting the strong growth in domestic demand.

CHART E: NORTH SEA OIL PRODUCTION
(MILLIONS TONNES)



The surplus is expected to fall further in 1989 and 1990 as the downward trend in production continues and domestic demand for oil remains quite buoyant. (Even after Piper Alpha, however, production is expected to remain above the centre of the 1988 Brown Book range.)

TABLE 10 : NORTH SEA OIL

	Average North Sea oil price $/barrel	£/barrel	N Sea output m tonnes (oil + NGLS)	Oil trade balance - £ billion -	N Sea* taxes
1986	14.2	9.7	127	4.1	4.8
1987	17.9	10.9	123	4.2	4.7
1988	14.7	8.4	116	2.3	3.4
1989	13.6	8.1	111	2.0	2.6
1990	14.0	8.4	108	1.8	2.3

* Financial years.

46. The detailed effects of the Piper Alpha disaster are explained in a separate note. The disaster is expected to increase the current account deficit by around £0.3 billion in 1988 and £0.4 billion in 1989. The loss of production is estimated to be worth around £0.4 billion in 1988 and £1¼ billion over the whole forecast period. There will also be substantial losses of tax revenue, but in 1988 this will probably be more than offset by payment of the tax due on insurance payments received by the affected companies.

Invisibles

47. Figures for the first half of 1988 show a very marked deterioration in the invisibles balance from 1987, which is almost entirely due to a decline in the balance on services.

- There has been a deficit on travel of £1 billion in the first half of the year, equal to the whole of last year's deficit. UK residents have been travelling more outside Western Europe, in particular to North America, and have been spending considerably more while abroad.

- The financial services surplus grew dramatically in the 1980s but has fallen back this year. The main cause has been a sharp drop in Lloyds net premiums, which for the year as a whole could be around £½ billion down on the 1987 level. The turnaround in Lloyd's position is attributable to a number of factors: the decline in the dollar since 1987Q3 (over two-thirds of Lloyds business is denominated in dollars); the downturn in the insurance cycle, which is thought to have peaked in the middle of 1987; the catch-up of claims with higher premiums which were introduced to protect Lloyds against large awards in the US courts in compensation cases.

48. The services balance is expected to be £2 billion lower in 1988 than in 198[redacted] Thereafter the surplus is forecast to rise slowly as the small exchange rates depreciation improves UK competitiveness.

TABLE 11 : INVISIBLES
£ billion

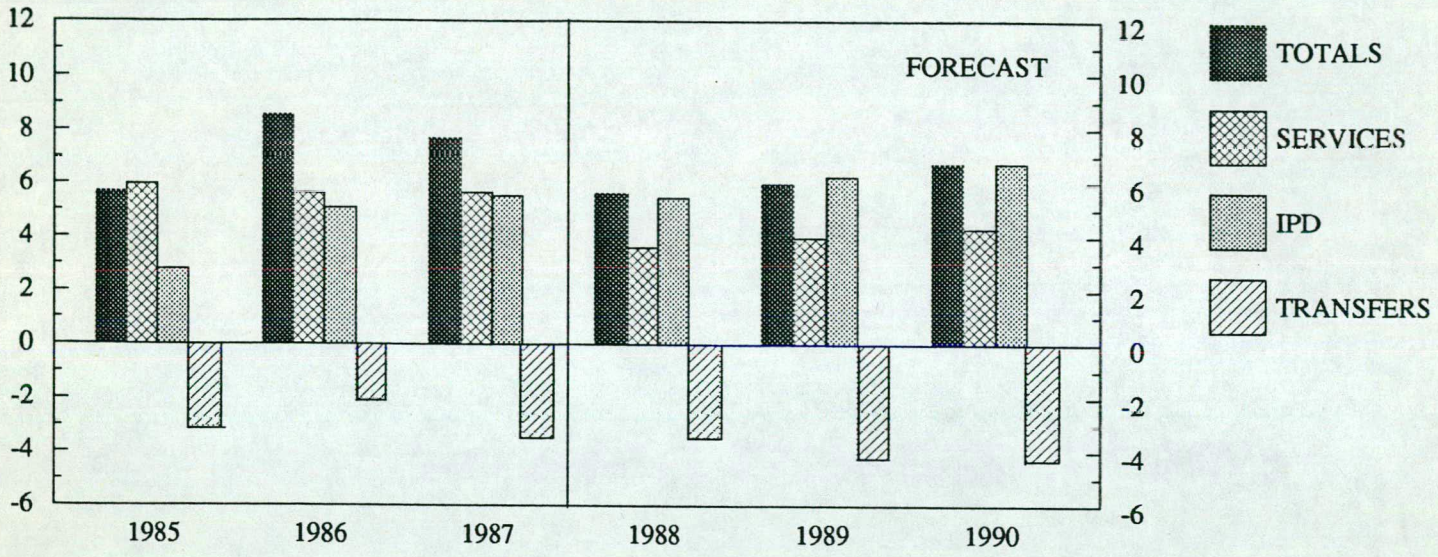
	Services	Oil IPD	Non-oil IPD	EC transfers	Other transfers	Total invisibles	Estimated net overseas assets (end-year)
1986	5.6	-1.3	6.3	-0.7	-1.5	8.8	114
1987	5.6	0.3	5.2	-1.8	-1.7	7.7	90
1988	3.6	1.2	4.3	-1.3	-2.2	5.6	98
1989	4.0	1.9	4.4	-2.1	-2.2	6.0	100
1990	4.3	2.1	4.6	-2.1	-2.2	6.7	106

49. **Net IPD earnings** in the first half of 1988 were close to their average level in 1987, although this hides an improvement in the oil balance, offset by a reduction in the non-oil surplus. Net oil IPD earnings should continue to rise as the declining level of production reduces payments abroad by North Sea companies. However the non-oil IPD surplus is expected to fall by almost £1 billion in 1988, due in part to the very low UK portfolio earnings and the subsequent repatriation by UK companies of part of their overseas assets after the October crash. Over the rest of the forecast the non-oil IPD surplus is flat. High bilateral aid led to the transfers deficit being erratically large in 1988H1. Over the forecast, the deficit on net transfers is expected to be a little higher than of late, as transfers to the EC increase.

50. The invisibles surplus for 1988 as a whole is likely to be around £2 billion lower than in 1987. As a percentage of money GDP this represents a decline from 2¼ per cent in 1986 to 1¼ per cent in 1988 at which level it is expected to remain over the forecast.

CHART F: INVISIBLE BALANCES

LEVELS (£,BILLIONS)



51. Large current account deficits are usually associated with a decline in a country's net asset position. However, the large deficits are expected to be accompanied by unusually high balancing items. The required net identified capital inflows are therefore quite small. For the purpose of forecasting invisibles and net foreign assets the forecast assumes that the balancing item reflects errors of equal magnitude in the capital and current accounts. The effect of sustained recorded current account deficits on forecast net foreign assets is offset by assumed unidentified current account credits (half the forecast balancing item) and by the positive revaluations of foreign assets (in sterling) as the exchange rate declines. As a consequence the published, identified, net overseas asset position is expected to remain at around £100 billion up to end-1990.

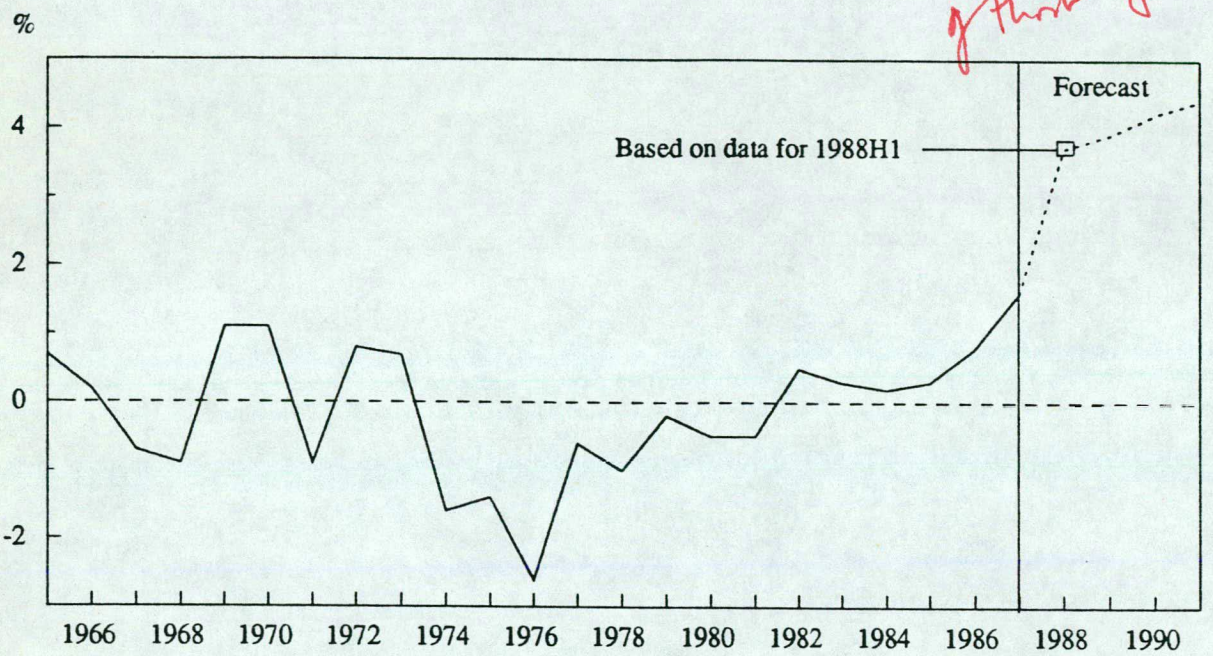
(5) THE NATIONAL AND SECTORAL ACCOUNTS

52. Serious inconsistencies in the national accounts continue to hamper interpretation of recent developments and assessment of prospects. Data revisions in the 1988 Blue Book led to some improvements to the annual data to 1987. The **residual error** (the difference between the current price income and expenditure measures of GDP) was reduced over 1985-87. But it was still 1½ per cent of GDP in 1987, and there remains a marked upward

trend over the past decade (Chart G). There were analogous improvements to annual estimates of the **compromise adjustment** (the difference between the average measure of real GDP and the expenditure measure of real GDP). But again there is an upward trend in the data. Despite these improvements, the **sectoral balancing items** deteriorated sharply over 1985-87. The personal sector balancing item (including life assurance and pension funds) is particularly disturbing; it is put at £22 billion in 1987, about 8 per cent of personal disposable income. There is a strong suspicion (now shared by the CSO) that the nominal and constant prices estimates of the expenditure measure of GDP have systematically understated actual growth over the past three years.

CHART G: RESIDUAL ERROR

(Proportion of GDP(E))



53. The problem has intensified with initial estimates of GDP in the first half of 1988. The residual error was an unprecedented 3½ per cent of nominal GDP(E) in 1988H1. GDP(E) rose much more slowly than the other measures, and the compromise adjustment was equivalent to 2½ per cent of real GDP(E). Most of the sectoral balancing items have also deteriorated further though there is a slight improvement in the personal sector).

CHART H: GROWTH IN DIFFERENT GDP MEASURES

(Percentage change on year earlier)

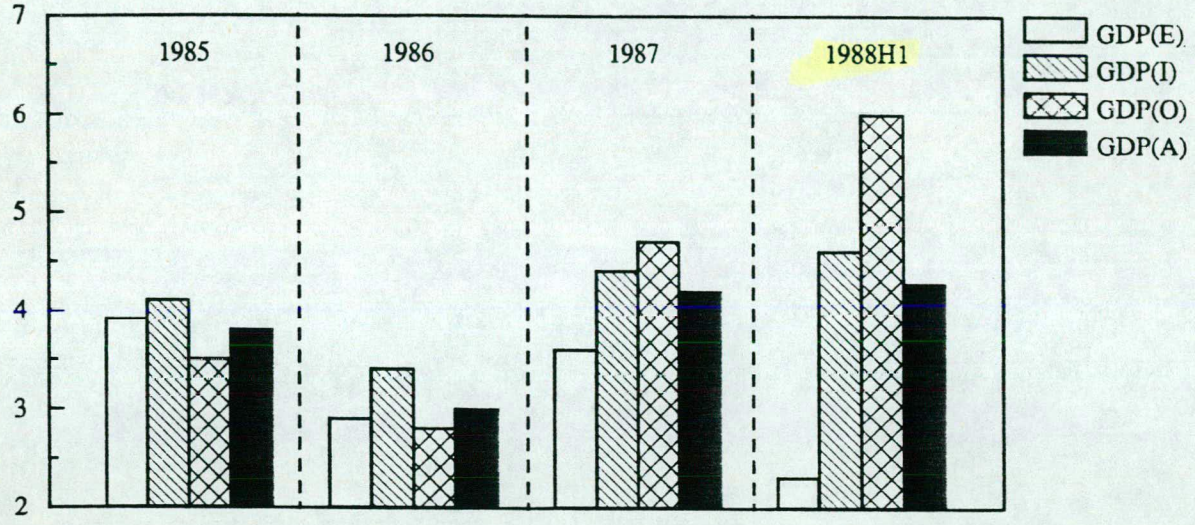
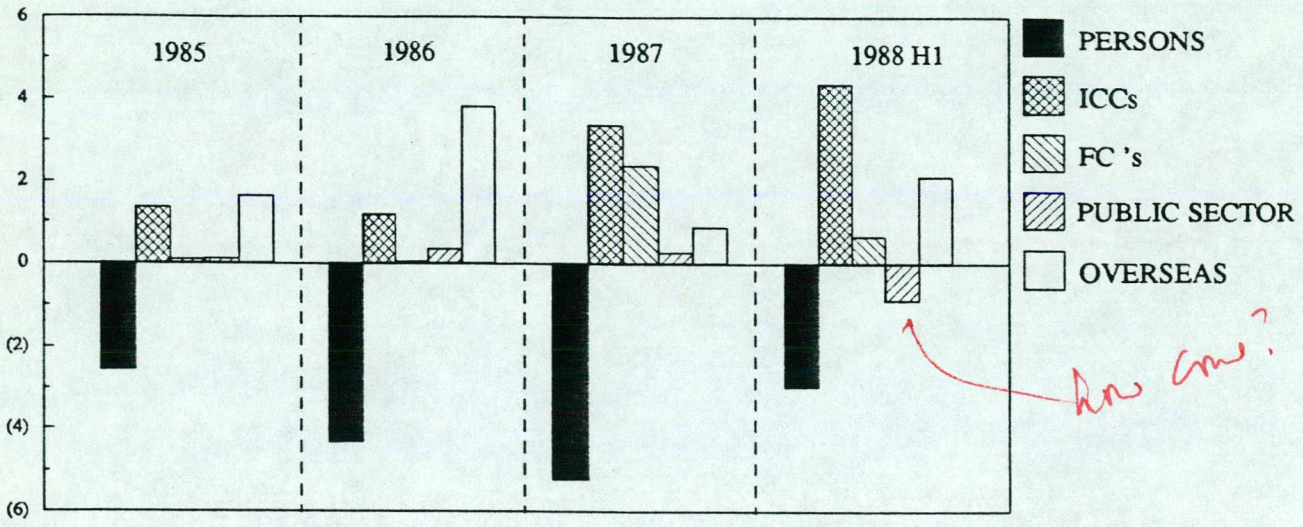


CHART I: SECTORAL UNIDENTIFIED TRANSACTIONS

(Per cent of money GDP)



54. The size of both the residual error and compromise adjustment present forecasting problems. The current forecast maintains the judgements made in June.

(i) The residual error rises over the future, broadly in line with its trend over the decade to 1987, but from the high 1988H1 level.

(ii) The compromise adjustment also rises in line with its long run again trend from the high 1988H1 level. This adds about ¼ per annum to growth in GDP(A) over the forecast period.

55. Neither of these judgements is firmly based. Ideally, we would allocate the past compromise adjustments to the different expenditure components (including exports and imports) according to the degree of uncertainty in their measurement. This would involve creating our own "shadow" measure for GDP(E) and its components. This could cause serious presentational difficulties in published forecasts. Moreover, we just do not know where the greatest uncertainties now are, nor where to allocate the missing expenditure.

(6) THE PERSONAL AND COMPANY SECTORS

Recent developments

56. Personal sector spending has continued to grow strongly 1988, though first estimates of total consumption indicate only marginal growth between the first and second quarters of 1988. The forecast discounts this feature of the data (the same phenomenon was apparent in first estimates in 1986 and 1987). The growth of imports, MO, and VAT in the second quarter are all consistent with faster consumption growth, and upward revisions to the consumers' expenditure data are likely as later information is incorporated. **Retail sales** data for July and August reveal a strong pick up relative to 1988Q2, and **new car registrations** also rose strongly. Together these point to a sharp rise in consumer spending in 1988Q3. **Private sector housing completions** throughout this year confirm other indicators of high levels of **personal sector dwellings investment** in the first half of 1988.

TABLE 12: RECENT PERSONAL SECTOR DEMAND INDICATORS

(Seasonally adjusted)

		Consumers' Expenditure (Percentage change on year earlier)	Retail Sales volume (Percentage change on year earlier)	New car Registrations (Percentage change on year earlier)	Private Housing completions (Thousands per month)
1987	1	4.5	5.1	5.3	14.2
	2	4.2	5.8	3.1	14.3
	3	5.4	6.6	10.1	14.4
	4	6.4	5.6	20.1	14.1
1988	1	6.9	7.8	10.7	16.4
	2	5.4	6.3	8.5	15.3
April			5.0	12.9	15.8
May			8.3	12.9	15.5
June			5.8	4.8	14.6
July			6.9	9.3	20.2
August			6.1	17.0	19.0

57. The 1988 business investment boom predicted by the last two DTI Investment Intentions Surveys (December 1987 and June 1988) and recent CBI Trends Enquiries is confirmed by latest data.

TABLE 13 : INVESTMENT GROWTH

(per cent growth on year earlier)

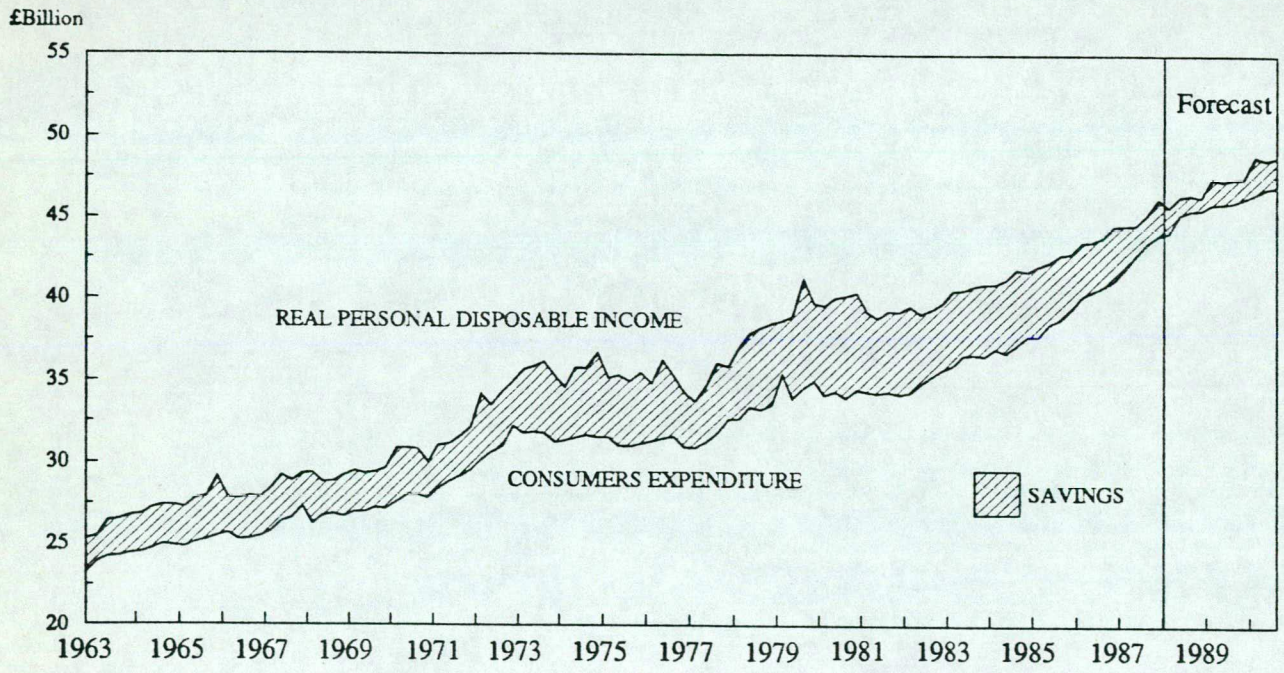
		Manufacturing incl leased assets	Non-manufacturing excl leased assets	Total Business Investment
1987	1	- 12.3*	9.3	- 1.0
	2	12.2	17.9	8.2
	3	9.0	13.1	6.1
	4	13.9	22.7	13.5
1988	1	13.7	15.3	10.4
	2	14.3	9.5	9.0

* This figure reflects a very high figure for 1986Q1, which was itself the result of changes to Corporation Tax in the 1984 Budget.

Personal Income and Expenditure : the forecast

58. **Consumer spending** has grown faster than expected over the last three years and the **saving ratio** has fallen to 4.2 per cent in 1988H1. The most likely explanation is that lower inflation expectations, increased wealth (especially increased housing wealth) and greater consumer confidence, have all reduced the perceived need for saving relative to income. Wealth increases have boosted personal borrowing capacity, and there has been increased demand for (and supply of) credit following financial deregulation and increased competition among financial companies. Overall, consumer spending is expected to rise by nearly 6 per cent in calendar 1988, with the savings ratio falling further (to 2¾ per cent) in 1988H2.

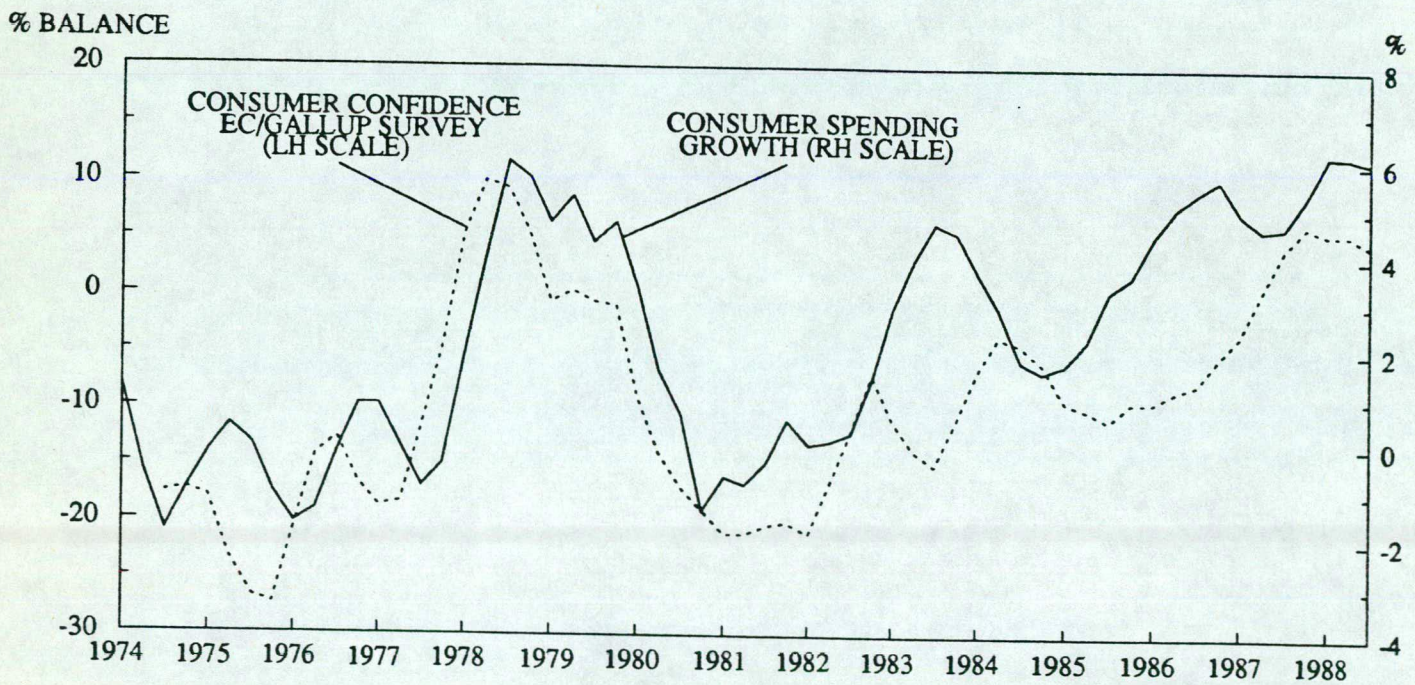
CHART J: PERSONAL SECTOR REAL DISPOSABLE INCOME AND SPENDING



60. There is as yet little or no evidence of a slowdown in consumer spending. Nonetheless, it should decelerate sharply in 1989. The rise in interest rates since the low point of May 1988 should discourage further strong growth in borrowing, and encourage greater saving. Moreover, the sharp rise in consumer debt over the last three years means that persons have become net payers of interest, reversing a long tradition of being net recipients of interest. Any increase in interest rates, therefore, now reduces personal sector disposable income rather than increasing it. (This is set out in more detail in the paper on the effects of interest rates in the forecast being circulated separately.) In addition to these influences, the rise in house prices and housing wealth is expected to abate sharply through 1989. Finally, the EC's UK consumer confidence index fell from a perecentage balance of +9 in June to -2 in September. This comes hard on the heels of recent interest rate increases, and there was a particularly sharp dip in the balance expecting to purchase major consumer durables.

CHART K: CONSUMER CONFIDENCE AND CONSUMER SPENDING

(3 quarter moving average)



61. Against this background, consumer spending is expected to rise by 3 per cent in 1989 and by about 2 per cent in 1990. The saving

ratio should gradually recover throughout 1989 and 1990, though only slowly. However, there may be a risk that consumer spending will rise more slowly than we foresee given what looks like a severe tightening of the personal sector financial position discussed in para 66 et seq.

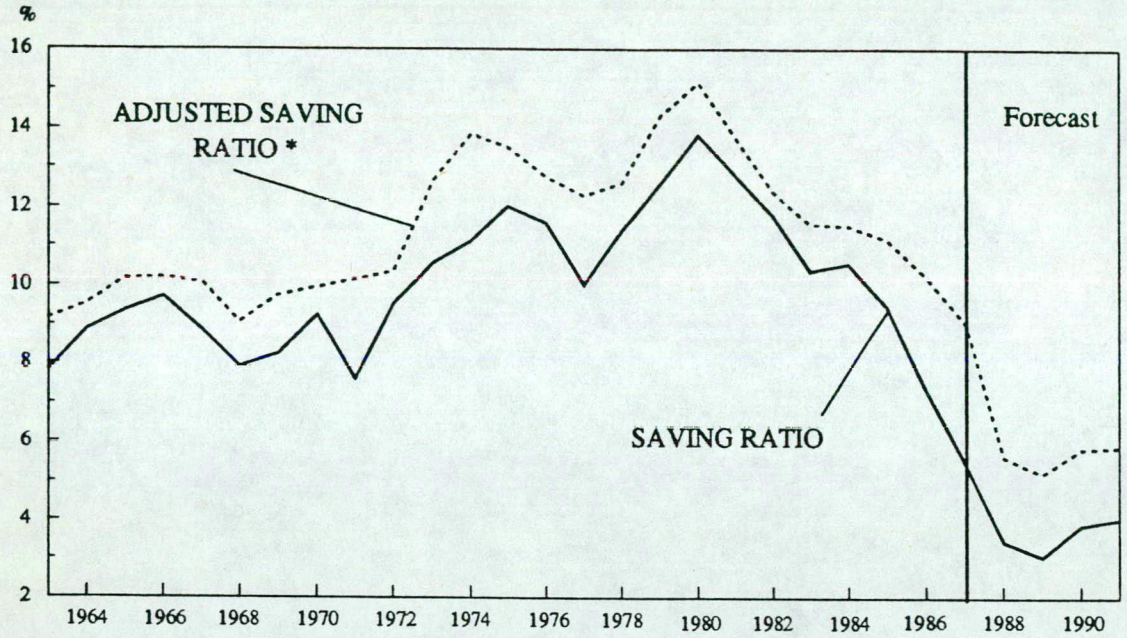
TABLE 14: PERSONAL INCOME, EXPENDITURE AND SAVING

	Real personal disposable income	Real consumer' expenditure	Personal savings ratio
1985	2.3	3.5	9.5
1986	2.9	5.4	7.3
1987	3.0	5.1	5.4
1988	3.6	5.8	3.5
1989	2.7	3.0	3.2
1990	2.7	1.9	3.9

61. How secure is this judgement in the light of the recent enormous personal sector balancing items, which suggest that personal sector income and saving may have been much higher than recorded? By way of illustration, the forecasters have looked at the implications of assuming that 50 per cent of the personal sector balancing item represents unrecorded income. (The personal sector balancing item has always been the same sign, consistent with under-recording of income.) Even on this assumption, it remains true that consumer spending has risen faster than income over the past three years and that the "adjusted" saving ratio has fallen to historically low levels. Even if income growth has been faster than recorded, consumption growth should still moderate relative to income, and the saving ratio should recover slowly over the next two years. (See Chart L). Nonetheless, the extent and timing of these movements could be different.

CHART L: SAVING RATIO

(Savings as per cent of personal disposable income)



* Assuming HALF the personal sector balancing item reflects unrecorded personal income

The Housing Market

62. The housing market has been particularly buoyant over the past year with **private sector investment in dwellings and improvements** expected to increase by 16 per cent in 1988, and mortgage lending projected to rise by about 20 per cent. But this exceptional growth seems to be tailing off. **Building society mortgage commitments** have been around 32 per cent lower in the two months August-September compared with July. The July figure was itself probably boosted by the ending of double MIRAS relief. Nonetheless, some of the fall in the last two months (and September was lower than August) probably does reflect a response to higher mortgage rates. Personal housing investment is forecast to slow markedly in 1989, to under 3 per cent, and to remain flat in 1990.

TABLE 15 : HOUSING FINANCE

(Percent change on a year earlier unless otherwise stated)

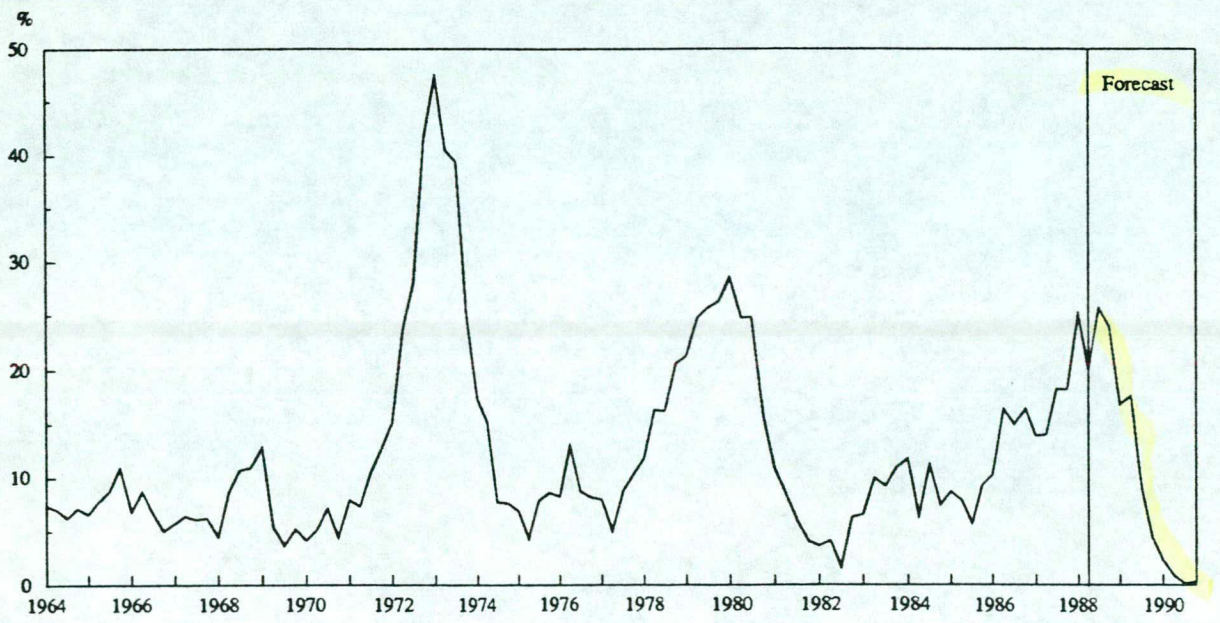
		New House Prices	Mortgage Borrowing from all sources		Estimated Mortgage Equity Withdrawal		Mortgage Rate
			%	£bn	%(1)	£bn	%
1985	Q4	9.2	17.7	19.1	5.3	6.7	13.2
1986	Q4	16.4	20.9	26.6	7.7	11.9	11.8
1987	Q4	18.2	19.3	29.7	6.9	12.6	11.5
1988	Q4	23.9	21.5	39.5	8.8	19.6	11.0
1989	Q4	4.6	15.2	33.9	4.3	11.1	12.8
1990	Q4	0.5	13.5	34.6	4.4	11.3	12.1

(1) As a percentage of outstanding stock of mortgage borrowing

63. The forecast has a dramatic reduction in house price inflation, as income growth slows, higher mortgage rates begin to bite, and new houses started during the current construction boom increase supply. Nevertheless, mortgage borrowing continues to grow fairly rapidly, the growth rate falling only to around 14 percent per annum. In part this represents financing of purchases of new houses and of home improvements.

CHART M: CHANGE IN NEW HOUSE PRICES

(Percentage change on year earlier)



Personal Sector Financial Position

64. The forecast projects a considerable tightening of the personal sector financial position. The forecasts of real consumer spending and housing investment already take account of this tightening through higher interest rates and their impact on income, lower net financial wealth and lower house price increases. Nonetheless, an emerging and significantly new feature of the forecast is that some part of the projected increase in mortgage (and other) borrowing is to sustain consumption and/or service debt. This imparts considerable uncertainty to the outlook for real personal spending.

65. Charts N and O summarise the personal sector's overall financial position. The two measures of net financial wealth shown in Chart N tell very different stories. If individuals disregard their pension fund surpluses when assessing their financial position, the measure excluding LAPFs (life assurance and pension funds) is relevant and this shows a deterioration in the personal sector's position to historically low levels. A similar, but less dramatic, picture emerges from Chart O which includes the value of housing in the measure of personal wealth.

CHART N : PERSONAL SECTOR WEALTH : RATIOS OF NET FINANCIAL WEALTH TO INCOME

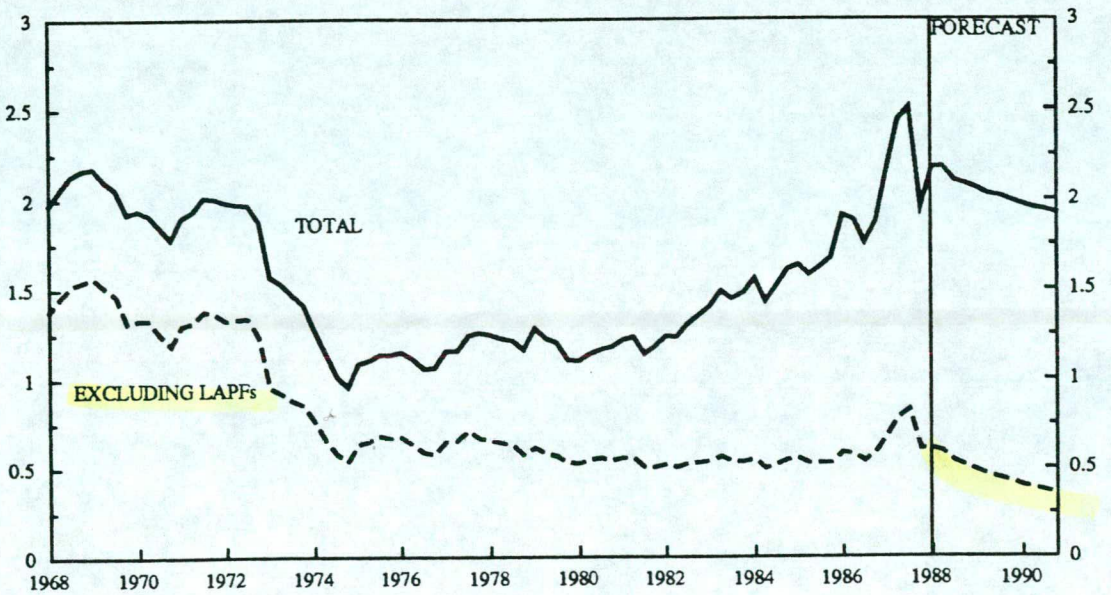
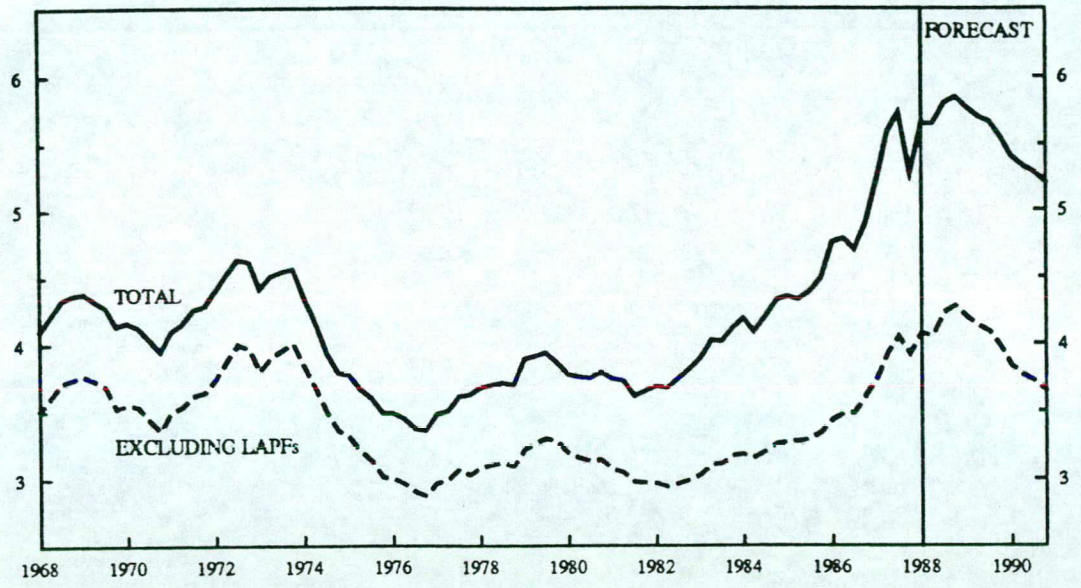
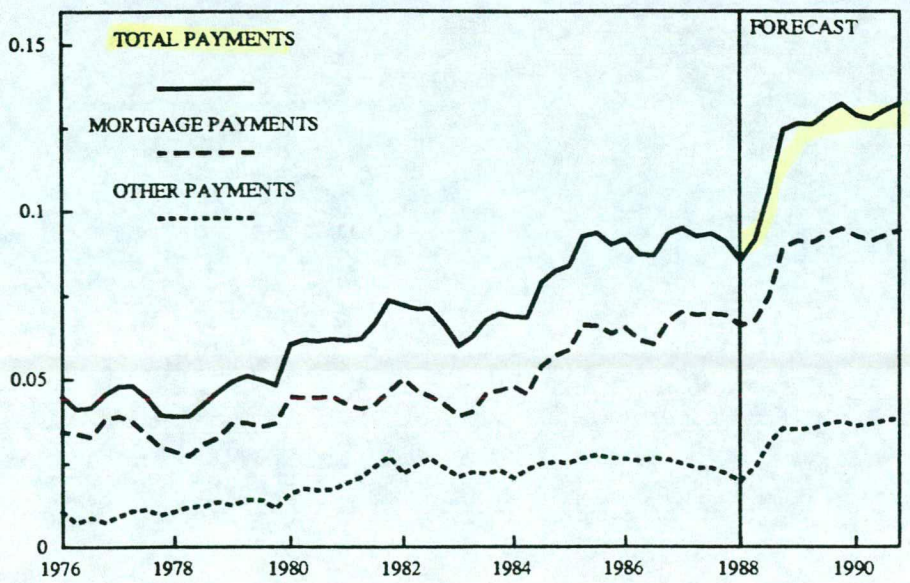


CHART O : PERSONAL SECTOR WEALTH : RATIOS OF TOTAL WEALTH (Including housing) TO INCOME



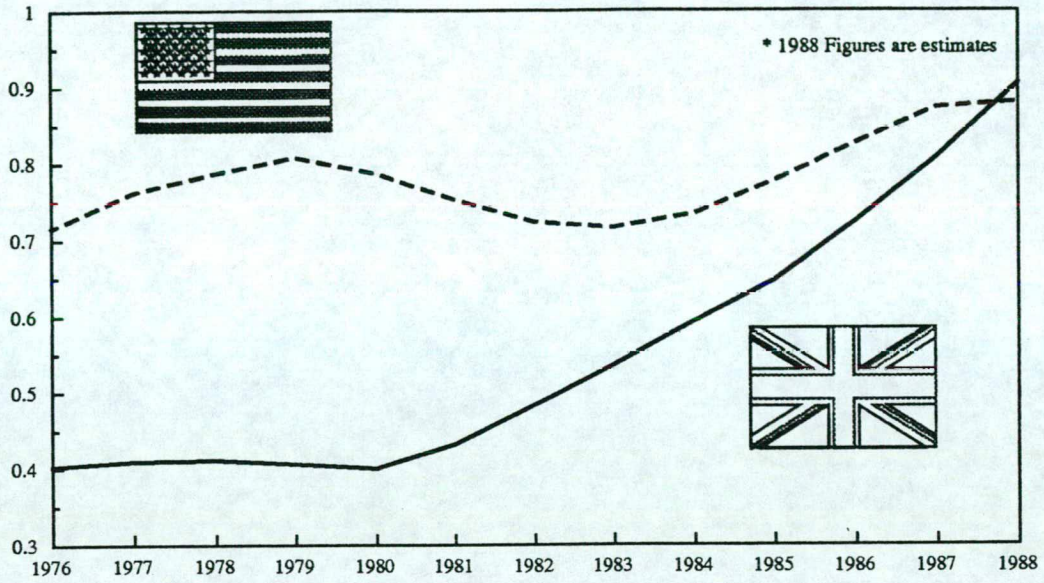
66. An additional indicator of the possible financial squeeze on the personal sector is gross income gearing. The increase in gross debt would raise personal sector income gearing to record levels. Total (gross) interest payments could account for about 14 percent of disposable income by the end of the forecast period.

CHART P : PERSONAL SECTOR INCOME GEARING
(ratio of personal sector gross interest payments to income)



67. The UK personal sector's gross debt-income ratio is currently at a similar level to that in many G7 countries. But the increase projected in the forecast would take the UK well above the average levels observed elsewhere, even the US.

CHART Q : HOUSEHOLD DEBT : INCOME RATIO US V UK



68. High income gearing could involve substantial financial difficulties for a small minority who have over extended themselves to buy a house. They may try to postpone cuts in consumption by lengthening the repayment period of their mortgage. Mortgage arrears and possessions are expected to increase and there could be a rise in the number of personal bankruptcies. But any increases will be from a very low base and will not have any discernible direct macroeconomic impact, except, perhaps, in inducing greater caution in future borrowing.

69. The relatively tight financial position of the personal sector could result in a more serious break in consumer confidence so that persons may rein back their spending by more than assumed in the forecast. On the other hand, financial deregulation has given consumers the ability to borrow more than ever before. They may exploit this to postpone spending cuts, in the hope that rising incomes and a swift reduction in interest rates will solve their problems. It remains to be seen just how the personal sector reacts; but the tight financial position clearly imposes a major uncertainty.

Company Income and Expenditure

70. **Business investment** has already shown very strong growth in the first half of 1988, and this is expected to continue into the second half of the year. Overall, **manufacturing investment** is likely to increase by 18 per cent in 1988 and **private non-manufacturing investment** by 13 per cent. Interest rates may have only a small impact on investment in 1989, and the level of investment is expected to be sustained through 1989 at about the same rate as in 1988H2. Overall, manufacturing investment is expected to be 10 per cent higher in 1989 than in 1988 (though with very little growth through the year) and private non-manufacturing 5 per cent higher (again with little growth - perhaps even a slight fall - through the year). Investment is expected to be flat in 1990, reflecting the sharp slowdown in growth in 1989 and 1990.

TABLE 16: GROSS DOMESTIC FIXED CAPITAL FORMATION
(percentage changes on previous year)

	1986	1987	1988	1989	1990
Business	- 2.0	6.7	13.3	6.9	0.6
of which:					
North Sea	-12.0	-22.3	13.4	17.0	30.4
Manufacturing	- 6.6	5.0	18.0	10.0	- 4.0
Other business*	0.8	10.0	11.9	5.3	- 0.1
Private dwellings	6.4	7.1	12.9	1.5	- 0.5
General government	7.2	- 3.4	- 2.4	4.4	7.6
Total Investment	**0.9**	**5.5**	**12.0**	**5.2**	**1.1**

* Includes public corporations

71. Though **stockbuilding** was the same in 1988H1 as in 1987H2 the rapid growth in output over the same period implied a further fall in stock-output and stock-sales ratios, continuing the trend declines of recent years. These ratios continue to fall though at a slightly slower rate, and stockbuilding will remain low.

72. **Non-North Sea industrial and commercial companies's profits** net of stock appreciation showed further strong growth (about 20 per cent) in 1987. Since 1984 profits growth has averaged 25 per cent a year. With buoyant domestic demand and output growth in 1988 profits should rise further, by about 24 per cent. Profits may grow more slowly in 1989 and beyond as economic activity slows down and the rise in profit margins abates. Despite the rise in company sector spending, ICCs net acquisition of financial assets remain in surplus throughout the forecast. ICCs' net income, which approximates the Corporation Tax base, grows more slowly in 1989 and 1990 than in the previous two years.

TABLE 17: COMPANIES' INCOME AND RATES OF RETURN

(a) Profit shares and rates of return

(per cent)	Total	Non-oil	Non-oil (excl privatised) companies	Net rate of return on assets, non-ICCs
1973-85 average	11.8	8.7	8.6	5.5
1986	15.4	12.8	11.7	8.9
1987	17.3	14.6	12.8	9.8
1988	18.3	16.3	14.4	11.7
1989	18.7	17.2	15.0	12.3
1990	19.0	17.5	14.8	12.2

(b) Growth of profits and net income (per cent change on a year earlier)

	Non-North Sea Industrial and Commercial Companies*		Financial Companies
	Gross Trading Profits**	Net Income	Net Income
1986	21.3(21.3)	24.8	28.8
1987	19.5(15.4)	29.9	12.5
1988	23.7(23.7)	17.9	29.4
1989	14.7(13.3)	9.2	23.8
1990	9.3(6.9)	6.9	14.9

* Figures in brackets show growth of profits adjusted to exclude the effect of newly privatised companies being included in the sector.
** Net of stock appreciation.

Company Sector Financial Position

73. In some ways the industrial and commercial company sector is in a similar position to the personal sector. It has always been a net payer of interest. Its sensitivity to interest rate rises has increased recently because it switched heavily from equity to bank finance after the stock market crash. To finance their forecast expenditure, ICC's will need to continue increasing their borrowing, particularly from banks. Gross liquidity falls a little as a proportion of TFE and the net liquidity position worsens considerably. It is a moot point as to how willing ICCs will be to run with this outlook. There must be some risk that they will cut back on their real spending.

(7) DOMESTIC DEMAND AND ACTIVITY

74. Table 18 summarises latest estimates of real GDP growth. Once again, GDP(E) presents an implausibly low picture of recent growth. GDP(O) is still thought, even by CSO, to present the most reliable guide over the past year. It points to very rapid growth, even faster than the income measure, which tracked the output measure reasonably closely in 1987.

TABLE 18 : REAL GDP GROWTH
per cent change on a year earlier

	GDP(O)	GDP(I)	GDP(E)	Average measure of GDP(A)	Compromise adjustment (% of GDP(E)
1985	3.5	4.1	3.9	3.8	0.0
1986	2.8	3.4	2.9	3.0	0.2
1987	4.7	4.4	3.6	4.2	0.7
1988Q1	6.3	5.1	2.4	4.5	2.2
1988Q2	5.7	4.1	2.3	4.0	1.8

75. Domestic demand growth is likely to be substantially higher in 1988 than 1987. But GDP growth is expected to remain at just over 4 per cent in 1988 (nearly 5 per cent excluding oil) due to weaker net exports of goods and services. GDP growth is likely to fall to 2½ per cent (3 per cent excluding oil) in 1989, and slow further in 1990. Changes in the compromise adjustment contribute an uncomfortably large amount to recent year-to-year fluctuations in growth.

TABLE 19: EXPENDITURE AND OUTPUT
(percentage changes on previous year)

	1986	1987	1988	1989	1990
Domestic demand	3.8	4.3	6.0	2.6	1.6
Export of goods and services	3.7	5.5	1.1	5.2	3.7
Import of goods and services	6.5	7.3	11.7	4.4	2.1
Compromise adjustment (change as a per cent of GDP.)	0.2	0.7	1.8	0.2	0.3
GDP(A)	**3.0**	**4.2**	**4.2**	**2.7**	**2.3**
GDP Output measure:					
Non-oil GDP	3.0	5.2	6.2	3.2	2.9
Manufacturing	0.9	5.8	6.4	3.7	2.5

(8) PRICES AND EARNINGS

Recent Inflation Trends

76. Inflation indicators have trended up so far through 1988. The all items RPI rose quite sharply in August, entirely due to increased mortgage interest rates. But, even excluding MIPS, there has been a pronounced increase in the RPI inflation rate in recent months. Producer prices (excluding food, drink, and tobacco industries) rose by 4.9 per cent in the year to 1988Q3, with continued strong growth in profit margins augmented by slowly rising unit labour costs.

TABLE 20: INFLATION INDICATORS
(per cent change on year earlier)

	Manufacturers output prices*	RPI		GDP (Market price) Deflator
		All items	Less MIPS	
1987 Q3	4.5	4.3	3.6	5.3
Q4	4.8	4.1	4.0	5.7
1988 Jan	4.8	3.3	3.7	
Feb	4.7	3.3	3.6	
March	4.7	3.5	3.8	
April	4.6	3.9	4.2	
May	4.7	4.2	4.4	
June	4.7	4.6	4.7	
July	4.8	4.8	5.0	
August	4.9	5.7	5.0	
Sept	5.0	5.9	5.2	

* excl food, drink and tobacco.

Producer Prices

77. Producer price inflation is likely to continue rising over the rest of this year. Domestic demand remains strong, so that margins continue to rise through 1988, by a little more than in 1987. Producer price inflation is expected to be around 5 per cent by end-1988. Thereafter, unit labour costs are expected to increase as recent exceptional productivity growth slows down. The forecast thus sees little prospect of any significant drop in producer price inflation through 1989, though it is expected to fall through 1990.

TABLE 21: COSTS AND PRICES IN MANUFACTURING

(percentage changes on previous year)

	Unit labour costs	Costs of materials and fuels	Estimated total costs	Domestic producer output prices*
1986 Q4	- 0.7	- 5.0	1.5	3.7
1987 Q4	1.4	5.1	1.3	4.8
1988 Q4	1.8	2.8	2.5	5.0
1989 Q4	4.9	5.1	4.8	5.0
1990 Q4	3.5	2.5	3.9	4.0

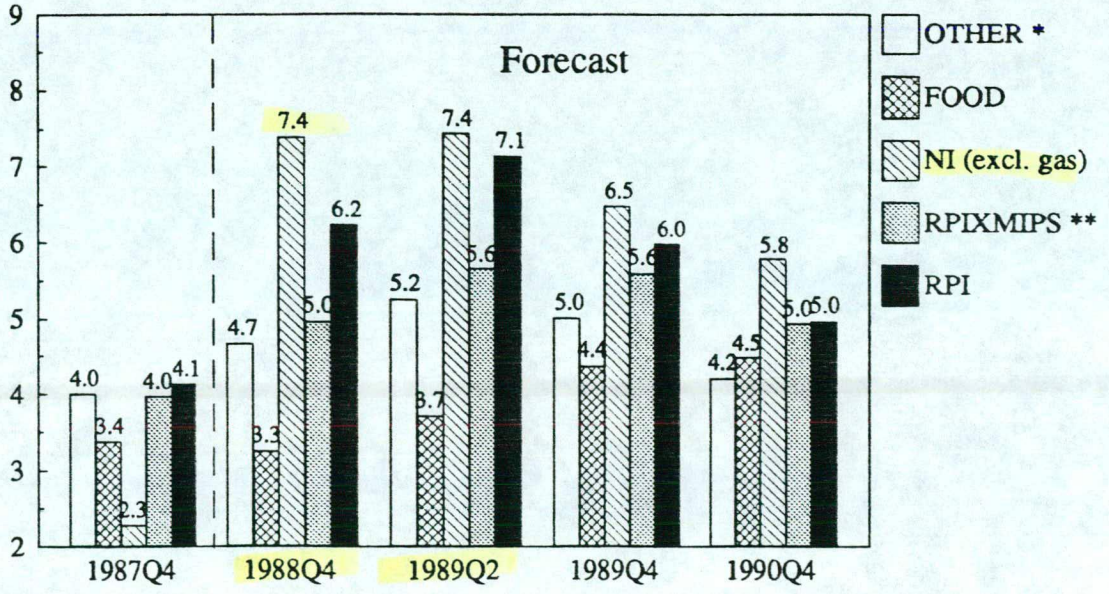
* Excluding food, drink and tobacco.

Retail Prices

78. RPI inflation will be over 6 per cent by end-1988, mainly as a result of higher mortgage rates, but also due to particularly sharp increases in nationalised industry prices (Chart R and Table 20.) It should rise further to around 7¼ per cent by mid-1989, with mortgage interest rates again the main impetus, though private sector prices generally are forecast to rise faster than last year. Local authority rent and rate increases also contribute to the rise.

CHART R: GROWTH IN MAIN RPI COMPONENTS

(Percentage change on year earlier)



* Private sector prices excluding food, housing and petrol.

** RPI excluding mortgage interest payments

79. RPI inflation should fall to around 6 per cent by 1989Q4 as the effects of mortgage interest rate increases through 1988H2 drop out. (The Annex presents a more detailed assessment of prospects for nationalised industry prices.)

TABLE 22: COMPONENTS OF THE RETAIL PRICE INDEX

	1986Q4	1987Q4	1988Q4	1989Q4	1990Q4
Food prices	3.2	3.4	3.2	4.4	4.5
NI prices	3.6	2.3	7.4	6.5	5.7
Housing costs	7.1	7.0	15.9	10.7	7.1
Other prices					
- petrol	-12.6	1.3	- 0.4	5.2	4.6
- other items	3.9	4.0	4.7	4.9	4.2
Total RPI	3.4	4.1	6.2	5.9	4.9
RPI excluding Mortgage Interest payments	3.4	4.0	5.0	5.5	4.8

80. Table 23 sets out the monthly RPI inflation path until the end of 1989 together with the path consistent with the FSBR forecast. Mortgage interest rate increases dominate the outlook. The profile assumes that interest rates rise in October 1988. Thereafter, mortgage interest rates are flat. The **all items RPI** is expected to peak at 7.3 per cent in July 1989. It then falls as the mortgage interest rate increases which took effect from mid-1988 drop out. It falls further in October 1989 as the October 1988 mortgage increase falls out. The **RPI excluding MIPS** peaks at 5.7 per cent in April 1989 and stabilises at 5.6 per cent thereafter.

Why so high?

TABLE 23: MONTHLY PATH OF RPI INFLATION

(percent changes on a year earlier)

	All items RPI		RPI excluding mortgage interest payments	
	FSBR	Autumn	FSBR	Autumn
1988 Aug	4.3	5.7	4.2	5.0
Sep	4.2	5.9	4.2	5.4 5.2
Oct	4.0	6.2	3.9	5.1
Nov	3.8	6.1	3.7	5.0
Dec	4.2	6.5	3.8	5.0
1989 Jan	4.5	7.1	4.1	5.3
Feb	4.5	7.1	4.2	5.5
Mar	4.4	7.1	4.1	5.4
April	4.3	7.0	4.0	5.7
May	4.1	7.1	3.8	5.6
June	3.9	7.2	3.6	5.6
July		7.3		5.6
August		6.4		5.6
Sept		6.5		5.6
Oct		6.0		5.6
Nov		5.9		5.5
Dec		6.0		5.6

The GDP deflator

81. The market price GDP deflator rose 5.3 per cent in 1987-88, compared with 3.4 per cent in 1986-87. (The low figure for 1986-87 was mainly accounted for by the collapse in oil prices during 1986.) The CSO's latest estimates are for a rise of 5.9 per cent in the year to 1988Q2. In the light of the poor short-term inflation prospects, it now looks as if the FSBR projections for GDP deflator inflation in 1988-89 were much too low. The outturn could be fully two points higher at about 6¾ per cent (7 per cent non-oil), compared with 4½ per cent in the FSBR (5 per cent non-oil). The GDP deflator is likely to rise by about 6 per cent in 1989-90.

TABLE 24: GDP DEFLATOR AT MARKET PRICES

(percentage change on previous year)

	1986-87	1987-88	1988-89	1989-90	1990-91
MTFS					
Total	3.2	4.9	4.5	3.9	3.5
non-oil	6.0	4.3	4.9	3.6	
October forecast					
Total	3.4	5.3	6.8	6.0	5.1
non-oil	6.0	4.8	7.0	5.9	5.0

82. The main influences underlying the bigger increase in the GDP deflator than expected in the FSBR (apart from the general faster rise in prices) are particularly sharp increases in the public authorities consumption deflator, dominated by public sector earnings growth. (Central government earnings are expected to rise by 9¼ per cent in 1988-89 and 7¾ per cent in 1989-90. Corresponding local authority earnings figures are 8¼ per cent and 9½ per cent respectively.) The improvement in the terms of trade in 1988-89 - to a considerable extent already recorded - also boosts growth of the GDP deflator in 1988-89, as it did in 1987-88

TABLE 25: COMPONENTS OF GDP DEFLATOR

(a) Component deflators (Percentage increase on previous year)

	Consumers' expenditure	Invest-ment	Stocks	General Government current expenditure on goods & services	Export	Imports	Total
1987-88	3.7	6.4	5.6	6.5	3.7	2.1	5.3
1988-89	5.4	6.3	5.1	7.8	2.3	1.3	6.8
1989-90	5.6	6.1	4.9	7.7	4.1	4.6	6.0
1990-91	5.0	3.8	4.3	7.1	4.3	4.3	5.1

(b) Contribution of components to total percentage increase in deflator

1987-88	3.6	1.6	0.2	0.9	0.9	- 2.0	5.3
1988-89	4.7	2.9	0.1	0.9	0.6	- 2.6	6.8
1989-90	3.6	1.3	-0.1	1.0	1.5	- 1.4	6.0
1990-91	3.2	0.3	0.0	1.3	1.5	- 1.2	5.1

Earnings

83. **Private sector settlements** have continued to edge up; they are now about ¾ per cent higher in manufacturing and ½ per cent higher in the private sector as a whole than a year ago. Non-manufacturing settlements have been running at a slightly higher rate than manufacturing (6 per cent rather than 5½ per cent).

84. Immediate prospects are finely balanced. Over the rest of this year and early next year (and the first half of the year is the key

period for settlements), many factors point to further increases in settlements. Tighter labour market conditions (firms are increasingly citing the need to recruit and retain labour as a factor in settlements) and buoyant company profits both point to such an outcome. Moreover, RPI inflation will be picking up strongly; the forecast is for RPI inflation to average over 7 per cent in the first half of 1989. Cost of living increases may, therefore, impart a sharp upward twist to pay claims.

85. Against that, however, the forecast has a pronounced slow down in growth in the first half of 1989, and recorded productivity growth should also slow down sharply. Employers may be well placed, therefore, to resist higher settlements. The forecast has **private sector settlements** rising by a further 1 per cent to 6¾ per cent in the 1988-89 pay round, before falling back thereafter.

86. Overtime in manufacturing increased steadily through 1987 and has been sustained at near record levels throughout 1988. Overtime has contributed some ¼ per cent to the 8½ per cent growth in **private sector earnings** over the year to 1988Q3. Other bonus payments and drift contributed to an increase of 9¼ per cent in **manufacturing earnings** in the year to August 1988. Earnings growth should slow down towards the end of 1988 as output growth itself moderates. For 1989, the continued slow down in activity should lead to lower settlements and earnings increases.

TABLE 26: PRIVATE SECTOR SETTLEMENTS AND EARNINGS
(Contributions to changes on a year earlier)

	1987Q3	1988Q3	1989Q3
Settlements	5¼	5¾	6¾
Drift	2¼	2½	2½
Overtime	½	¼	- ¼
Increase in average earnings	8	8½	9

87. In the year to August 1987 **local authority earnings** grew more rapidly than in the private sector. Over the year to August 1988 they rose more slowly. Teachers were paid 7½ per cent from October, as the second step of their 1987 settlement, and received another 1 per cent in April from restructuring. They received an increase of 4¾ per cent in April. Local authority manuals settled on a 10½ per cent increase.

88. Overall, **underlying local authority earnings** are likely to rise 7½ per cent in the 1987-88 pay round (compared to about 8½ per cent in the private sector), and 8 per cent in the following round. They rise slightly faster than private sector settlements thereafter. **Actual local authority average earnings** increase by 8.1 per cent and 9.0 percent respectively in the 1987-88 and 1988-89 rounds. The difference between underlying and actual earnings is due to the timing of back pay.

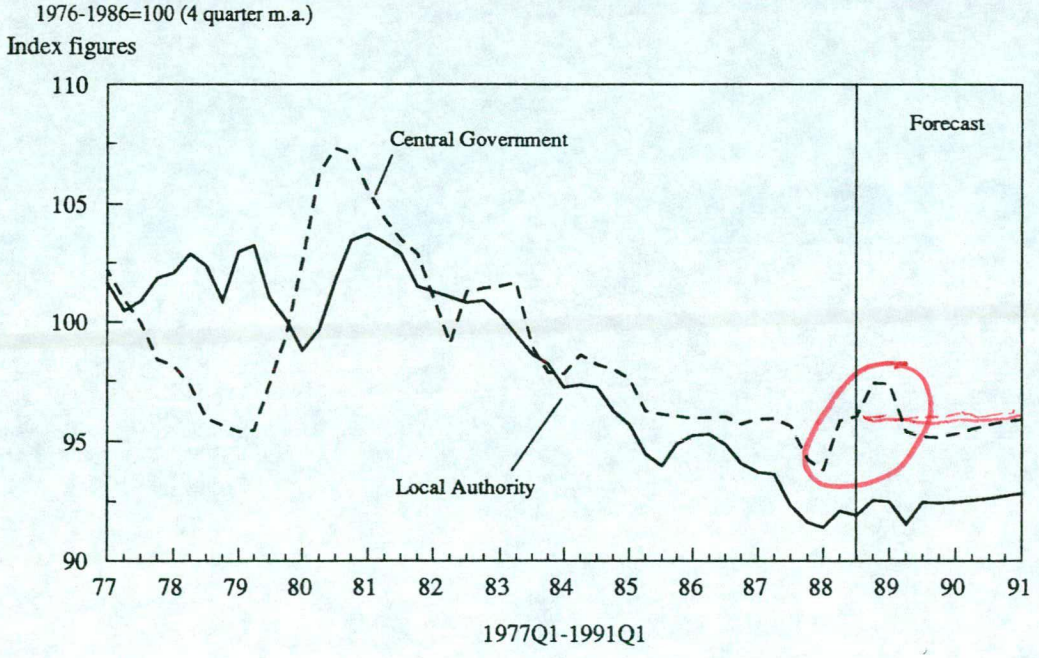
89. **Central government earnings** grew more slowly (7¼ per cent) than the private sector in the 1986-87 pay round, though nurses and some other health workers fared notably better. For central government earnings as a whole, the forecast has increases of 9 per cent for the 1987-88 and 8 per cent 1988-89 pay rounds.

TABLE 27 : PUBLIC AND PRIVATE SECTOR UNDERLYING AVERAGE EARNINGS

(percentage changes over years to August)

Pay rounds	Central Government	Local authorities	Private sector
1986-87	7¼	10¼	8
1987-88	9	7½	8½
1988-89	8	8	9
1989-90	9	9	8½

CHART S: RATIO OF LOCAL AUTHORITY AND CENTRAL GOVERNMENT EARNINGS TO PRIVATE SECTOR EARNINGS



Labour Costs

90. Manufacturers' unit labour costs are likely to rise more quickly over the next two years than in 1987 and early 1988, mainly because productivity growth falls back to more normal rates as output growth moderates.

TABLE 28: LABOUR COSTS INCREASES IN MANUFACTURING
(percentage increases on previous year)

	UK	Major 7 (less UK)
1986	4.9	2.5
1987	0.3	0.5
1988	1.4	0.7
1989	3.8	1.6
1990	3.9	2.3

(9) EMPLOYMENT, UNEMPLOYMENT AND PRODUCTIVITY

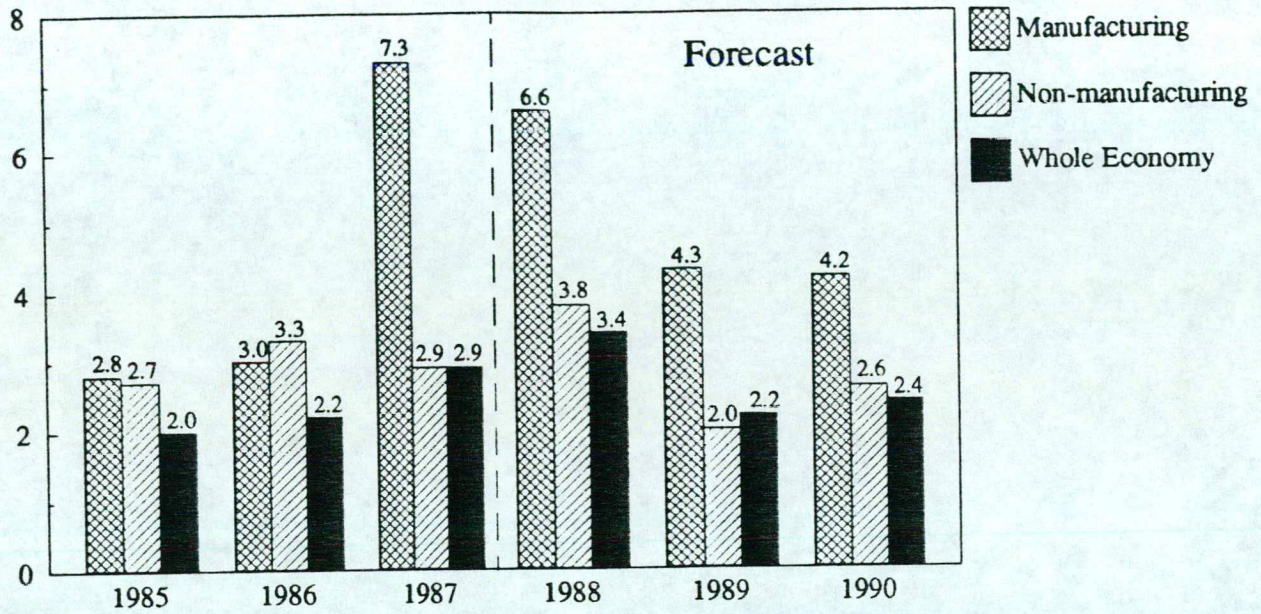
91. The employed labour force rose by 450,000 in the year to 1988Q2, (a reflection of strong output growth) bringing the total rise over the past five years to 1.8 million. Unemployment fell by 550,000 in the year to 1988Q2, and by a further 100,000 between June and August. (Unemployment figures for September became available after the forecast was completed. They show no fall. But this should be discounted - the numbers are thought to be affected by the postal dispute.) The fall in unemployment has been somewhat faster than the rise in employment. This probably results from the so-called Layard effect, where administrative measures have reduced the tendency to claim benefits and led to a reduction in the measured working population relative to a more comprehensive measure of labour supply (which would include non-claimant unemployed).

92. With growth likely to be fairly strong over the rest of this year, employment should go on rising into 1989, though at a slower rate than recently. Beyond mid-1989 employment is expected to stabilise as output slows down. The outlook for unemployment (UK seasonally adjusted) reflects the employment prospect; it continues to fall to mid-1989 before settling at around 1.9 million.

93. Much of the recent exceptional increases in productivity (especially in the manufacturing sector) are cyclical, reflecting very

strong output growth. Productivity growth is thus likely to slow down in 1989 and 1990 as output growth itself moderates. Even so, we expect employers to maintain pressure for better productivity performance and to lay-off labour in manufacturing and curtail recruitment in the non-manufacturing sectors more quickly, relative to output, than in previous slowdowns in the 1960s and 1970s.

CHART T: LABOUR PRODUCTIVITY
(Percentage change on year earlier)



(10) FINANCIAL CONDITIONS

Yield curve and Funding

94. In the first half of 1988 the yield curve sloped upwards, a rare occurrence in the UK during the last three years. Short rates are currently well above long rates and this pattern is predicted to continue throughout the forecast period.

TABLE 29 : UK SHORT AND LONG INTEREST RATES

	3 month interbank (1)	20 year gilts (2)	Yield gap (2)-(1)
1985	12.2	10.6	-1.6
1986	11.0	9.9	-1.1
1987	9.7	9.5	-0.2
1988 Q1	9.0	9.4	0.4
Q2	8.2	9.2	1.0
Q3	11.0	9.5	-1.5
Oct 11	11.8	9.2	-2.6
1988	10.1	9.5	-0.6
1989	12.0	9.8	-2.3
1990	11.0	9.8	-1.3

95. A major factor holding down gilt yields is their scarcity. The combination of large PSDRs and the requirement not to overfund means that the Bank will have to buy in a significant portion of the outstanding stock of gilts. Life assurance and pension funds are particularly attracted to gilts as they help to match the profiles of their assets and liabilities. Companies may take the opportunity of the negatively sloped curve to substitute long term bonds for bank lending as a source of finance. This would enable LAPFs to invest the funds previously earmarked for gilts into a sterling asset of similar nature, but probably shorter maturity (although higher risk), rather than in domestic equities or overseas assets.

TABLE 30 : PSBR AND FUNDING (£ BILLION)

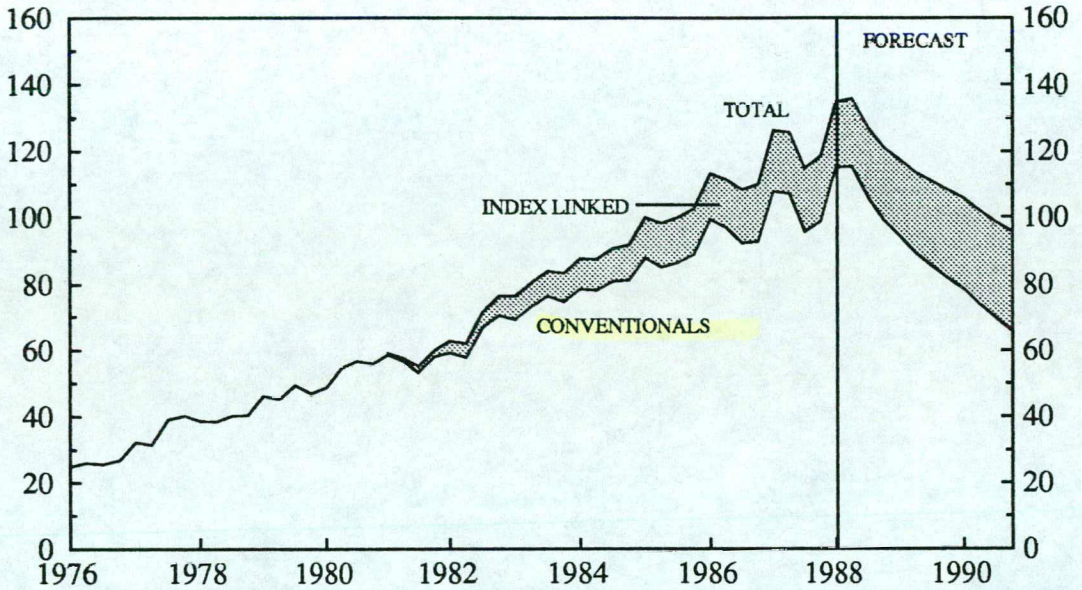
	PSBR	Net Gilt Sales to nbnbsps*	Nat Savings	Other Debt Sales to nbnbsps	Reserves	Other overseas finances†	Over funding+	Gross gilt sales to all sectors
1985-86	5.7	3.5	2.1	-1.4	-2.4	4.3	0.4	12.4
1986-87	3.4	3.8	3.4	-1.7	-3.8	5.3	3.5	16.6
1987-88	-3.5	4.1	2.1	-0.4	-11.1	2.8	1.3	13.9
1988-89	-11.8	-12.5	2.0	-2.1	0.2	1.0	0.4	-5.4
1989-90	-11.4	-13.4	1.0	-0.7	2.2	-0.5	0	-5.6
1990-91	-12.2	-14.5	1.0	-0.4	2.5	-0.8	0	-9.1

* non-bank non-building society private sector
† includes foreign currency finance
\+ overfunding on M4 definition

96. Table 30 shows the financing of the PSBR. National Savings are assumed to bring in £2 billion in 1988-89 and £1 billion each financial year thereafter. Gross gilt sales are negative every year from 1988-89. The combined effect of the PSDR forecast and the other funding assumptions is

that the stock of outstanding gilts declines substantially. There may also be a sharp decline in the bill mountain, particularly if the buying in is concentrated on short gilts which are held mainly by banks and building societies. Buying in short gilts alters the redemption profile. This effect has been incorporated in the final column of Table 30.

CHART U : OUTSTANDING STOCK OF GILTS
(market value £bn)



Monetary aggregates and credit

97. M0 has been growing at a rate well in excess of its current target. The increases in interest rates that have already taken place should soon start to slow down its growth rate. Indeed in the forecast M0's growth on a year earlier peaks in the current quarter at 8¼ percent and then falls back to around 3 per cent on average in 1989-90.

98. MO has grown on average by around 4 per cent less than money GDP since the mid 1970s, although there have been considerable short run fluctuations in velocity. Over the forecast period MO growth falls before money GDP growth following the recent increases in interest rates. By the end of the forecast the gap between the growth rates of MO and money GDP returns to its long run average level of 4 per cent.

TABLE 31 : MONETARY AGGREGATES AND CREDIT

(percent change on a year earlier)

	Money GDP	M0	M4
1985-86	9.3	4.0	13.5
1986-87	6.8	4.4	15.6
1987-88	10.0	5.1	15.6
1988-89	11.1	7.1	14.8
1989-90	8.7	2.3	11.9
1990-91	7.3	3.7	11.4

99. The growth rate of M4 is expected to come down much more gently. This is largely because interest rates have an increasingly ambiguous effect on M4. Higher interest rates make bank and building society borrowing more expensive, but the household sector could well maintain its borrowing to avoid an unpleasantly sharp decline in spending and to help pay the interest on the current level of borrowing. The latter - a kind of household sector rescheduling - may make the banks and building societies a little nervous, and they will probably try to persuade clients in this position to cut their spending even further.

(11) PUBLIC FINANCES

100. Table 32 compares the forecast with the FSBR and internal June forecast.

TABLE 32 : PUBLIC SECTOR EXPENDITURE, REVENUE, AND BORROWING
(£ billion)

	1988-89			1989-90			1990-91		
	FSBR	June Fore-cast	Oct Fore-cast	FSBR	June Fore-cast	Oct Fore-cast	FSBR	June Fore-cast	Oct Fore-cast
General Government Expenditure	183	181	181	193	194½	194	201½	205½	206
General Government receipts	185	187½	190½	195	204	206½	205	216	221½
Assumed cuts in personal taxes (cumulative)				3½	2½	2	4½	3½	3½
GGBR	-2	-6	-9½	1	-7	-10½	1	-7½	-12
Public corporations' overseas and market borrowing	-1	-1	-2	-1	-½	-1	-1	0	-½
PSBR (per cent of GDP)	-3 (-¼)	-7½ (-1½)	-12 (-2½)	-0 (0)	-7½ (-1½)	-11½ (-2¼)	0 (0)	-7½ (-1½)	-12 (-2¼)

PSBR

101. There has been a further large upward revision to the forecast of the PSDR in 1988-89, to £12 billion or 2½ per cent of money GDP. This compares with a forecast of £7½ billion in June and £3 billion in the FSBR. Much of the further revision is the result of higher than expected economic activity. Table 33 summarises the main changes to the forecast since the Budget and June. The forecast makes the working assumption that the PSDR excluding privatisation proceeds will be the same, as a percentage of GDP, in 1989-90 and 1990-91, as forecast for 1988-89.

102. If the forecast is correct the budget surplus for 1988-89 will exceed the surplus of 1¼ per cent of GDP achieved in 1969-70 and be the largest recorded in the period since records of the PSBR began in 1952. Excluding privatisation proceeds however the 1988-89 surplus will be the same as that in 1969-70.

TABLE 33 : MAIN CHANGES TO THE PSBR FORECAST FOR 1988-89

	£ billion	
	Changes since FSBR	June
Higher General Government Receipts		
- higher PAYE and NICs reflecting higher wages and salaries, which are not yet fully reflected in the national accounts data;	2.0	2.0
- North Sea revenues lower than in June due to Piper Alpha and lower prices, but still a little up on FSBR;	0.1	-0.2
- stamp duty up on FSBR, reflecting higher house prices and stock market turnover, but down a little on June;	0.5	-0.1
- higher VAT and specific duties mainly reflecting higher consumer spending;	1.9	0.9
- higher interest receipts (largely reflecting removal of presentational adjustments in Budget forecast);	0.7	-
- higher ECGD trading deficit than in the FSBR on the assumption of no refinancing of loans but not as high as in June;	-0.4	0.2
- higher other receipts	0.6	0.2
TOTAL RECEIPTS	5.5	3.0
Lower General Government Expenditure		
- lower programme spending, mainly on social security and local authority capital	-1.9	-1.7
- higher privatisation proceeds	-1.0	-0.1
- changes to other adjustments largely reflecting switch of PC borrowing from market to central government	0.8	1.3
TOTAL GGE	-2.1	-0.4
Lower Public Corporations' market borrowing	-1.0	-1.0
TOTAL CHANGE IN PSBR FORECAST	-8.6	-4.4

Public Expenditure

103. The planning total excluding privatisation proceeds could fall in real terms in 1988-89, following zero growth in 1987-88. This reflects a number of factors including a deceleration in the growth of social security spending, a (temporary) fall in net EC contributions, improved nationalised industry performance, high local authority capital receipts and a squeeze on cash limited expenditure from higher than expected inflation. Some of these forces could be less strong from now on.

However, with inflation assumptions for the Survey below those now forecast, it is possible that 1989-90 will see a further real squeeze on cash limited spending.

104. Table 34 compares the forecast of the planning total in cash terms with the PEWP and Survey Baseline. The main changes from the June forecast are lower social security expenditure and higher local authority capital receipts in the next two years. Local authority current spending is still seen as the largest potential claim on the Reserve. Taking defence and health together, about three-quarters of the forecast overspend in cash terms in 1989-90 and 1990-91 on existing plans is attributable to pay. Forecast overspending on other central government programmes is consistent with some future increase in provision for investment in roads, prisons etc.

TABLE 34 : PLANNING TOTAL EXCLUDING PRIVATISATION PROCEEDS

	1988-89	1989-90	1990-91
£ billion current prices			
1988 FSBR	161.8	172.1	181.1
Forecast	159.9	173.8	187.6
Real growth %			
1988 FSBR	2½	2¼	1¾
Forecast	-¾	2½	2¾

Local authorities

105. With the ending of grant penalties local authority current spending may rise relatively quickly in 1989-90 - the forecast has an underlying increase of 4 per cent in real terms. Some of this may represent spending brought forward from later years, and a smaller real increase of about 1 per cent is forecast for 1990-91. This summer's grant settlement for 1989-90 was for a 4¼ per cent increase in total cash grant. This is likely to be well below the general rate of inflation and the rate of increase of LA current spending. But if authorities run down balances to finance spending, average rate poundage increases of around 7½ per cent are in prospect, much the same increase as in 1988-89. For 1990-91, the first year of the Community Charge in England, it is assumed that the growth of grant and non-domestic rates together, will be such as to leave the Community Charge per head unchanged in real terms from LA domestic rates per head in the previous year. The forecast is that this will involve a real increase in grant of 3-4 per cent.

106. The forecast assumes that local authority capital receipts will be maintained as best at the level expected for 1988-89. On this basis the

LA[redacted] as a percentage of GDP may on average be a little lower over the period 1988-89 to 1990-91 than in the three previous years.

Public corporations

107. Against a background of falling nationalised industry prices in real terms, slower growth of economic activity, heavy capital investment programmes, less scope for productivity gains than in the past 10 years, and large restructuring costs for the coal industry, nationalised industries remaining in the public sector are not likely to achieve the reductions in external finance which have been a feature of recent years. In addition, by comparison with the PEWP and Survey baseline, public expenditure will be increased by the loss of the negative EFLs of those industries due to be privatised. But this "EFL offset" is partially offset on the receipts side of the public finances by government dividend and interest receipts from residual equity and debt holdings respectively in the newly privatised companies. By 1990-91 these might amount to only £¼bn, but they could be approaching £1 billion in the year after that.

TABLE 35 : FORECAST ADDITIONS TO EXPENDITURE PLANS

£ billion

	1988-89		1989-90		1990-91	
	PEWP 1988	Forecast Claims on Reserve	Survey Baseline	Forecast Claims on Reserve	Survey Baseline	Forecast Claims on Reserve
Allocated to programmes						
1. Social Security (including HB)	46.9	-0.6	49.5	-0.1	52.0	1.7
2. Defence	19.2	0.2	20.0	0.7	20.6	1.5
3. Health	21.8	1.1	22.9	2.0	24.0	3.2
4. Net EC	0.8	0.2	1.5	0.6	1.3	0.6
5. Other CG	29.3	0.2	31.1	1.4	32.0	3.3
6. LA current (excluding HB)	34.9	1.4	35.2	4.1	36.2	5.6
7. LA capital	4.0	-0.6	3.9	-0.5	3.8	-0.4
8. Nationalised industries	0.7	-0.3	-	0.5	-0.4	1.4
9. Other PCs	0.8	-	1.0	-	1.2	-
10. Total programme	158.3	1.6	165.1	8.7	170.7	16.9
11. Privatisation proceeds	-5.0	-1.0	-5.0	0.0	-5.0	0.0
12. Expenditure met from existing reserve						
(i) allocated to programme baseline	0.0	0.6	0.0	7.0	0.0	10.5
(ii) unallocated	3.5	0.0	7.0	0.0	10.5	0.0
13. Underspend (-) Required Addition to Reserve (+)	0.0	-2.9	0.0	1.7	0.0	6.4
PLANNING TOTAL	156.8	153.9	167.1	168.8	176.2	182.6*

* Forecast of the planning total outcome

108. General government **gross debt interest payments** are forecast to be a little higher in 1988-89 than in 1987-88 because the need to finance the rise in the foreign exchange reserves has continued to push up the gross stock of debt outstanding. After 1988-89, with large repayments of debt by general government and a partial unwinding of the rise in the reserves assumed, gross interest payments fall sharply, particularly in 1990-91.

10[redacted] The ratio of GGE (excluding privatisation proceeds) to money GDP is forecast to fall by about two percentage points in 1988-89. It is forecast to fall further, by just over one percentage point, over the next two years.

TABLE 36 : RATIO OF GGE EXCLUDING PRIVATISATION PROCEEDS TO MONEY GDP (per cent)

	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91
1988 FSBR	44½	43¾	41¾	41¾	40¾	40
October forecast	44½	43¾	41¾	39½	38¾	38½

110. Table 37 compares the forecast of GGE excluding privatisation proceeds with earlier internal forecasts, successive PEWPs and the 1988 FSBR. The October forecast is little different from the June forecast in current prices, but somewhat lower in real terms.

TABLE 37 : PAST AND CURRENT FORECASTS OF GGE EXCLUDING PRIVATISATION PROCEEDS (£ billion)

Forecast	1987-88 Current Prices	1987-88 Real Terms*	1988-89 Current Prices	1988-89 Real Terms*	1989-90 Current Prices	1989-90 Real Terms*	1990-91 Current Prices	1990-91 Real Terms*
PEWP 1986	174	168	179	168	-	-		
Oct 1986	178	171	188	172	-	-		
PEWP 1987	179	172	185	172	193	174		
Oct 1987	178	170	190	172	203	175		
PEWP 1988	178	170	188	173	198	176		
Jan 1988	177	169	188	171	200	173		
FSBR 1988	177	169	188	171	198	174	207	175
June 1988	177	169	187	168	200	171	210	173
Oct 1988	177	168	187	166	199	167	211	169

* 1986-87 prices

(c) Receipts

111. General government receipts are forecast to rise by 9½ per cent in 1988-89, about a percentage point and a half less than the growth of money GDP. Without the budget tax reductions receipts would probably have grown at a similar rate to GDP. Non-North Sea taxes and NICs are forecast to grow faster than total receipts - non-North Sea corporation tax (up 22 per cent), capital taxes (up 30 per cent) and VAT (up 14 per cent) are forecast to grow particularly fast. But with the peak month's for corporation tax receipts being October and January (accounting for more than 50 per cent of the annual total), the corporation tax forecast is still very uncertain. The total tax burden may fall by around ½ percentage point in 1988-89, but,

with a sharp fall in North Sea revenues, the fall in the non-oil tax burden will be less.

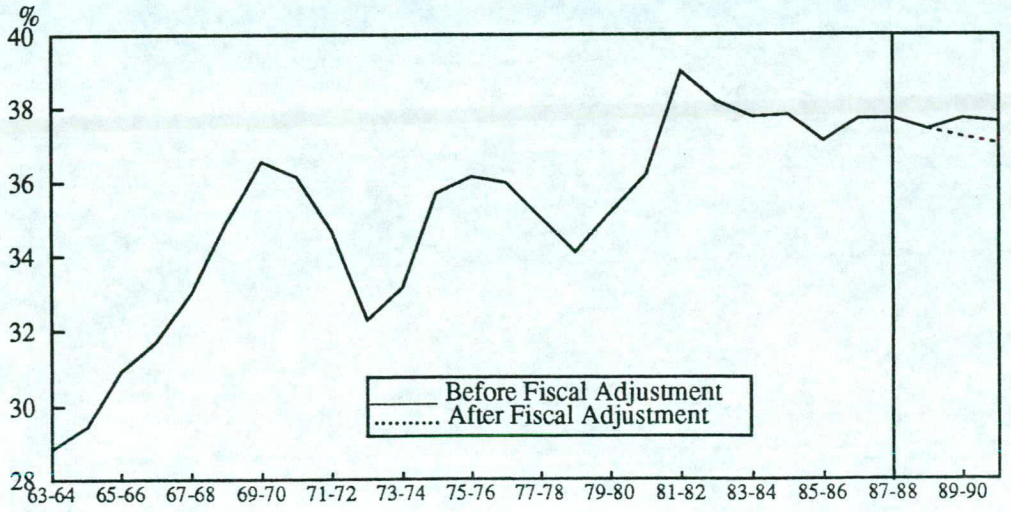
112. The growth of general government receipts (before fiscal adjustment) is forecast to be lower in 1989-90 and 1990-91, around 8½ per cent and 7 per cent respectively. The deceleration in 1989-90 mainly reflects lower growth of expenditure and incomes, and occurs despite a further rise of around 25 per cent in non-North Sea corporation tax - the delayed effect of buoyant 1987 and 1988 profit growth. A further fall in North Sea revenues is forecast and the rapid growth of capital taxes is expected to end. The ratio of total taxes and NICs (before fiscal adjustment) to money GDP is forecast to change very little in 1989-90 and 1990-91 from the level forecast for 1988-89. After fiscal adjustment the total and non-North Sea tax burdens may edge down a little, by about ½ percentage point over two years.

TABLE 38 : NON-OIL TAXES AND NICs AS A PERCENTAGE OF NON-OIL GDP

	1986-87	1987-88	1988-89	1989-90	1990-91
MTFS					
(a) pre-fiscal adjustment	37.5	37.7	37.7	37.7	
(b) post-fiscal adjustment	37.5	37.7	37.7	36.9	36.6
October Forecast					
(a) pre-fiscal adjustment	37.7	37.7	37.4	37.7	37.6
(b) post-fiscal adjustment	37.7	37.7	37.4	37.2	37.0

CHART V : NON-NORTH SEA TAXES & NICS

(As a Percentage of non North Sea GDP)



ANNEX A: RPI OUTLOOK

1.1 Table 1 sets out the detailed changes in nationalised industry prices assumed for domestic consumers over the years to 1988Q4, 1989Q4 and 1990Q4, and Table 2 gives real price increase over a run of financial years.

TABLE 1: NOMINAL NATIONALISED INDUSTRY PRICE INCREASES FOR CONSUMERS

(per cent)	Year to 1987 Q4	Year to 1988 Q4	Year to 1989 Q4	Year to 1990 Q4
Post	3.0	6.1	0.0	6.9
Rail	5.7	6.6	9.7	7.8
Electricity	- 0.5	8.6	6.0	5.4
Coal and coke	0.5	2.4	1.3	1.2
Bus	6.7	6.9	8.1	6.7
Water	6.9	8.1	9.0	6.0

TABLE 2: REAL NATIONALISED INDUSTRY PRICE INCREASES

(percent changes on previous financial year; weighted average for consumers and industry)

	Average 1983-84 - 1985-6	1986-87	1987-88	1988-89	1989-90	1990-91
British Coal	0.8	- 3.5	- 3.4	- 4.0	- 4.5	- 3.3
Electricity	- 3.0	- 2.0	- 3.8	0.7	- 0.4	0.6
BSC	- 1.4	- 2.0	- 2.9	- 3.4	- 4.5	- 2.4
Post Office	- 3.0	- 2.1	- 0.3	- 1.9	- 3.7	- 0.5
Water	1.9	4.5	2.3	2.0	2.5	1.0
LRT	- 6.1	2.2	2.1	4.6	5.2	5.3
British Rail	- 3.1	2.7	1.5	0.8	0.2	1.2

1.2 Increased nationalised industry prices will, by themselves, raise RPI inflation in 1988Q4 by ¼ per cent compared with inflation in 1987Q4. Other influences underlying the RPI inflation outlook to 1988Q4 are:

(i) **Mortgage interest payments** add 1¼ per cent to inflation in 1988Q4.

(ii) **Gas prices** rose by 6 per cent in April after a 4½ per cent fall in 1987. (The difference is worth about ¼ per cent on total RPI inflation).

(iii) An 8½ per cent rise in average **domestic local authority rate poundage** compared with 7¾ per cent last year (the difference is worth less than 0.1 per cent on inflation).

.3 All the above factors put upward pressure on inflation in the year to 1988Q4. Moreover, they are augmented by a steady rise in inflation in other private sector prices, which are projected to rise by 4¾ per cent in the year to 1988Q4, compared to 4¼ per cent in the year to 1987Q4. There was a step increase in the inflation rate in 1988Q2, mainly due to Budget measures. Other private sector price inflation rises further to 5.0 per cent by end-1989, largely because of rising costs and import prices. Only food and petrol prices rise more slowly to 1988Q4 than they did in the year to 1987Q4.

WEP

swm.2.12.1

CONFIDENTIAL

FROM: S W MATTHEWS
DATE: 12 October 1988

CHANCELLOR

cc Economic Secretary
PCC Members
Mr Evans
Mr Mountfield
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Turnbull
Mr Bottrill
Mr S Davies
Mr Grice
Mr Hibberd
Mr Mowl
Mr O'Donnell
Mr Dolphin
Mr Hood
Mr Savage
Mr Harris
Mr Cropper
Mr Tyrie

WORLD ECONOMIC PROSPECTS : OCTOBER 1988

I attach a report on the latest WEP exercise. It provides the world economic background to the forecast report circulated by Mr Sedgwick.

2. The first page of the report summarises the forecast. Data published since June have confirmed our last forecast of strong growth in 1988 of both G7 output and world trade.

3. The WEP report includes, for comparative purposes, some figures for the UK taken from the domestic forecast. These will not be included in any version of the report shown to outside Departments.

S W MATTHEWS

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WORLD ECONOMIC PROSPECTS: OCTOBER 1988

Table 1 summarises the forecast. The main points are:

a. Little loss of momentum in the growth rate of activity in the major industrialised countries is expected in the second half of 1988, but in 1989 major seven real GNP growth is forecast to be more in line with potential.

b. There was a strong spurt in the growth of world trade volumes towards the end of 1987. Trade is forecast to continue to grow strongly in 1988 and 1989, helped by the improved position of many developing countries.

c. Despite the strength of activity and large rises in non-oil commodity prices, the average rate of consumer price inflation in the major seven remains low. But demand pressures have increased and a small rise is projected for next year.

d. Progress in reducing the current account imbalances of the United States and Japan has been a little greater than earlier expected. Further limited progress is expected in 1989.

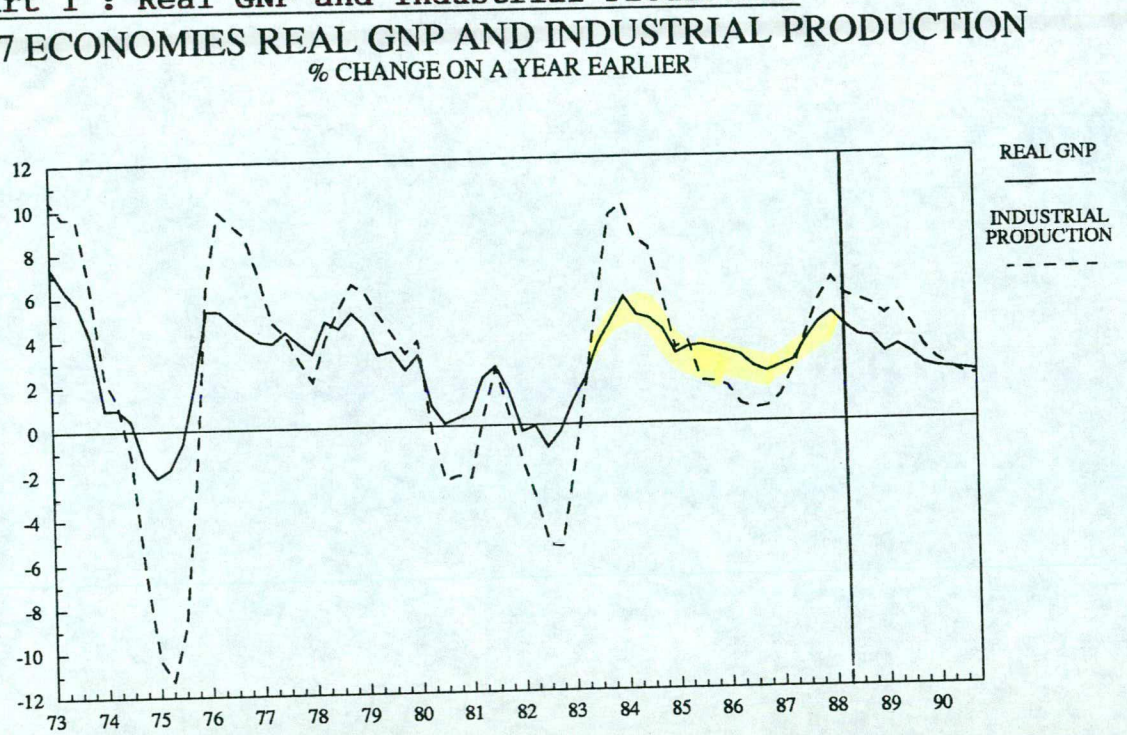
Table 1: Output, Inflation and Trade

Percentage change on year earlier	1986	1987	1988	1989	1990
Major 7 real GNP	2.7	3.3	4	3	2¼
Major 7 real domestic demand	3.7	3.7	4¼	3	2¼
Major 7 industrial production	0.9	3.2	5¾	4¼	2¼
Major 7 consumers' expenditure deflator	2.4	3.2	3	4	4
World trade					
- total	5.1	4.9	9	6½	4½
- manufactures	2.6	5.4	8½	7½	5

I RECENT DEVELOPMENTS

Since the recession of 1982, real GNP in the major seven industrialised countries has grown at an average rate of 3½ per cent a year and unemployment has fallen by about 1½ percentage points. The upswing has included a number of spurts and hesitations in the rate of growth - see chart 1.

Chart 1 : Real GNP and Industrial Production



2. After about a year of below average growth, there was a spurt in the pace of expansion during 1987, with exports and business investment picking up strongly (see chart 2). The main factors behind this appear to have been:

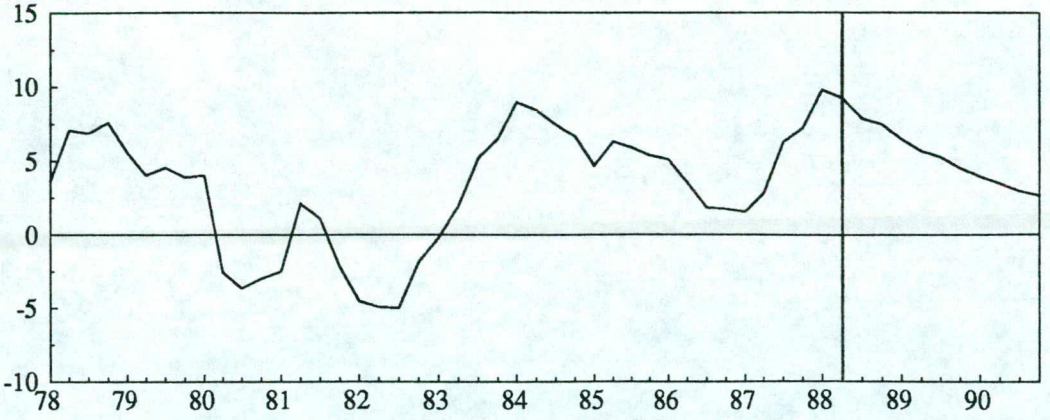
(i) a pick up in developing countries' imports, as a result of more buoyant export receipts due to a recovery in commodity prices;

(ii) a fall in nominal and real interest rates, and a substantial increase in international liquidity;

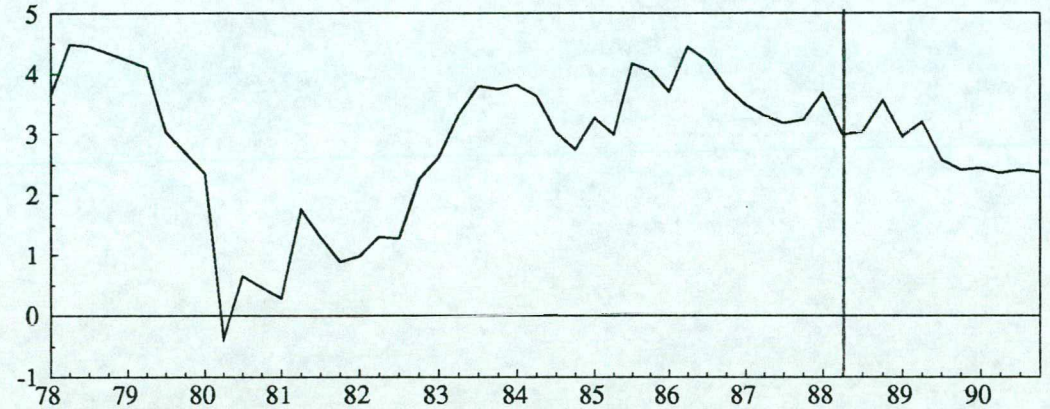
(iii) the pick up in investment was also encouraged by the continued strong growth in consumers' expenditure leading to higher rates of capacity utilisation.

CHART 2 : COMPONENTS OF MAJOR SEVEN GROWTH

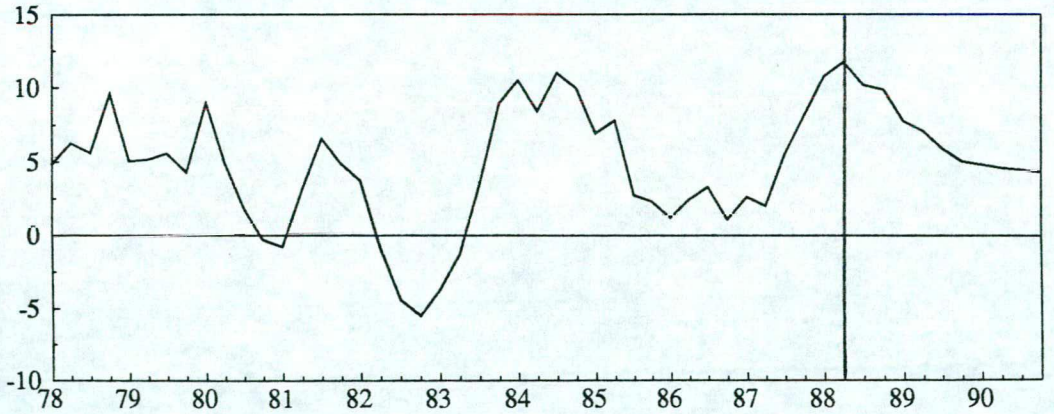
INVESTMENT



PRIVATE CONSUMPTION



EXPORTS



3. Industrial production figures for the third quarter of 1988, where they are available, do not suggest any significant slowdown. Data for order-books, employment and investment intentions generally confirm this picture. While commodity prices have fallen a little recently, this may reflect lagged supply responses to earlier price increases rather than any weakening of demand. Overall, the data that have become available since the June forecast was completed confirm our judgment then that real GNP growth in the G7 in 1988 is likely to be around 4 per cent. Most other forecasters now share this view.

II FISCAL AND MONETARY POLICIES

4. Rapid economic growth has helped to produce a reduction in budget deficits in most countries. In the United States some expenditure restraint plus additional revenues from the tax reform produced a sharp reduction in the Federal budget deficit in fiscal year 1987. Continued expenditure restraint and strong growth meant that the deficit was similar in fiscal year 1988 (which has just ended) despite cuts in personal taxes.

Table 2 : Estimates of US Federal Budget Deficit

	FY 86	FY 87	FY 88	FY 89	FY 90
OMB Current Services*					
$ billion	221	150	152	132	111
% of GNP	5.3	3.4	3.2	2.6	2.0
WEP					
$ billion			150	165	135
% of GNP			3.2	3.2	2.4

*Office of Management and Budget, 1988 Mid-Session Review

5. Table 2 sets out the latest official projections of the Federal budget deficit (by the Office of Management and Budget) on a "current services" basis (ie unchanged policies). We have modified these projections to allow for undue optimism on OMB's part in its assumptions about interest rates and future spending commitments. At present the prospect of any significant additional measures to cut the budget deficit in FY 1989 look slim, but we have assumed that tax increases and public expenditure cuts with an ex ante effect of ¾ per cent of GNP will be implemented in FY 1990.

6. In Japan buoyant tax revenues have meant that, despite the package of public works expenditure in 1987-88 and tax cuts in 1988-89, the budget deficit (as measured by the GGFD) has fallen. We assume that it will be kept at present levels over the forecast period, with the proposed switch from direct to indirect taxes (through the introduction of a general sales tax) being broadly revenue neutral.

7. In Germany tax cuts equivalent to ¾ per cent of GNP have been made this year (although, as in Japan, this in part only compensates for fiscal drag). We assume that indirect taxes will be increased by DM 10 billion in 1989 (½ per cent of GNP) followed by cuts in direct taxes in 1990 of DM 20 billion.

Table 3: General Government Financial Deficits

% of GNP	1986	1987	1988	1989	1990
US	3.5	2.4	2	2	1½
Japan	1.1	0.2	0	0	0
Germany	1.2	1.7	2	1½	2
France	2.9	2.3	2	2½	2½
Major 6	3.1	2.5	2¼	2¼	2

8. Following the worldwide rises in interest rates during the summer, three month rates in the US and Germany are 1½ percentage points higher than at the start of the year, while rates in Japan have risen ¾ percentage point. Real interest rates have probably risen rather less as inflation expectations have worsened (although this is obviously difficult to determine). In relation to actual inflation real rates are still low compared to their average levels in the 1980s.

9. Further rises in short rates in 1989 are forecast for the US, in response to continued inflationary pressures. There is a risk that loss of confidence in the current account adjustment process (and hence the dollar) and/or difficulties in agreeing cuts in the budget deficit could put additional upward pressure on US interest rates.

Table 4 : Short-Term Interest Rates

	Nominal				Real*			
%	1987	1988	1989	1990	1987	1988	1989	1990
US	6.9	7.7	9.4	9.5	2.4	3.6	4.2	4.0
Japan	4.2	4.6	5.0	5.0	4.4	4.6	3.6	3.5
Germany	4.0	4.3	5.0	5.0	3.5	3.2	3.1	3.7
France	8.2	7.9	8.0	7.7	5.2	5.4	5.2	4.8
Major 6	6.5	6.9	7.8	7.7	3.5	4.0	4.1	3.7

* Average annual three month interest rate less change in consumers' expenditure deflator over the previous year.

10. The forecast is based on an assumption of broadly constant real effective exchange rates at around average September levels. Given the difficulties of forecasting exchange rates this is the most convenient conventional assumption to make, but it is naturally subject to a substantial margin of error. While current account imbalances have been financed comfortably so far this year, this will not necessarily continue to be the case.

III ECONOMIC ACTIVITY IN THE MAJOR COUNTRIES

11. Capacity constraints in several countries, notably the United States, suggest that the investment boom is likely to continue for a while yet. Some easing in the pace of expansion seems probable in 1989 though, as a result of the modest tightening of monetary policy this year, with the growth of both consumers' expenditure and investment (particularly residential) slowing a little.

Table 5: Growth of Real GNP and Contribution of Domestic Demand

Percentage change on year earlier	GDP/GNP 1987	1988	1989	1990	Estimated Growth of Productive Potential
US	3.4	3.9	2.9	1.8	2¼-2¾
Japan	4.2	5.5	3.7	3.3	3½-4½
Germany	1.7	3.1	2.2	2.4	2 -2½
France	2.3	3.5	2.4	2.5	2¼-2¾
Italy	3.1	3.7	3.1	1.6	2¼-2¾
Canada	4.2	4.8	4.1	2.8	2¼-2¾
UK	4.2	4.2	2.7	2.3	2¼-2¾
Major 7	3.3	4.1	2.9	2.2	2½-2¾

Percentage change on year earlier	Domestic Demand Contribution 1987	1988	1989	1990
US	3.2	3.0	2.3	1.5
Japan	4.9	7.6	5.1	4.2
Germany	2.8	3.5	2.3	3.2
France	3.3	3.6	3.1	2.5
Italy	4.8	4.7	3.7	1.4
Canada	5.5	5.6	4.7	3.4
UK	5.0	6.9	3.1	1.9
Major 7	3.8	4.4	3.1	2.3

12. Major seven real GNP is expected to grow at an annual rate of around 4 per cent in the second half of 1988, before slowing to 2½-3 per cent in 1989. In 1990 growth is forecast to slow further, mainly as a result of the assumed tightening in US fiscal policy, but also because of continued high interest rates.

13. In the United States real GNP growth exceeds domestic demand growth over the next few years, though by a diminishing margin as the effects of the gain in competitiveness over the period 1985-87 diminish. Without the assumed policy-induced slowdown in domestic demand inflation in the US would rise further, increasing the risk of a more severe recession later.

14. Japan has experienced the strongest investment boom of any of the major countries over the past year. Both investment and consumers' expenditure are likely to remain fairly strong in 1989 and 1990. In Germany, GNP and domestic demand are growing at similar rates as export growth has picked up. The planned tightening of fiscal policy in 1989 and loosening in 1990 contribute to the cyclical pattern in the forecast of German domestic demand growth.

IV WORLD TRADE

15. World import volumes are estimated to have grown by about 5 per cent between 1986 and 1987, but growth picked up during the year so that in the fourth quarter of 1987 imports were over 8 per cent higher than a year earlier. Information about the first half of 1988 is largely confined to the major seven countries, but it appears that world trade has continued to grow rapidly.

Table 6: World Import Growth

Percentage change on year earlier	(Share of 1986 imports)	1986	1987	1988	1989	1990
Total developed economies*	(75)	8	6	9	6½	4½
of which:						
US	(18)	14	3½	6½	3	2
Japan	(6)	10½	9	17	12	9
EC(6)**	(33)	6½	6½	9	6½	4½
OPEC	(5)	-22	-11	2	-5	-4½
NIEs	(5)	14	21	17	14	12
Other NODCs	(10)	-3	-1	7	7	5
Total***	(100)	5	5	9	6½	4½
World trade in manufactures		2½	5½	8½	7½	5

* OECD plus South Africa
** Belgium, France, Germany, Italy, Netherlands and UK
*** Includes net imports by centrally planned economies.

16. The main feature of 1987 was the strong pick up in imports by developing countries, though this is masked by the year-on-year growth rates shown in Table 6. During 1987 imports by the four Asian newly-industrialised economies continued to grow strongly, but other developing countries also began to increase imports after several years of cutbacks. Even OPEC countries seem to have begun to increase imports again after severe contraction in earlier years, if data on OECD countries' exports to OPEC are any guide (there is little direct information on OPEC's imports).

17. The four Asian NIEs have been increasing their share of world exports for some time, and their exports are now 20 per cent larger than their imports. Strong export growth is expected to continue. As a result, even four years of import volume growth averaging 16 per cent has little effect on their current balance.

(interesting to see split — & how is HK current a/c stimulated) RTSL

Table 7: Asian NIEs

Percentage change on year earlier	1986	1987	1988	1989	1990
Export volumes	18	20	12	9	10
Import volumes	14	21	17	14	12
Terms of trade	-2	2	2	0	2
Current Account ($bn)	22	31	32	27	31

18. The prospects for other non-OPEC developing countries are summarised in table 8. Stronger commodity prices in 1987 and first half of 1988 have boosted the export revenues of many developing countries, although the pattern is somewhat uneven. Buoyant world demand has also enabled them to increase their exports of manufactures. As current account deficits in aggregate have probably now been reduced to sustainable levels, most of the rise in export receipts is likely to feed through into higher imports.

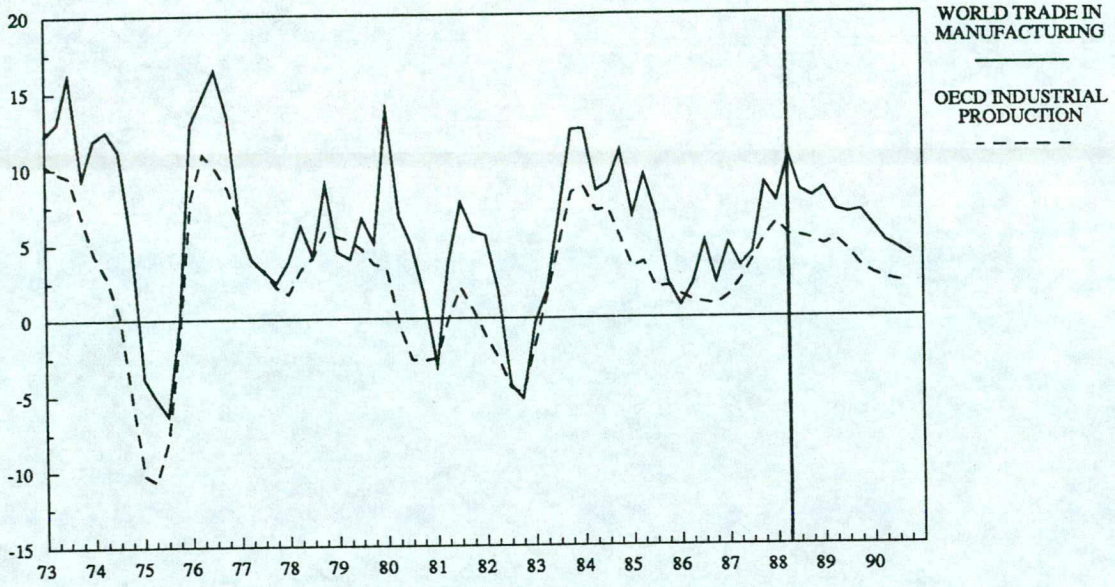
Table 8 : Other NODCs Current Account

Percentage change on a year earlier	1986	1987	1988	1989	1990
Export volume growth	0	8	5	7	5
Import volume growth	-3	-1	7	7	5
Terms of trade	-3	-	1	-	-
Current account ($bn)	-35	-22	-28	-31	-34

19. The projected strength of developing countries' imports in 1989 means that total world trade slows down rather less than activity in the major seven. Developing countries' imports have a high share of manufactures, so world trade in manufactured goods will probably grow slightly faster than total trade, at about 7 per cent in 1989. As Chart 3 shows, it is usual for total world trade in manufactures to grow more quickly than OECD industrial production, and for slowdowns in the latter to lead the former.

Chart 3: OECD Industrial Production and World Trade in Manufactures

WORLD TRADE IN MANUFACTURING AND OECD INDUSTRIAL PRODUCTION GROWTH



PERCENTAGE CHANGE OVER YEAR EARLIER

V PRICES AND INFLATION

a. The oil market

20. In recent weeks, oil prices have weakened sharply because Saudi Arabia is now producing well above its quota and the existing OPEC production agreement is perceived to be collapsing. Trends in demand and non-OPEC supply suggest only modest increases in the demand for OPEC oil over the next few years, so prospects for oil prices depend crucially on OPEC's ability to reach a new agreement to limit production. This may be achieved at OPEC meetings later this year, but, since OPEC export capacity substantially exceeds all projections of demand for their oil over the next few years, it is quite probable that overproduction will recur at some time during 1989-90. In these circumstances prices are likely to be volatile, but on average rather weak. The forecast is for an average oil price (for OECD imports) of $13 per barrel in 1989, rising only fractionally in 1990.

Table 9: The Oil Market

Millions of barrels per day	1986	1987	1988	1989	1990
Total Demand	48.3	48.6	49.4	50.7	51.6
Supply:					
Non-OPEC	28.8	29.3	29.1	29.6	29.8
OPEC	19.5	19.3	20.3	21.1	21.8
Oil price* ($ pb)	14.3	17.2	14.3	13.1	13.5

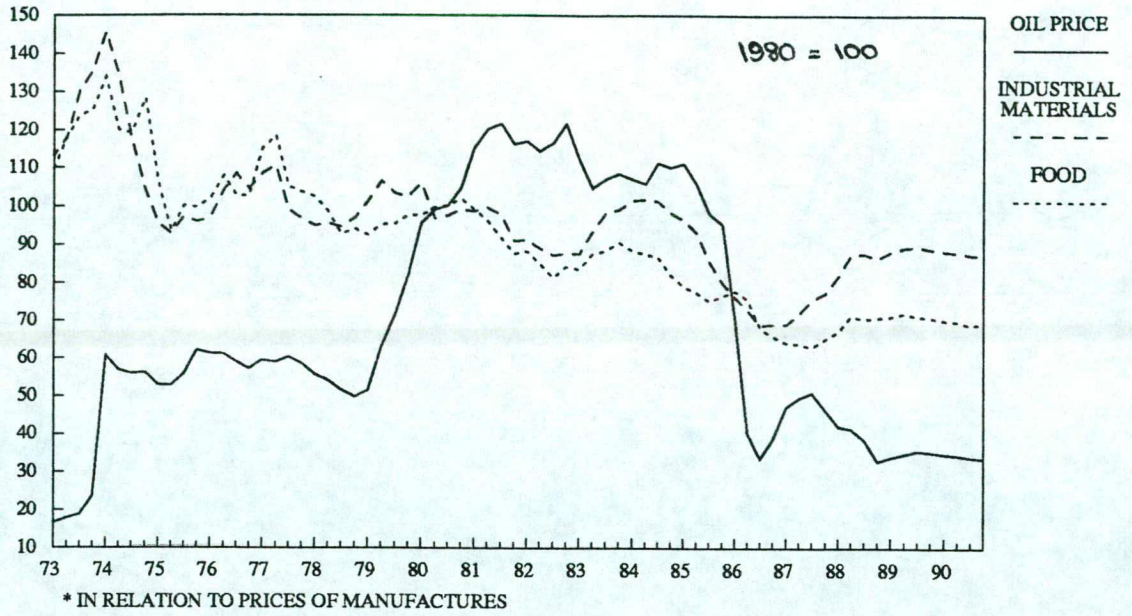
* Average price of oil imported into OECD countries (fob).

b. Non-oil commodity prices

21. Non-oil commodity prices rose strongly during 1987 and the first half of 1988, but appear to have peaked in June. The Economist index of spot prices (measured in SDRs) has fallen over 10 per cent since then, though it is still almost 20 per cent up on a year earlier. The wider measures of commodity prices used in the forecast (since they are a better guide to likely developments in export and import values and consumer prices) fluctuate less than spot prices, but still show non-oil commodity prices in 1988Q2 were 15 per cent higher in SDR terms than a year earlier.

22. Very little further rise in real commodity prices is expected in 1989 and 1990. The recent behaviour of spot prices suggests that the supply of commodities is reacting, albeit with a lag, to the earlier strength of prices. But the continued strength of activity in 1989 is expected to prevent any further falls in real prices.

Chart 4: Real Commodity Prices*



* IN RELATION TO PRICES OF MANUFACTURES

c. Inflation in the major countries

23. Consumer price inflation in the major industrial countries has averaged around 3 per cent a year since the effects of the fall in oil prices dropped out in the middle of 1987. The large increases in non-oil commodity prices do not appear to have had any effect on inflation, in part because they have been offset by weaker oil prices. (Total commodity prices have probably not risen at all over the past year).

Table 10: Consumer Prices

	Consumers' Expenditure Deflator			
Percentage change on year earlier	1987	1988	1989	1990
US	4.5	4.1	5.2	5.5
Japan	-0.2	0.0	1.4	1.5
Germany	0.5	1.1	1.9	1.3
France	3.1	2.5	2.8	2.9
Italy	5.7	5.2	4.9	5.6
Canada	4.3	3.4	3.8	4.8
UK	3.8	4.8	5.8	5.1
Major 7	3.2	3.1	4.0	4.1

24. There are, however, signs pointing to a build up of inflationary pressures in some of the major industrial countries and more are likely to appear if demand and activity grow as strongly as projected. Capacity utilisation in several countries is approaching previous peaks - see table 11 - and unemployment in the United States is around its lowest rate for over a decade. This has already produced some acceleration in US producer price inflation. In the US and Japan wage settlements and earnings growth have picked up. Further increases in wage inflation in the US are forecast over the next few years, and these are likely to have some impact on consumer price inflation.

Table 11 : Rates of Capacity Utilisation

	Previous peaks*		Average 1987	Latest	
	73-74	79-80			
United States	88.6	86.9	81.0	83.7	(Aug)
Japan**	+34	-6	-23	-5	(Q2)
Germany	88.1	85.9	84.3	86.2	(Q2)
France	86.1	82.5	80.0	82.5	(Q2)
Italy	78.8	77.7	77.0	78.6	(Q2)
Canada	92.8	86.6	86.6	86.4	(Q1)

Notes: *Figures are for the quarter within these periods which had the highest rate of capacity utilisation.

**Japanese figures are for balance between 'excessive capacity (-) and 'insufficient capacity (+).

25. Both the Japanese and German Governments plan to raise indirect taxes in 1989. These contribute about ¼ percentage point to the projected rise in major seven inflation.

VI CURRENT BALANCES

26. The current account imbalances of the United States and Japan look to have peaked, in dollar terms, in 1987. Trade volumes have been adjusting to exchange rate changes since 1985, but the size of the imbalances was such that substantial volume adjustment was required to set them on a downward path.

Table 12 : External Balances and Trade Ratios

	1986	1987	1988	1989	1990
Current balance ($bn)					
US	-141	-154	-127	-95	-94
Japan	86	87	75	68	68
Germany	38	44	44	49	47
United Kingdom	-	-4	-24	-24	-21
NODCs	-13	9	4	-4	-2
OPEC	-14	4	-17	-18	-10
Current balance (% GNP)					
US	-3.4	-3.4	-2.6	-1.8	-1.7
Japan	4.3	3.7	2.7	2.3	2.1
Germany	4.2	3.9	3.7	3.9	3.5
United Kingdom	-	-0.6	-3.0	-2.8	-2.4
Trade balance ($bn)					
US	-144	-158	-114	-79	-88
Japan	93	96	86	77	76
Germany	53	65	64	66	63
Trade ratio (exports/imports, volumes, 1980=100					
US	53	58	68	73	76
Japan	116	104	93	87	83
Germany	111	108	107	105	102

27. Further progress in reducing the US current account deficit is expected in 1989, but by 1990 the effects of the dollar's depreciation since 1985 may have largely worn off. Even so, when expressed as a percentage of GNP the deficit is forecast to halve between 1987 and 1990, while the Japanese surplus halves between 1986 and 1990.

28. If US demand does not slow down more rapidly than demand in the rest of the world, as projected in this forecast, then it is quite likely that the US current account deficit will begin to

rise again during 1989 or 1990. Exports cannot continue to expand as rapidly as they have in the last year, because capacity utilisation in several export industries is already higher than previous peaks, so the adjustment must necessarily come from the import side (though slower domestic demand growth will also free some resources to allow exports to grow more rapidly than would otherwise be possible).

ANNEX

COMPARISON OF THE WEP AND IMF FORECASTS FOR THE UNITED STATES

1. As Table 1 shows, overall the latest WEP forecast and the recently published IMF WEO forecast are very similar, but both differ from the now out-of-date last OECD forecast.

Table 1 : Comparison of world economic forecasts

		WEP Oct 1988	IMF Sept 1988	OECD June 1988
Major 7 real GNP growth	1987	3.3	3.4	3.1
	1988	4.1	4.1	3
	1989	2.9	3.0	2½
Major 7 consumer price inflation	1987	3.2	2.8	2.9
	1988	3.1	3.2	3
	1989	4.0	3.5	3¼
World trade (volume)	1987	4.9	5.7	5.2
	1988	8.8	7	6¾
	1989	6.5	5½	6
World trade in manufactures (volume)	1987	5.4	n.a.	6.5
	1988	8.7	n.a.	8¼
	1989	7.3	n.a.	7

2. The major difference between our view and that of the IMF is on prospects for the US economy. In particular, the WEP envisages higher inflation in the US and greater improvement in the current account deficit in 1989 and 1990 than does the IMF WEO. This annex compares the main elements of the two forecasts for the US economy and sets out the factors underlying these differences.

3. Table 2 summarises the two forecasts.

Table 2 : Forecasts of the US economy

		HMT WEP	IMF WEO
Real GNP growth (%)	1988	3.9	4.0
	1989	2.9	2.8
	1990	1.8	2.8
Consumer price inflation (%)	1988	4.0	4.1
	1989	5.2	4.5
	1990	5.5	4.1
Current account ($bn)	1988	-127	-129
	1989	-95	-129
	1990	-94	-148

4. Real GNP growth in the US averaged an annual rate of 4½ per cent over the last year and a half. With capacity utilisation approaching previous peaks and unemployment at its lowest level for over a decade, this looks unsustainable. Growth during the second half of 1988 and in 1989 is expected to be broadly in line with potential.

5. The IMF also project growth close to potential in 1990. This is unsurprising given their assumption that policies will not be changed. The WEP, on the other hand, assumes a further 1 percentage point rise in US interest rates in the first half of 1989 and a tightening of fiscal policy equivalent to about ¾ per cent of GNP in Fiscal 1990 (which begins in October 1989). These combine to reduce domestic demand growth by about 1 percentage point, and real GNP growth by a little less, in 1990.

6. The assumed tightening of monetary policy in 1989 reflects our view that US inflation will rise above 5 per cent, largely as a result of domestic demand pressures. There are already clear signs of a build up of inflationary pressures : capacity utilisation approaching previous peaks, unemployment at a 14-year low, wage settlements rising for the first time in four years and earnings growth and the growth of employment costs both picking up. The prevalence of multi-year wage settlements in the US means that inflation tends to pick up slowly, but equally makes

it difficult to reduce inflation very quickly. We expect inflation to peak towards the end of 1989, before falling back to around 5 per cent by the end of 1990.

7. The IMF, on the other hand, take a more sanguine view about domestic inflationary pressures in the US. (Both forecasts have similar oil/non-oil commodity price projections, and so have similar external pressures on US inflation). In particular, the IMF expect very little pick up in earnings growth between 1988 and 1989. This seems to ignore recent data showing that earnings are already accelerating quite rapidly.

8. Table 3 compares the two forecasts of trade volumes. Both assume constant real exchange rates.

Table 3 : Export and import volume growth (%)

		HMT WEP	IMF WEO
Exports	1988	26.3	23.1
	1989	10.6	10.4
	1990	5.7	n.a.
Imports	1988	6.6	6.3
	1989	2.8	6.6
	1990	2.1	n.a.

IMF forecasts for 1990 have not been published.

9. It is generally agreed that export volumes cannot continue to expand as rapidly as they have done recently because many export industries are already operating at very high capacity utilisation rates. This is reflected in both forecasts.

10. The different views on import volumes are the key to the difference between the WEP and IMF forecasts for the US current balance. The IMF argue that any competitiveness effects from the dollar's depreciation since 1985 have worked through and that, if growth is to be broadly in line with potential, import volumes will grow at around 6-7 per cent a year. The WEP forecast suggests that competitiveness effects typically take longer to feed through fully. As evidence of this, import volumes fell in the second quarter of 1988, despite strong demand growth.

Although further falls are not expected - the second quarter data probably reflect a rundown in stocks - imports are seen as growing only at 2-3 per cent a year over the next 18 months or so. Then, in 1990, when the competitiveness effects are weakening, imports are hit by the assumed policy-induced slow down of domestic demand.

11. So, the main differences between the two forecasts are:

i. The WEP expects earnings growth, which has picked up already in 1988, to continue to rise in 1989. This is seen as leading to some rise in consumer price inflation, profit margins having already been trimmed this year.

ii. Unlike the WEO forecast, the WEP suggests that continuing competitiveness effects from the depreciation of the dollar will keep US import growth low in 1989, thus contributing to an improvement in the current account deficit.

iii. The WEP forecast assumes a tightening of US monetary and fiscal policy, which combine to reduce domestic demand and import growth in 1990, thus preventing any increase in the current account deficit. The WEO forecast, as usual, is based on unchanged policies.

PUBLIC FINANCES

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TREASURY ECONOMIC FORECAST: PUBLIC FINANCES

I attach the report on the forecast for the public sector finances. It provides more detailed explanation of the forecasts of expenditure and receipts summarised in section 11 of the main forecast report circulated by Mr Sedgwick on 12 October (copies of section 11 attached for those who have not seen it).

KEITH VERNON

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TREASURY ECONOMIC FORECAST

PUBLIC FINANCES

AUTUMN 1988

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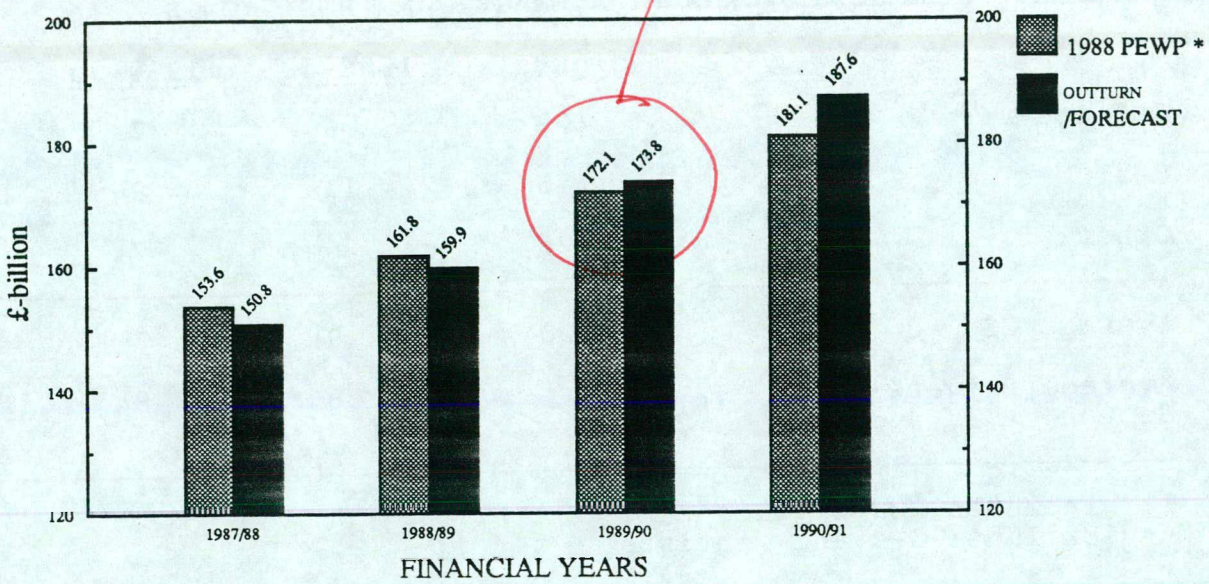
TREASURY ECONOMIC FORECAST: PUBLIC SECTOR FINANCES

I. PUBLIC EXPENDITURE

CHART A

PLANNING TOTAL EXCLUDING PRIVATISATION PROCEEDS
(Outturn/Forecast compared to Plans)



* 1987-88 plans from 1987 PEWP

Central Government Pay

1. Table I sets out the forecast for central government average earnings. Earnings growth in a particular financial year mainly reflects settlements in the pay round beginning the previous September. In the 1987-88 pay round, settlements of central government employees edged ahead of the private sector average, boosted in particular by the nurses award. The forecast assumes that central government earnings as a whole will lag behind the private sector in the 1988-89 pay round and grow a little faster subsequently.

2. The projections of pay increases for the main groups within central government are less firm than those for the sector as a whole. Some disaggregation is required to assess the pressures on separate programmes. Earnings of health service workers in 1988-89 are heavily influenced by the nurses' settlement and other NHS review body awards close to the private sector average. The large proportion of health

employees covered by pay review bodies - around 75 per cent - is a factor in projecting earnings at the top of the central government range. Average pay of the armed forces has fallen behind the private sector average in recent pay rounds and this trend is expected to continue, albeit to a lesser extent. Implicitly civil servants' earnings growth converges towards the private sector average.

TABLE I: CENTRAL GOVERNMENT AVERAGE EARNINGS GROWTH - %

	(Weights)	1988-89	1989-90	1990-91
Defence*	(29)	6	7	8½
Health**	(45)	13	8¼	9
Other	(26)	6¼	7¾	9
Average CG	(100)	9¼	7¾	9
Average Private Sector		8¾	8¾	8¼

* Includes MOD civilians
** Excludes GPs and dentists

Defence

3. Defence expenditure has been falling in real terms since 1985-86, reflecting the end of the NATO commitment. The forecast initially continues and then reverses this trend, on the grounds that the scope for further real reductions in procurement is limited and the pay bill will rise inexorably in real terms. Table II shows projected overspends on current plans rising sharply to £1½ billion in 1990-91 as the pressure for higher procurement spending begins to bite.

4. Under special arrangements, MOD can carry forward significant amounts of underspend on final cash limits into the following year. This end year flexibility (EYF) has allowed the department to increase its 1988-89 cash limit by over £½ billion. The forecast implies that a little under half of this is used to accommodate the overspend on plans in 1988-89 with the remainder carried forward into 1989-90.

TABLE II: DEFENCE EXPENDITURE

	Estimated outturn 1987-88	Forecast 1988-89	1989-90	1990-91
£ billion current prices				
Forecast	18.9	19.4	20.7	22.1
Planned*	18.8	19.2	20.0	20.6
Forecast overspend	0.1	0.2	0.7	1.5
(of which pay)		(0.3)	(0.5)	(0.9)
Real growth rates (%)				
Forecast	-1½	-3½	0	1¾
Planned*		-2½	¼	0

* 1987-88 from 1987 PEWP, later years from 1988 PEWP

Health

5. Health spending is forecast to rise on average at about the same rate in real terms as over the past two years, but significantly faster in both real and cash terms than in the current plans. The forecast reflects the real pay increases for health workers described earlier and the view that other spending will rise at the same rate in real terms as over the past five years.

TABLE III: HEALTH EXPENDITURE

	Estimated outturn 1987-88	1988-89	1989-90	1990-91
£ billion current prices				
Forecast	20.7	22.9	24.9	27.2
Planned	20.0	21.8	22.9	24.0
Forecast overspend	0.7	1.1	2.0	3.2
(of which pay)	(0.3)	(0.8)	(1.4)	(2.2)
Real growth (%)				
Forecast	4½	3¾	2½	4
Planned		1	1½	1¾

Social Security Expenditure

6. The forecast of social security expenditure takes account of:

(a) the forecast for unemployment and upratings;

(b) some modest additions to expenditure to allow for possible future policy changes;

(c) what the forecasters regard as realistic 'underlying' growth (ie. growth after allowing for the effects of upratings, changes in unemployment and policy, demographic factors etc).

7. There is now some evidence from the outturns under the new benefit regime introduced in April of slower than expected growth. The latest assessment from the DSS in-year monitoring system implies a fall in the underlying growth of expenditure from 4 per cent in 1987-88 to 1¼ per cent in 1988-89. Even if the relatively high 1987-88 growth is partially discounted, the DSS projection could be too low. But the forecast gives some weight to the outturn information in assuming underlying growth of 2 per cent in 1988-89 (compared with 3 per cent in the June forecast), rising to 2½ per cent thereafter as benefit claimants become accustomed to the new regime.

TABLE IV: UNDERLYING GROWTH IN SOCIAL SECURITY EXPENDITURE - %

	1986-87	1987-88	1988-89	1989-90	1990-91
1988 PEWP			¾	1¼	1½
Forecast	3¼	4	2	2½	2½

8. Table V shows that the resulting forecast of expenditure is reduced compared to the PEWP because of lower unemployment (Table VI). In 1988-89 and 1989-90 this is enough to offset the impact of higher upratings, the adoption of faster underlying growth and allowance for policy changes.

TABLE V: EFFECTS OF ECONOMIC AND OTHER FACTORS ON THE SOCIAL SECURITY FORECAST

£ billion

	1987-88	1988-89	1989-90	1990-91
Forecast overspend*	0.3	- 0.6	- 0.1	1.7
Due to:				
(a) Economic Assumptions:				
(i) Unemployment	- 0.9	- 1.2	- 1.9	- 2.0
(ii) Upratings	-	-	0.5	1.7
(b) Policy changes	0.1**	0.1	0.3	0.5
(c) More realistic underlying growth	1.1	0.5	1.0	1.5

* relative to 1987 PEWP for 1987-88 and to 1988 PEWP thereafter

** additional payment following the RPI error.

TABLE VI: ECONOMIC ASSUMPTIONS UNDERLYING THE FORECAST OF SOCIAL SECURITY EXPENDITURE

	1988-89	1989-90	1990-91
1. Unemployment* (GB, million)			
PEWP 1988	2.6	2.6	2.6
Forecast	2.1	1.8	1.8
2. Upratings** (% pa)			
(i) RPI			
PEWP 1988	4.2	4½	3¼
Forecast	4.2	5.8	6.4
(ii) ROSSI***			
PEWP 1988	3.2	3½	3
Forecast	3.2	4.5	5.0

* Latest assumption for 1988-89 issued to DSS is 2.1m

** Outturn inflation to September 1988, on which the 1989-90 upratings are based is 5.9 per cent for the RPI and 4.7 per cent for ROSSI

*** RPI less housing costs

The National Insurance Fund

9. The forecast growth of real earnings continues to drive National Insurance Contributions up at a faster rate than National Insurance benefit expenditure, which is also reduced by lower unemployment. This produces large flow surpluses on the National Insurance Fund (GB) as shown in Table VII, even though the forecast assumes that the Treasury Supplement will be abolished in April 1989.

TABLE VII: NATIONAL INSURANCE FUND (GB) SURPLUSES - £ billion

	1987-88	1988-89	1989-90	1990-91
Surplus: flow	1.3	3.2	2.2	2.6
: level end-year	7.0	10.2	12.4	15.0
Treasury Supplement	2.1	1.6	0	0
(rate, per cent)	(7)	(5)	(-)	(-)

Net EC Contributions

10. Table VIII shows the forecast of total net payments to EC institutions and compares this with the PEWP.

TABLE VIII: NET EC CONTRIBUTIONS (£bn)

	1987-88	1988-89	1989-90	1990-91
1988 PEWP		0.8	1.5	1.3
Forecast	1.6	1.0	2.1	1.9

11. The forecast is aligned with EC division's latest view. It takes account of the Brussels European Council decision in February to increase the ceiling on EC own resources from 1.4 per cent of community VAT to 1.2 per cent of GNP. Buoyancy of the UK economy leads to higher Custom's duty payments on imports from outside the EC, and higher VAT/ GNP contributions.

Other Central Government Expenditure

12. This includes expenditure on transport, agriculture, employment, industry, education, law and order etc. Real growth in 1988-89 is boosted by expenditure on Rover and by a low outturn in 1987-88. Thereafter the forecast is influenced by

(i) higher than planned housing and ECGD subsidies reflecting upward revisions to interest rates;

(ii) the transfer of polytechnics in April 1989, leading to a step increase in education grants, and

(iii) higher than planned real investment in roads and prisons.

TABLE IX: 'OTHER' CG EXPENDITURE

	Estimated outturn 1987-88	1988-89	1989-90	1990-91
£ billion current prices				
Forecast	26.2	29.5	32.5	35.3
Planned*	27.3	29.3	31.1	32.0
Forecast overspend	- 1.1	0.2	1.4	3.3
Real growth (%)				
Forecast	- 4	5	4¾	3½
Planned*		2½	2¾	- ¼

* 1987-88 from 1987 PEWP, later years from 1988 PEWP

Local Authorities

13. The forecast of local authority (LA) current expenditure in 1988-89 is largely derived from authorities' own budgets which in recent years have proved to be an accurate guide to outturn. Unlike previous years, when LAs have tended to underspend their budgeted expenditure slightly, the forecast is for a small overspend in 1988-89 both because inflation is higher than councils allowed for and because recent changes to the grant system reduce the incentive to stick within budgets.

14. Something like three-quarters of current expenditure is on pay. Information on settlements suggests that LA average earnings will rise by 8¼ per cent in 1988-89. Employment growth could well be negative - in sharp contrast to recent years - partly because of a once-for-all reduction in manpower due to the reduction of community programme (CP) but also because the underlying growth of employment is likely to be lower. Even so, the pay bill is forecast to exert a real squeeze on other current spending given LAs' budgeted expenditure.

15. Falling school rolls and compulsory competitive tendering are two factors bearing down on employment growth throughout the forecast period. The forecast also takes account of the transfer of polytechnics out of the LA sector in April 1989, which may reduce the headcount measure by over 2 per cent.

TABLE X: LA EMPLOYMENT AND PAY
(per cent increases)

	1986-87	1987-88	1988-89	1989-90	1990-91
Staff numbers (headcount)	2¼	2	- ½	- 2¾	¾
LA average earnings	8½	7½	8¼	9½	8½
Memo: Private sector earnings	7½	8½	8¾	8¾	8¼
Staff numbers excluding polytechnics and CP	2¼	2	¾	¾	¾

16. LA average earnings are forecast to rise faster than the private sector average in 1989-90, reflecting the drop out of CP workers who are paid below the average. This change, together with the transfer of polytechnics, needs to be borne in mind when interpreting the expenditure forecast. The underlying forecast is for rapid real growth of about 4 per cent in 1989-90 as expenditure is brought forward in advance of community charge, but real growth of only about 1 per cent in 1990-91 when expenditure is affected by the abolition of rate fund subsidies to LAs' housing operations.

17. Barring unforeseen events, grant payments in 1989-90 have already been fixed and imply a steep fall in grant percentage (on the basis of the forecast of current expenditure) following a modest decline in 1988-89. Next year's fall partly reflects the revised financing of polytechnics and partly the surge in expenditure ahead of community charge. In 1990-91 the forecast assumes that, taking grant and business rates together, the burden rates of CC will be unchanged in real per capita terms from 1989-90. This implies an increase of about 1 percentage point in grant percentage (after continuous falls since 1981-82) and a grant settlement 3-4 per cent higher in real terms than in 1989-90.

18. Income from domestic rates (including CC in Scotland) is forecast to rise by around 9 per cent in 1989-90, little different from the increase in 1988-89. This implies rate poundage rises of around 7½ per cent. In 1990-91 income from CC is flat in real terms by assumption while income from business rates grows in real terms (i) because the RPI on which business rate poundage is based grows faster than the GDP deflator and (ii) due to the buoyancy of commercial property investment.

19. The main feature of the LA capital account recently has been the unexpectedly high level of capital receipts - from sales of council houses and other physical assets and repayments of LA mortgages. The forecast assumes that receipts continue to grow in real terms - albeit at a slower rate - reflecting high asset prices and administrative incentives for councils to sell capital assets. Coupled with modest real growth of gross capital expenditure, the forecast implies sizeable underspends on LA capital relative to the Survey baseline.

TABLE XI: LOCAL AUTHORITY RATE FUND ACCOUNT

PES terms, GB

£ billion

	1987-88	1988-89	1989-90	1990-91
Expenditure				
Relevant Public expenditure	32.4	34.5	37.4	39.9
Memo: Overspend on Plans	1.4	1.3	3.8	5.4
Total Rate Fund expenditure	35.4	38.2	41.3	44.0
Receipts				
Grant (cash)	16.3	16.8	17.5	19.1
Rates	18.9	20.6	21.8	13.2
of which:				
Domestic	8.9	9.7	9.6	0
Non-domestic	10.0	10.9	12.1	13.2
Community charge	-	-	0.9	11.2
Drawings from balances	0.3	0.8	1.0	0.6
Total finance	35.4	38.2	41.3	44.0
Grant percentage (% accruals)	45.6	45.2	42.8	43.7
Cash		Annual percentage changes		
Total Rate Fund expenditure	8.9	7.9	8.0	6.6
Grant	9.4	3.4	4.2	8.9
Rates & community charge	9.4	9.3	10.0	7.2
of which:				
Domestic	9.4	9.3	9.1	5.6
Non-domestic	9.4	9.3	10.8	8.7
Real terms				
Total Rate Fund expenditure	3.5	1.1	1.9	1.4
Grant	4.0	-3.1	-1.7	3.6
Rates and community charge	3.9	2.4	3.8	2.0
of which:				
Domestic	3.9	2.4	2.9	0.4
Non-domestic	3.9	2.4	4.6	3.4

20. The forecast of LA borrowing - the LABR - in 1988-89 is informed both by the projections of LA income and expenditure and by provisional outturns for borrowing so far this year. The latter suggests higher borrowing than the former although in previous years monthly borrowing patterns have been erratic (coincidentally the LABR in April to August is close to the level in the same period in both of the two previous years; but borrowing varied by over £1 billion between 1986-87 and 1987-88 as a whole). The forecast of the LABR thereafter mirrors projected movements in the balance of income and expenditure. The fall in borrowing in 1990-91 can be seen as partly reflecting less use of rate fund balances to finance expenditure and partly reflecting slower expenditure growth, for example from the abolition of housing subsidies.

LABR - £ billion

1986-87	1987-88	1988-89	1989-90	1990-91
¼	1½	¾	¾	-½

Nationalised Industries and the PCBR

21. The forecast assumes that BSC and Girobank are privatised in autumn 1988, the water authorities in autumn 1989, electricity distribution in summer 1990, the larger generating company in autumn 1990 and Scottish electricity early in 1991. The forecast of aggregate external finance allows for the loss of these companies' negative external finance from the date of privatisation. (Table XII, however, includes steel, electricity and water throughout.) The forecast of central government interest and dividend receipts also allows for dividend receipts from residual shareholdings in water and electricity and for interest receipts on water, electricity and gas debt.

22. In line with past experience NIs' output growth in 1987-88, at 3 per cent, was less than the growth of the economy as a whole. It is forecast to fall back to under 2 per cent by 1990-91.

23. Although prices charged by NIs to domestic consumers are forecast to rise in real terms, particularly in 1988-89, competitive pressures will almost certainly continue to produce real reductions in prices charged to industry. In particular, coal prices are thought likely to

come under pressure from the electricity supply industry, prior to the latter's privatisation. NI prices as a whole may therefore fall in real terms, continuing the trend over the recent past.

24. Strong labour productivity growth has been a noteable feature of NIs' performance in the 1980s and is an important explanation of the relatively fast growth of NIs' profits over the same period. The scope for reducing overmanning in most NIs is now more limited though not exhausted, so labour productivity growth is likely to be lower over the future. Combined with real price falls this implies a fall in the growth of NIs' profits compared with the recent past.

TABLE XII: NATIONALISED INDUSTRY TRADING PERFORMANCE AND INVESTMENT*

% increases

	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91
Output	2¾	2	3	3	1¾	1½
Employment	- 7¼	- 5½	- 4½	- 2½	- 2½	- 2
Productivity	10¾	8	8	5½	4¼	3½
Real Prices	- ¾	- 1¼	- 2¼	- 1	- 1¾	- ½
Profits**	28½	7	18¼	17¾	11¾	6
Investment Volume	- 5¼	- 2¼	- 1¾	13¼	3¼	5

* The figures relate to the current composition of the NI Sector and adjust for the coal strike.

** gross of depreciation

TABLE XIII: EXTERNAL FINANCE AND THE PCBR (£bn)

	1987-88	1988-89	1989-90	1990-91
External Finance				
1988 PEWP		0.7	0	- 0.4
Forecast	0.4	0.4	0.3	0.6
PCBR				
1988 Budget Forecast	- 1.4	- 0.8	- 1.1	- 1.4
Forecast	- 1.6	- 1.0	- 0.8	- 0.5

25. Table XIII shows the forecast of external finance and the PCBR. Given the general buoyancy of the economy NIs should undershoot their EFL in 1988-89. This year's external finance will also benefit by £0.2 billion from the sale of Girobank. The proceeds of the sale go to the Post Office. After this year the outturn for external finance could be well above existing plans, partly because of over-optimistic profit projections, partly because of increased investment needs, but also because those industries due to be privatised, particularly steel and electricity, will no longer be making negative contributions to external finance.

26. In the first six months of the financial year the PCBR was close to Budget profile. This trend is likely to continue. Taken together with the sale of Girobank this implies an outturn for the year as a whole which is £0.2 billion lower than the Budget forecast.

Debt Interest

27. General government gross debt interest payments in 1988-89 are now forecast to be £0.1 billion higher than in the FSBR and £0.1 billion higher than last year. Although the GGBR is now forecast to be more negative in 1988-89 than at Budget time, sales of gilts to finance last year's increase in official reserves prevents gross debt interest from falling. After 1988-89 a more negative GGBR than was forecast at Budget time and some rundown of reserves leads to a lower forecast for gross debt interest payments.

TABLE XIV: GENERAL GOVERNMENT GROSS DEBT INTEREST PAYMENTS

£ billion

	1987-88	1988-89	1989-90	1990-91
1988 PEWP	17.8	18.0	18.0	18.0
FSBR	17.5	17.5	17.1	16.7
Forecast	17.5	17.6	16.6	15.2
(% of GDP)	(4¼)	(3¾)	(3¼)	(2¾)

28. The counterpart of a large rise in official reserves last year is a big increase in interest receipts. In 1990-91 net payments are also reduced by dividend receipts from residual shareholdings in the privatised electricity and water industries.

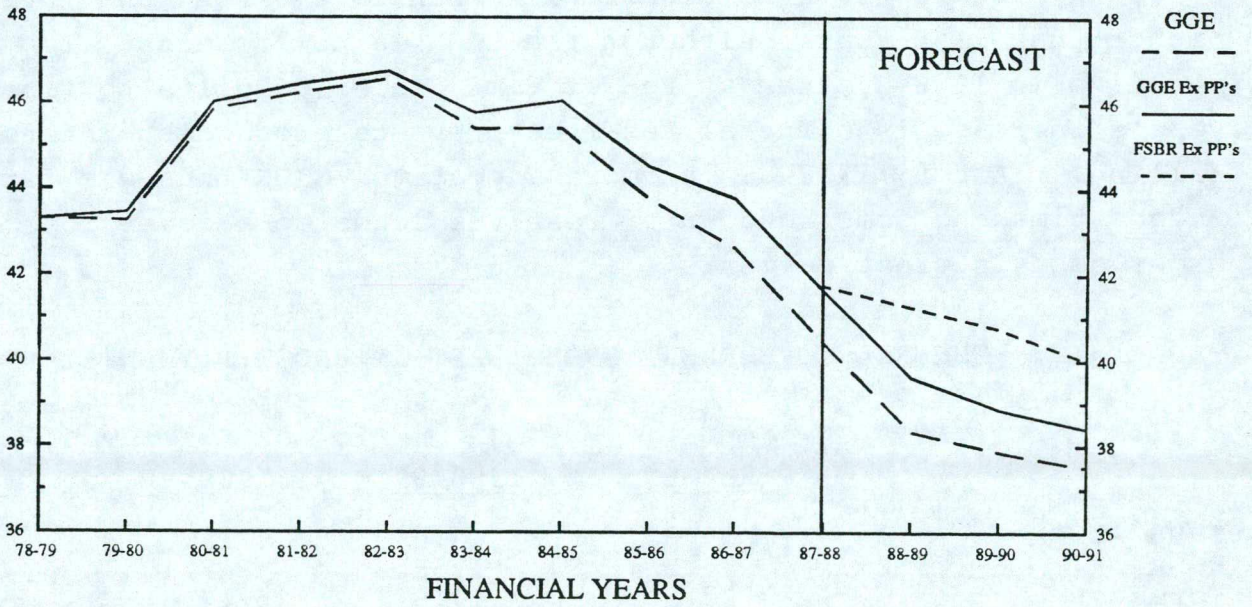
TABLE XV: GENERAL GOVERNMENT NET DEBT INTEREST PAYMENTS

£ billion

	1987-88	1988-89	1989-90	1990-91
1988 PEWP	12.3	13.0	13.0	13.0
FSBR	11.2	11.8	11.7	12.0
Forecast	11.5	11.2	10.3	8.8
(% of GDP)	(2¾)	(2½)	(2)	(1½)

CHART B

GENERAL GOVERNMENT EXPENDITURE
AS A PERCENTAGE OF GDP



GENERAL GOVERNMENT RECEIPTS

29. Table XVI presents the forecast of general government receipts in the format of FSBR Table 1.2. All the figures in this section of the report are before taking account of the fiscal adjustment.

TABLE XVI: GENERAL GOVERNMENT RECEIPTS
(per cent changes)

	Shares in 1988-89	1987-88	1988-89	1989-90	1990-91
Income Tax	0.23	9	4	7½	8½
Corporation Tax (excl. North Sea)	0.09	27	25	26	8½
Capital Taxes	0.02	18½	30	2	- 6
VAT Receipts	0.15	13	14½	9	7
Local Authority Rates and CC	0.10	8	11½	8	7
Stamp Duties	0.01	30	- 1½	12½	11
Other Expenditure Taxes	0.15	1½	8	5½	6
North Sea Revenues	0.02	11	- 35	- 18½	- 8
Total Taxes and Royalties	0.76	9½	9½	9	7
National Insurance Contributions	0.17	9	11	8½	8
Interest and Other Receipts*	0.07	- 8	+ 14	2	23
General Government Receipts	1.00	8½	9½	8½	7
Memo:- Money GDP		10	11	8½	7½

* including gross trading surpluses of general government bodies.

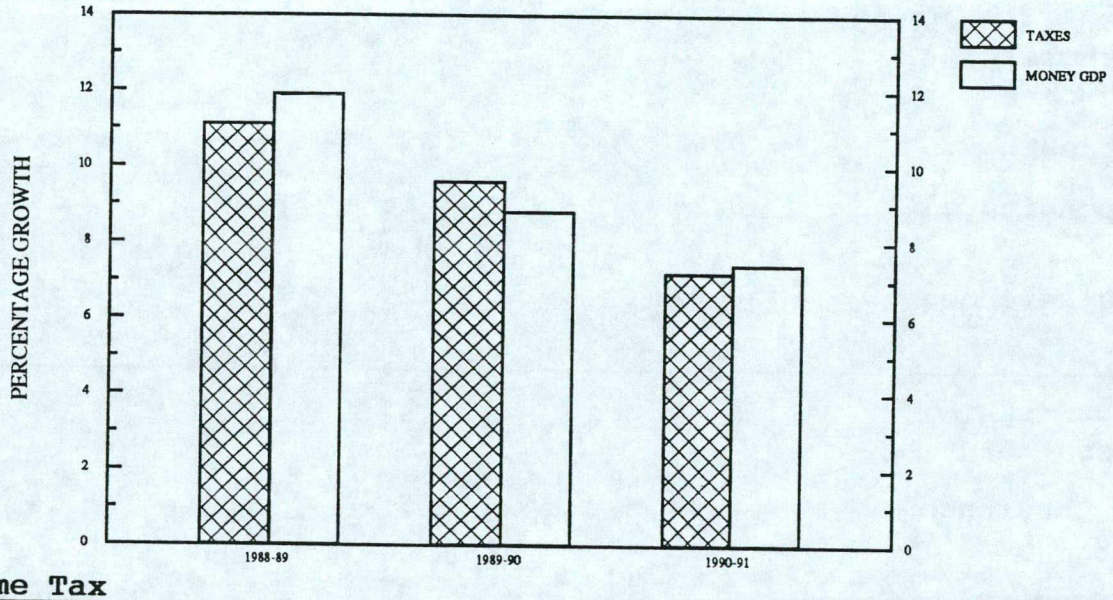
30. General government receipts are forecast to rise by 9½ per cent in 1988-89 - below the forecast growth rate of 11 per cent for money GDP. This largely reflects the Budget tax changes, which reduced 1988-89

receipts by £4 billion (2 per cent of General Government receipts) compared with an indexed base. Apart from income tax those receipts whose growth is expected to be below that of GDP include North Sea revenues, and stamp duties, depressed by the stock market crash, which are both expected to fall. Those receipts expected to grow significantly more than money GDP are non-oil corporation tax, VAT and capital taxes.

31. The forecast non-oil tax burden is summarised in Table 38 of the main report. Growth of non-oil taxes is compared with that of GDP in Chart C below.

CHART C

GROWTH IN NON-NORTH SEA MONEY GDP AND TAXES
AND NATIONAL INSURANCE CONTRIBUTIONS(BEFORE FISCAL ADJUSTMENT)



Income Tax

32. Income tax revenues for 1988-89 are forecast to be some £1.3 billion (3 per cent) higher than in the FSBR. This is primarily due to higher than expected PAYE receipts. The forecast has been heavily influenced by the outturn in the first half of the year when PAYE receipts were above the budget profile. The annual forecast can be only partly be explained by a revised forecast of wages and salaries in 1988-89 - some 1½ per cent higher than at Budget time. It is possible that wages and salaries growth have been underestimated in the National Accounts. Other potential reasons for the 'unexplained' higher receipts this year are a more rapidly changing income distribution than anticipated and perhaps improved compliance. (The effect of the latter is thought to be marginal.)

33. The effective rate for PAYE income tax is projected to fall by ¾ a percentage point in 1988-89 as a result of the budget tax cuts - a fall comparable to the ½ per cent in 1987-88 when the tax cuts were worth around two thirds of those in the current year.

TABLE XVII: EFFECTIVE RATES OF INCOME TAX

	1986-87	1987-88	1988-89	1989-90	1990-91
PAYE Accruals as a per cent of wages and salaries	19.2	18.8	18.0	18.2	18.2
Total Income Tax Accruals as a per cent of personal income	13.2	13.5	13.2	13.2	13.4

34. In 1989-90 and 1990-91 the forecast makes the usual assumption of indexation of allowances in line with RPI inflation. Other things being equal, moderate real earnings growth forecast in 1989-90 and 1990-91 would lead to a rise in the effective PAYE rate as a result of real fiscal drag. This is true in 1989-90 but the offsetting cost of introducing independent taxation in 1990-91 results in no change in the PAYE effective rate.

35. The 1988 Budget tax changes are expected to lead to further gains or losses in tax revenues as a result of changes in economic behaviour. Some tentative estimates of these measures were taken on board in the June forecast, for the first time, and have been maintained in the current forecast. The most important of these are the effects of the Budget changes in higher tax rates that are assumed to yield £400 million by 1990-91 from a combination of increased labour supply from high rate taxpayers and substitution of (taxable) cash income for (tax deductible) expenses or benefits in kind. Table XVIII below summarises these effects.

TABLE XVIII: BEHAVIOURAL EFFECTS OF 1988 BUDGET CHANGES

(Differences from an indexed base) **£ million**

	1988-89	1989-90	1990-91
Car scales and home improvement loans	15	30	45
Higher rates	40	240	400
Independent taxation			-100
Total behavioural	55	270	345

Corporation Tax

36. Onshore mainstream corporation tax (MCT) rose by 35 per cent in 1987-88 following increases of 21 per cent in 1985-86 and 58 per cent in 1986-87. While this reflects buoyant profits growth in 1984 to 1986 tax receipts have risen significantly more than profits resulting in a rise in the effective tax rate for MCT from 11 per cent in 1985-86 (1984 accruals) to 15½ per cent in 1987-88.

37. Table XIX gives the forecast for non-North Sea MCT and Advance Corporation Tax (ACT). MCT Receipts are forecast to continue rapid growth - over 25 per cent - in 1988-89 following strong company income growth of 24 per cent in 1987. The projection of MCT receipts for 1988-89 will be subject to revision when the actual receipts for October have been assessed (over 50 per cent of Corporation Tax receipts fall due in October and January). The current projection is little changed from that of the FSBR .

38. MCT receipts are expected to continue their strong growth - nearly 30 per cent - in 1989-90 due to buoyant profits growth in 1988 when the income of Non-North Sea Industrial and Commercial Companies is projected to rise by 18 per cent.

39. In 1990-91 receipts are expected to grow by only 8 per cent as a result of the slow down in income growth to 10 per cent in 1989.

TABLE XIX: DETERMINANTS OF NON-NORTH SEA CORPORATION TAX AND EFFECTIVE RATES

	Percentage Growth Rates for:-					
	Revenue		Tax determinants		Effective Tax Rates (per cent)	
	MCT+ Receipts	ACT	Company Incomes (previous calendar year)	Dividends (Calendar year)	MCT	ACT
1987-88	35	11	18	37	15.5	44.6
1988-89	27	17	24	29	15.5	40.5
1989-90	28	19	17	20	16.3	40.2
1990-91	8	13	10	13	16.1	40.3

\+ includes MCT on capital gains

40. Strong growth of dividends in 1987 and 1988 has led to high growth in ACT receipts - but, because of reductions in the basic rate of income tax in the last two budgets - much smaller growth than that of dividends.

VAT

41. VAT receipts in 1988-89 are forecast to be £27.6 billion - a rise of 14 per cent on the 1987-88 outturn and 5 per cent up (£1.4 billion) on the FSBR forecast. The forecast reflects the buoyancy of receipts in the year to date and growth of nominal consumer expenditure in 1988 of some 2 per cent greater than expected at budget time.

42. The rise of 14 per cent is greater than that the forecast of nominal consumers expenditure - up 11 per cent in 1988. This is true even when special factors such as impact of the Keith report changes to collection procedures and the 1987 Budget measures are discounted. However the large rise accords with the observed phenomenon that when real consumers expenditure grows strongly - 5¾ per cent in 1988 - there is a shift in the composition of consumers expenditure towards VATables. Nevetheless buoyant VAT receipts strengthen the suspicion that growth of consumers' expenditure in 1988 is being under-recorded.

43. Table XX shows the forecast for VAT. There is a large increase in the effective tax rate in 1988-89. In 1989-90 and 1990-91 the effective tax rate is forecast to change little - as real consumers expenditure growth slows down to average levels and there is unlikely to be a further shift in expenditure towards VATables.

TABLE XX: VAT RECEIPTS FORECAST

	Percentage Growth Rates in:-			Forecast Levels (£bn)		
	VAT Receipts (Underlying)	Consumers' Expenditure+	Effective Tax Rate (%) (Underlying)	Underlying Receipts	Special Factors*	Total Receipts
1987-88	12.6	9.2	9.13	23.6	0.5	24.1
1988-89	13.8	10.8	9.37	26.9	0.7	27.6
1989-90	9.3	9.0	9.40	29.4	0.7	30.1
1990-91	6.7	7.1	9.37	31.4	0.7	32.1

* eg. reduction of arrears from Keith
\+ Calendar year

44. The special factors taken into account in deriving these forecasts are Customs and Excise latest estimates of the effects of Keith changes. It also takes account of the extension of VAT to spectacles (worth about £30 million in a full year) resulting from a European Court Judgement (ECJ). The forecast does not, take any account of the latest ECJ requiring the extension of VAT to non domestic new construction etc.

Specific Duties

45. Table XXI below shows effective tax rates for specific duties assuming revalorisation of all duty rates in line with RPI inflation in future budgets.

TABLE XXI: EFFECTIVE TAX RATES FOR SPECIFIC DUTIES: RATIO OF DUTY TO CONSUMERS' EXPENDITURE (per cent)

	Tobacco	Alcoholic drink	Hydrocarbon oils	Total
1986-87	2.0	1.7	3.1	6.8
1987-88	1.7	1.6	3.0	6.4
1988-89	1.7	1.5	2.9	6.2
1989-90	1.6	1.5	3.0	6.2
1990-91	1.6	1.5	3.0	6.1

46. The slight downward trend in the forecast effective rate for tobacco reflects the tendency for tobacco expenditure to grow more slowly than consumers expenditure.

47. For alcoholic drink and hydrocarbon oils there is no reason to think that consumption will rise any differently from consumers expenditure and this is reflected in unchanged effective rates for those goods over the forecast period.

North Sea Revenues

48. Government revenues from the North Sea in 1988-89 are projected at £3.4 billion, £0.1 billion higher than in the FSBR forecast. The sterling oil price is slightly higher in 1988 than assumed in the FSBR while North Sea production is unchanged. The switch to taking royalties in cash (RIC) leads to a one-off reduction in receipts of £0.1 billion this year.

49. The effects of Piper Alpha on production have been largely, but not completely, offset in 1988 by revised higher production figures for the North Sea. Estimates of the effects of Piper Alpha on government revenues from lost production, increased investment and insurance payments are given in a separate note.

50. In 1989-90 a lower oil price and a further fall in oil production leads to North Sea revenues declining to £2.6 billion, despite the ending of repayments of APRT (the latter is expected to reduce net receipts by £0.4 billion in 1988-89). Thereafter revenues are expected to decline further as production falls.

TABLE XXII: GOVERNMENT REVENUES FROM THE NORTH SEA

	Oil price (£/barrel)	Oil production (millions of tonnes)	Gross North Sea Profits (£ billion)		Government Revenues* (£ billion)	
1987	10.9	123	9.5	1987-88	4.7	(4.7)
1988	8.4	116	7.6	1988-89	3.4	(3.3)
1989	8.1	111	6.6	1989-90	2.6	(2.9)
1990	8.4	108	6.8	1990-91	2.3	(2.6)

* FSBR in brackets

Stamp Duties and Capital Taxes

51. Stamp duties and capital taxes (capital gains tax-CGT; inheritance tax-IHT; CT on capital gains) have grown rapidly in recent years. The bull market in stocks to October 1987 and rising house prices would have boosted stamp duties and taxation receipts of capital gains (CGT and CT). The stock market crash last October would have had a fairly immediate impact on receipts from stamp duties, but payments lags mean that only now will there be an effect on the yield of capital taxes.

TABLE XXIII: STAMP DUTY AND CAPITAL TAXES (per cent growth rates)

	1988-89 Forecast (£b)	1986-87	1987-88	1988-89	1989-90	1990-91
STAMP DUTIES	2.4	51½	30	-1½	12½	11
of which:						
land and buildings	1.6	43½	50½	49	12½	5½
shares	0 6	55½	7	-27	19½	24½
CAPITAL TAXES	4.7	21	18½	30	2	- 6
of which:						
capital gains tax	1.9	17	29½	38	-5½	-16½
inheritance tax	1.1	12	9½	- 3	0	4½
companies tax on gains	1.8	47½	18	39½	11	- 1½
MEMO:						
New house prices		15½	19	21½	8	½
Equity prices		26	19	- 6	6	6
Stock market volume		48	81	-14	14½	17½

52. Stamp duties, overall, are expected to change little in 1988-89. Growth in house prices, and consequently value of transactions on which stamp duty is levied, results in strong growth in stamp duty on land and buildings. This is offset by a large fall in stamp duty on shares resulting from lower equity prices in 1988-89 and considerably reduced turnover. In 1989-90 and 1990-91 stamp duties rise at over 10 per cent a year. Duty on shares rises rapidly indeed as turnover, and to a lesser extent prices, pick up from this years depressed levels. Part of the forecast increase in turnover is associated with privatisation 'issues' over the next two years. Growth of stamp duty on land and buildings is expected to decline as house price growth and turnover fall.

53. Capital taxes in 1988-89 are projected to rise by a substantial 30 per cent. They will reflect gains made on transactions in 1987-88 - a substantial number will have been made at high pre-crash prices. No significant increases in receipts from taxes on capital gains are forecast in 1989-90 and 1990-91 when lower post-crash stock market prices will have their full impact in reducing gains.

National Insurance Contributions

54. Table XXIV shows effective tax rates for National Insurance Contributions (NICs denominator-wages and salaries).

TABLE XXIV: EFFECTIVE RATES FOR NICS (per cent)

	Employees	Employers	Total Accruals	Total Receipts
1986-87	6.9	7.4	14.3	14.3
1987-88	7.0	7.4	14.4	14.1
1988-89	6.8	7.7	14.4	14.4
1989-90	6.7	7.8	14.4	14.4
1990-91	6.6	7.8	14.4	14.4

55. The effective rate remains at the 1987-88 level to 1990-91. The main point of interest is the switch in 1988-89 in the burden of NICs (accruals basis) from employees to employers associated with changes in the rate structure introduced in April of this year. 1988-89 receipts are about £0.8 billion up on the FSBR forecast largely as a result of an upward revision to the current years wage and salary forecast.

Other non-tax receipts

56. Forecast for these are given below:

TABLE XXV: NON-TAX RECEIPTS

£bn

	1987-88	1988-89	1989-90	1990-91
Interest and Dividend Receipts	6.0	6.3	6.3	6.9
Gross Trading Surplus and Rent	3.1	3.1	3.4	3.8
Capital Consumption	2.8	3.0	3.2	3.4
Other Miscellaneous Receipts	1.2	0.9	0.9	1.0
Accruals Adjustments	- 0.9	- 0.1	- 0.4	0.3
Miscellaneous Financial Transactions (including balancing items)	- 0.5	- 0.2	- 0.3	- 0.3
Total Other Receipts	11.7	13.0	13.1	14.6

57. The only point of interest on this is a change of around £0.8 billion in accruals adjustments (increasing receipts) for 1988-89. It results largely from the accruals adjustments on NICs; where the gap between accruals and receipts is unusually small in 1988-89 because of the introduction in April 1988 of incentive rebates on NICs for personal pensions. The accruals adjustment on VAT falls by £0.3 billion in 1988-89 - as a result of improved compliance. This effect remains over the forecast period to 1990-91.

FINANCIAL FORECAST

SECRET

FROM: GUS O'DONNELL

DATE: 14 OCTOBER 1988

ECONOMIC SECRETARY

cc: Chancellor
Chief Secretary
Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Sir Geoffrey Littler
Mr Scholar
Mr Monck
Mrs Lomax
Mr D Moore
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Gieve
Mr Hibberd
Mr S Davies
Mr Grice
Miss O'Mara
Miss Noble
Mr Hurst
Mr Ritchie
Mr Brooks
Mr Owen
Mr Lyon
Mr Call
Mr Tyrie

FINANCIAL FORECAST

1. The attached note on the financial forecast, largely written by Martin Hurst and Michael Lyon, covers the period up to 1990-91. It complements the note on the Treasury internal forecast circulated by Mr Sedgwick on 13 October. Topics which are covered in detail in the internal forecast, such as the expected financial squeeze on the personal and corporate sectors, are not repeated in this paper.

2. The main features of the forecast are listed below. The paragraph numbers in brackets refer to the relevant paragraphs in the attached note.

(i) Interest rates are expected to remain at current levels until the end of next year. This is thought to be consistent with little change in the exchange rate for at least the next six months. Thereafter the exchange rate is forecast to decline by around 3 percent a year because of the higher level of UK inflation. [para 1]

(ii) MO growth is expected to slow down over the next few months in response to the higher level of interest rates and the reduction in domestic demand but it is unlikely to be within its target range by the end of the financial year. [paras 2-4]

(iii) Large PSDRs and the zero overfunding rule together imply massive buying in of gilts. The outstanding stock of conventional gilts could decline by a third over the forecast period. [para 6]

(iv) Institutions will need to find an alternative investment to gilts. Companies might be inclined, given the high cost of bank borrowing and the poor outlook for new issues, to issue corporate bonds. If the domestic bond market does not take off, institutions may look overseas for places to invest the money that would have been used to purchase gilts. [paras 7-10]

(v) Mortgage equity withdrawal has increased dramatically during the 1980s and has helped to finance the spending boom. This is not expected to continue because house prices and turnover are projected to grow much more slowly in the next two years. [paras 11-13]

(vi) Building societies are forecast to make increasing recourse to wholesale funding. [paras 14-15]

(vii) Equity prices are expected to drift up in line with GDP but turnover should recover a little more sharply as transactions costs return to pre-crash levels. [para 16]

(viii) The outlook for privatisations is rather mixed. The subdued equity market, memories of the crash and the squeeze on the personal sector's financial position will not help. But the large number of net savers, who moved into building society deposits from equities after the crash, are gaining from the high interest rates and may soon be ready to invest in privatisations that have generally proved profitable for them. In addition the institutions will have plenty of cash. They might as well buy equities from the government if they cannot buy their bonds. [para 17]

Gus O'Donnell

A T O'DONNELL

INTEREST AND EXCHANGE RATES

1. Details of the forecast for interest rates and exchange rates are set out in the main forecast report. Since these form the background to much of the discussion in this paper a summary of the forecast is presented in table 1 below.

Table 1: Interest and Exchange Rates, average value over period

	Interest Rates				Exchange Rates		
	Short Rate	Long Rate	Euro-$ Rate	Mortgage Rate	£ ERI	£/$	£/DM
1986-87	10.5	9.7	6.4	11.7	71.5	1.49	3.05
1987-88	9.3	9.4	7.3	11.0	73.9	1.70	2.99
1988-89	10.8	9.6	8.6	11.6	75.9	1.73	3.12
1989-90	11.8	9.8	9.6	12.6	73.6	1.67	3.00
1990-91	11.0	9.8	9.5	12.0	71.3	1.65	2.87
1988 Q1	9.0	9.4	6.9	10.3	75.1	1.79	3.01
Q2	8.2	9.2	7.4	10.0	77.8	1.85	3.14
Q3	11.0	9.5	8.6	10.9	75.9	1.70	3.16
13 Oct	11.9	9.2	8.6	12.8	76.7	1.75	3.18

NARROW MONEY

2. M0's growth so far this year has been greater than predicted in previous forecasts. The failure to predict the rapid increase in money GDP explains most of the underprediction of M0 growth. It is, however, difficult to assess whether M0's velocity has altered significantly because the GDP data for this year are particularly unreliable. M0 growth was more rapid relative to recorded money GDP growth over the first part of the year than would be expected on the basis of their historical relationship, but there are good reasons to believe the GDP(E) figures to be seriously underestimated. Any underlying divergence could in any case be explained by the reduction in interest rates in late 1987 and, more recently, an increase in the proportion of the population paid in cash as a result of the construction boom.

3. The recent increases in interest rates should affect M0 more rapidly than money GDP. M0 is expected to grow relatively slowly over the next six months but is unlikely to return within its target range by the end of the financial year. It would be particularly worrying if M0 growth does not slow down over the next few months because it has proved a reliable indicator, particularly this year. Unfortunately the postal strike seems to have distorted recent M0

growth so it may be a little time before its behaviour can be assessed separately.

CHART A: M0 GROWTH

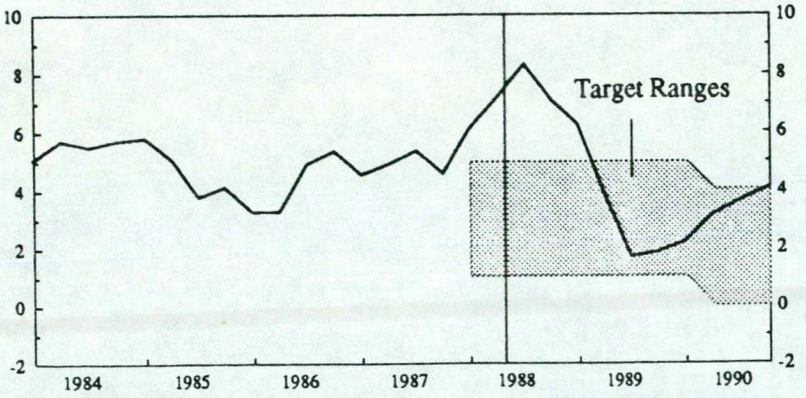
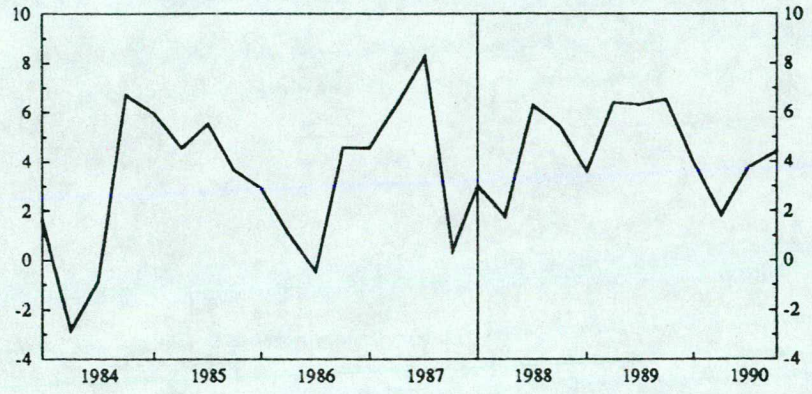


CHART B: % CHANGE IN M0 VELOCITY



4. The longer run trend relationship between the monetary base and money GDP has broken down in Germany and the US. This could reflect the use of these currencies in other countries, such as Eastern Europe and South America respectively, and the growth of the drugs trade which is conducted almost entirely using dollars. In the UK more mundane factors, such as the decline in the use of cash as a means of wage payment, determine the long run velocity relationship. This cannot continue to depress M0 growth for ever. However, other financial innovations, such as the introduction of EFTPOS, could slow M0 growth even further.

Table 2: Monetary aggregates and credit: Average growth rates over year earlier

	M0	M4	Money GDP	Personal Borrowing Mortgage	Personal Borrowing Other	Bank and Building Society lending
1986-87	4.4	15.6	6.8	10.8	13.6	18.7
1987-88	5.1	15.6	10.0	20.3	16.0	19.7
1988-89	7.1	14.8	11.1	20.1	17.7	21.6
1989-90	2.3	11.9	8.7	14.8	12.8	15.2
1990-91	3.7	11.4	7.3	13.1	9.4	13.4

BROAD MONEY/MONETARY SECTOR

5. Sectoral behaviour of M4 lending and deposits is shown in Charts C and D. The main issues over the forecast period concern the extent to which persons and ICCs will continue expanding their bank borrowing and run down liquidity to support respectively their consumption and investment, while facing heavy net interest payments. These issues are discussed at length in the main forecast report, but it is worth emphasising that while this vicious circle - greater borrowing generating still more interest payments - could not continue for ever, it may continue for some months if recent increases in interest rates are not perceived as permanent. In order to meet this continuing demand for borrowing, banks will need to compete aggressively to attract deposits from OFIs and from the savers in the personal and ICCs sectors. Banks will obtain some more deposits from overseas, which should not be difficult given the perceived strength of sterling and our relatively high interest rates. The banks may also have to accept some loss of share in the mortgage market, lacking the funds at suitably low cost to compete strongly with the building societies and mortgage corporations.

CHART C: M4 Lending and Deposits : Personal Sector (% change on year earlier)

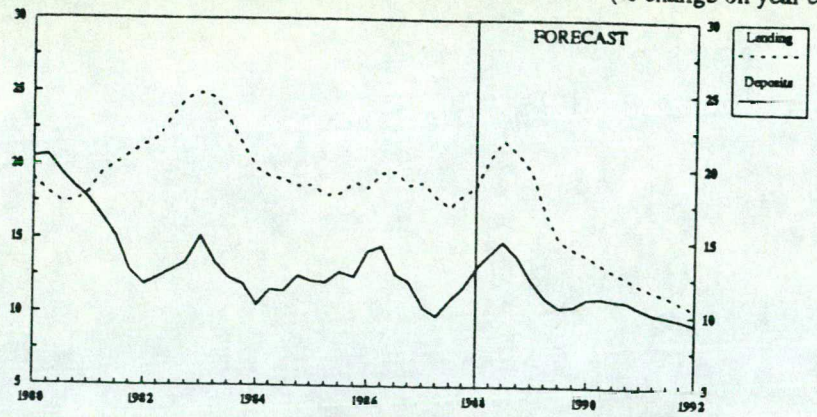
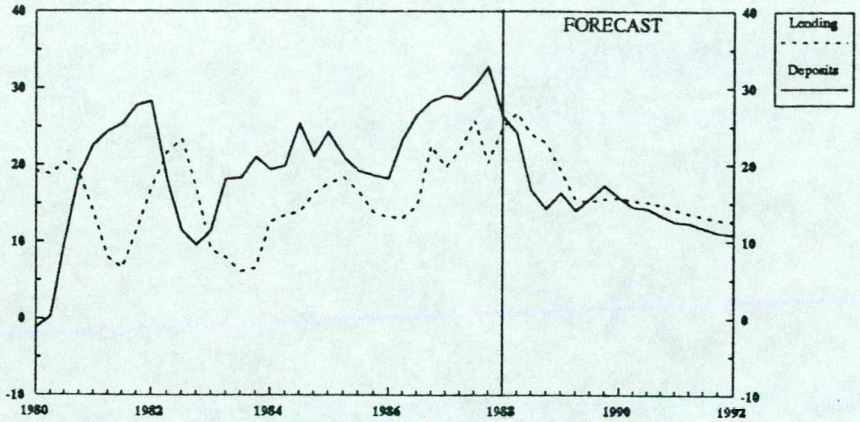


CHART D: M4 Lending and Deposits: Corporate Sector

(% change on year earlier)



FUNDING AND THE BILL MOUNTAIN

Table 3: Gilt Sales and the Bill Mountain £ billion

	1986-87	1987-88	1988-89	1989-90	1990-91
Gilt sales to:					
nbnbsps*	3.8	4.1	-12.5	-13.4	-14.5
(o/w LAPFs)	(1.3)	(2.0)	(-6.5)	(-7.0)	(-7.5)
overseas	2.6	3.7	1.2	-1.0	-1.0
banks/b.socs	1.4	-0.4	-2.1	-0.6	-0.6
Total net sales	7.8	7.4	-13.4	-15.0	-16.1
Redemptions	8.8	6.5	8.0	9.3	7.0
Gross sales	16.6	13.9	-5.4	-6.3	-9.1
Bill mountain	7.1	9.5	5.5	3.8	2.9

* non bank non building society private sector

6. Details of the forecast for individual funding instruments can be found in paragraph 96 of the main forecast report. There are two main features of the forecast, which are set out in table 3.

- The policy of fully funding the PSBR implies the need for large and increasing buying in of gilts over the forecast period. Since we have assumed that the policy of issuing index linked stock continues, this has considerable consequences for the outstanding stock of conventional gilts which declines by over a third during the forecast period. The sectoral consequences of the buying in - where funds which are displaced from the gilts market will move - are discussed in the section on institutional investment.

- The public sector forecast has local authorities (LAs) continuing to borrow from the PWLB. The improving financial position of the LAs over the forecast period suggests the trend of net redemptions of LA debt is likely to continue. Since most outstanding LA debt is now held by banks and building societies, these sectors are likely to bear the brunt of these redemptions. Other LAs, which have financial surpluses which they are unable to spend, will continue to deposit with banks and building societies. Combined with buying in of short gilts, of which around one fifth are held by building societies, this leads to a dramatic run down in the bill mountain. In order to retain their capacity to operate in the money markets under this scenario, particularly at times when the bill mountain would be seasonally low, the Bank will need to sell significant quantities of treasury bills.

INSTITUTIONAL INVESTMENT

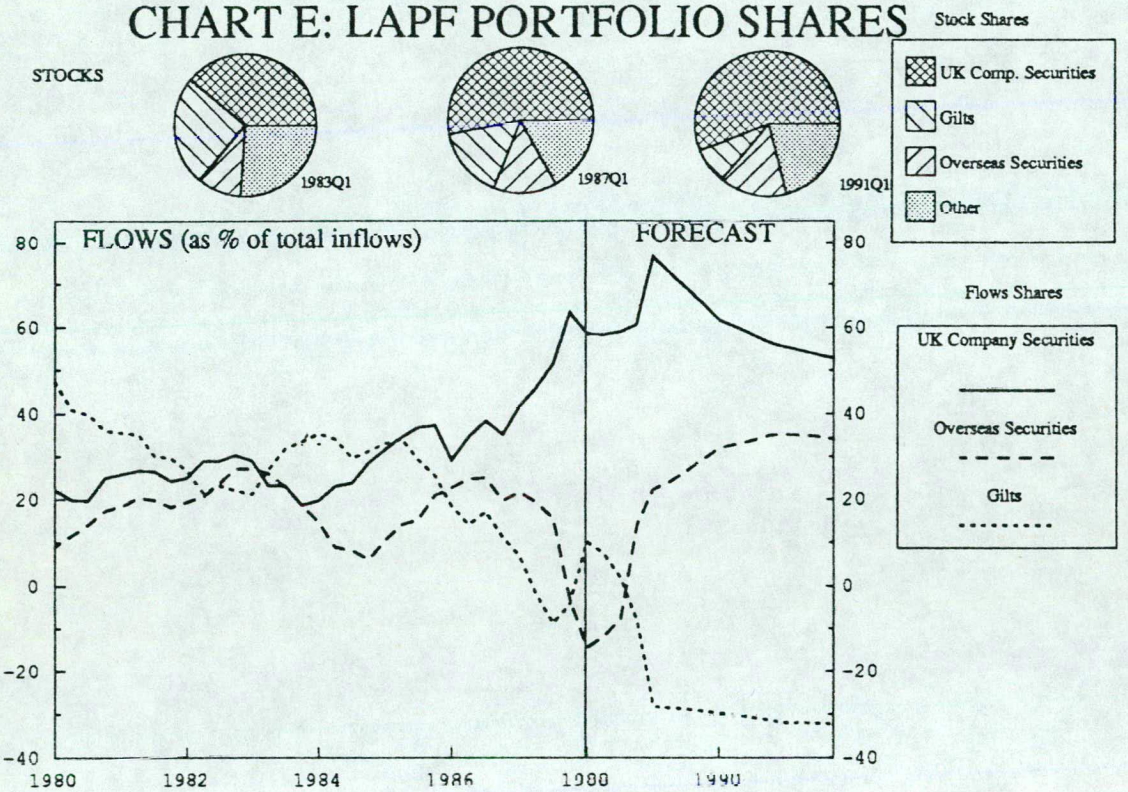
7. Net inflows into life assurance and pension funds (LAPFs) are expected to remain fairly constant at £19-21 billion per year. As the largest holders of gilts, LAPFs will not escape the consequences of the considerable negative net gilt sales, and will 'lose' £7 billion of gilts per year to redemptions and buying in. Other investing institutions, principally general insurance companies and certain other financial institutions will also see large net outflows of gilts.

8. The closest substitutes to gilts are domestic corporate bonds and overseas (probably US) government bonds. The former market is not well developed in the UK but may respond to the opportunity provided by the shortage of gilts as it did the first half of this year.

Overseas government bonds carry less default risk but involve increased exchange rate exposure. This could be overcome to some extent, and at some cost, by hedging. One possibility is that there will be an increase in the supply of mortgage-backed bonds and credit card receivables, both of which are already features of the US market and might well appeal to the LAPFs.

9. The institutions may decide to return in large measure to the domestic equity markets. They may also attempt to rebuild their overseas equity holdings which were cut dramatically after the crash. This strategy involves increased exchange rate risk but it can be argued that an internationally diversified portfolio is less risky than one that is entirely dependent on the fortunes of its domestic markets.

CHART E: LAPF PORTFOLIO SHARES



10. Chart E shows how institutions' portfolio shares are expected to change over the forecast period, but there are obviously great uncertainties about how their investment behaviour will adapt to a world where one of their traditional assets, gilts, is in short supply.

MORTGAGE EQUITY WITHDRAWAL

11. Table 4 indicates the personal sector's new mortgage borrowing and their physical investment in the housing stock, including purchases from other sectors. Substantial flows of mortgage equity withdrawal - the excess of borrowing over new investment - continue over the forecast period. Funds released via this mechanism will be available both for maintaining consumption in the face of mounting interest payments, and for limited investment in the wider range of financial assets open to persons as a result of various forms of financial innovation. Although as a whole the personal sector is likely to be constrained in its ability (or desire) to invest in financial assets, the sector is far from homogenous. Some individuals will therefore continue to invest in competitive bank and building society accounts (made more attractive by high interest rates), as well as equity-based investments and privatisation issues.

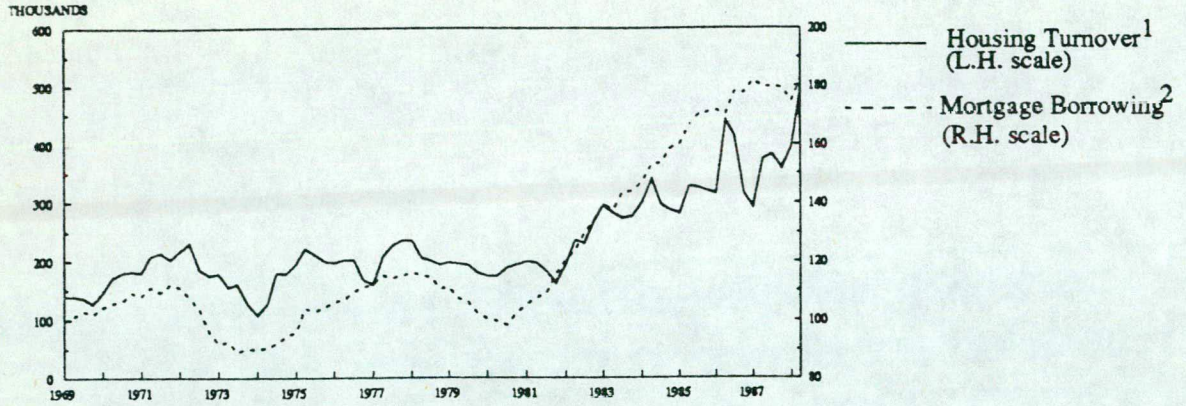
Table 4:

£bn	New mortgage borrowing	Invest-ment in in new dwellings	Invest-ment in in new dwellings	Improve-ments	Total housing market	Mortgage equity withdrawal
1978	5.4	2.6	0.0	1.4	5.4	1.4
1980	7.4	3.0	0.8	3.0	6.8	0.6
1982	14.1	3.2	2.3	3.5	9.1	5.0
1984	17.0	4.4	2.8	4.5	11.6	5.4
1986	26.5	5.1	3.8	5.6	14.6	11.9
1988	39.5	8.3	5.3	6.3	19.8	19.6
1990	34.6	8.9	5.9	8.6	23.3	11.3

12. The scale of equity withdrawal has been substantial since 1981. In part this can be viewed as a process of adjustment by persons whereby they are enabled, in a freer mortgage market, to adopt a higher desired level of mortgage debt in response to greater house prices. This adjustment can be made most easily when people move. Housing turnover would be expected to rise, therefore, as individuals increase the size of their mortgages and as more individuals are able to purchase houses. Chart F shows that housing turnover and mortgage debt (deflated by house prices) have indeed increased during the 1980s, suggesting that persons have made the most of the opportunity provided by the greater availability of mortgage funds to withdraw housing equity on an unprecedented scale. The predicted decline in

house prices and turnover should result in a reduction in mortgage equity withdrawal which may help to hold down consumer spending.

CHART F: Housing Turnover & Mortgage Borrowing (deflated)



1 - Housing turnover = no. of loans for house purchase
2 - Deflated by house prices ; 1980=100

13. In the longer term there are likely to be significant demographic effects as the sub-population of elderly outright owner-occupiers starts to climb rapidly. As housing is released, due to deaths and moving into rented accommodation, substantial mortgage borrowing will be required to finance the extent to which property is transferred to the generation of first time buyers. With a fall in the number of such buyers, due to the lagged effects of the 1960s baby boom and an eventual stabilisation in the proportion of home owners in the population, there will be lower underlying upward pressure on house prices. This in turn could slow growth in construction of new dwellings. But it should be emphasised that demographic effects are, by their nature, long term phenomena.

BUILDING SOCIETIES

Table 5: Building Societies Summary Table

	Interest Rate Differentials							
	Mortgage Rate less gross deposit rate	less base rate	Net deposit less bank deposit rate	% change in retail inflows	Share of new mortgage lending	% change in B.socs mortgage lending	Liquidity ratio (%)	Wholesale Funding (%)
1986-87	1.35	1.19	1.27	10.4	69.3	18.8	15.1	9.7
1987-88	1.47	1.72	1.83	12.4	51.8	13.9	15.4	10.2
1988-89	1.48	0.79	1.24	12.1	60.7	17.1	16.0	14.6
1989-90	1.38	0.88	1.25	9.9	59.6	12.7	16.0	16.5
1990-91	1.38	1.00	1.19	9.5	59.5	11.4	16.0	17.8
1991-92	1.38	1.00	1.11	8.5	59.3	10.7	16.0	19.2

14. Mortgage lending has been very high in the first three quarters of 1988, reflecting both high demand (boosted by Budget changes, particularly the withdrawal of multiple tax relief) and some recovery in building societies' market share following a large fall in 1987. Lower demand is already evident in the latest figures for new mortgage commitments, and a sharp fall in mortgage lending is expected starting in 1988 Q4. Growth of mortgage lending for 1989 is expected to be around 5 percent down on the 1988 figure, but still well above growth in PDI. Thereafter, building societies are forecast to maintain their share of the total market for mortgage lending which continues to grow by around 12 percent per annum. This entails a substantial rise in the societies' wholesale funding ratio, as the forecast growth in retail deposit inflows is expected to be significantly slower than that of mortgage demand.

15. Retail inflows have been very high since the stock market crash, but there are already signs in the most recent data that this is ending. The forecast has growth falling to under 10 percent per annum, as the personal saving ratio remains depressed. But the effective removal of restrictions on wholesale funding, together with a growing expertise in tapping these markets, means that societies will in future be much less constrained by their retail funds position as to the amount of mortgage lending they can do. This should make it easier for them to maintain market share through periods when retail inflows are low.

EQUITY MARKET

16. The UK equity market has been generally subdued so far in 1988. Equity prices have moved within a fairly narrow range, with the FT All-Share index moving between 890 and 970 (the more familiar FTSE 100 moving between 1700 and 1850) - around 20 and 25 per cent below the levels seen immediately prior to the crash last October. Turnover volume in 1988 has been well down on 1987. For neither prices nor turnover has there been any clear upward trend over the year - recoveries have tended to last a month or so, and then peter out. The forecast shows some recovery in equity prices (as usual, based on a stylised equation which links growth in real equity prices to a proportion of real growth), and a rather more substantial recovery in turnover volume. The latter reflects both the effects of coming privatisation issues, and an assumption that transactions costs - which increased on average post-crash - gradually return to their pre-crash level.

CHART G : NOMINAL EQUITY PRICES

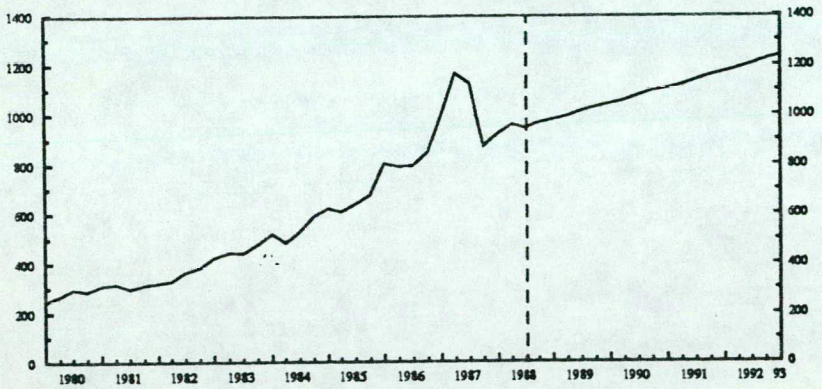
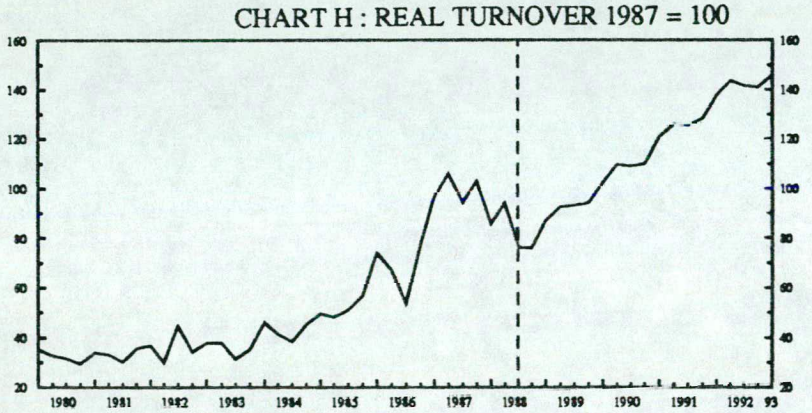


CHART H : REAL TURNOVER 1987 = 100



The Outlook for Privatisations

17. The subdued outlook for the equity market, coupled with the memory of the stock market crash, does not present an ideal background for privatisations. The squeeze on the personal sector's financial

position may also reduce their enthusiasm for new equity investments. But the net savers within the personal sector are benefiting from the higher interest rates and these people still have ample funds to invest in privatisations. Such individuals' past experience with these investments has generally been favourable. Despite their experience with BP, most institutions are also likely to be keen to take up their share of privatisations, particularly in the utilities area, to make up for the probable reduction in their holdings of gilts.

NET OVERSEAS ASSETS

18. After the large fall in net overseas assets between end-1986 (£114 billion) and end-1987 (£90 billion) there was a recovery through the first half of 1988 back to almost £100 billion. This position is expected to be maintained until the end of the year with a small increase forecast by end-1990 (£106 billion).

Table 6: Decomposition of the change in the net overseas asset position

£bn	Current balance	Balancing item	Currency revaluations		Error and price revaluations*	Change in net overseas assets (end year on end year)
			Dollar	Non-dollar		
1986	0	+14½	-1½	+17½	+2½	+33
1987	-2½	+3½	-20½	-5	+1	-23½
1988	-14	+9½	+10	-2½	+5	+8
1989	-14	+9	+1	+4½	+2½	+2½
1990	-13	+8½	+1½	+6	+2	+5

* after 1988 price revaluations only

19. The effect of the large current account deficits on the net overseas asset position is principally offset by a large projected balancing item. Sterling's forecast depreciation and the effect of projected rises in equity prices on the large net portfolio asset position also contribute to the increase in the overall net overseas asset position seen over the forecast.

CAPITAL ACCOUNT

20. Table 7 provides the capital account detail. The main features are that, notwithstanding the high balancing items, large total net capital inflows are required over the future. In particular high outflows into UK banks are likely to be required. As stated earlier, this should not create a problem as long as confidence in sterling is maintained and UK interest rates are kept high relative to those in the main G7 countries.

21. There are continuing net outflows on direct investment and a resumption of the usual (1986-excluded) net outflow on non-bank portfolio flows. Net outflows on direct investment occur despite moderate growth (from a low base) in inward direct investment. Net outflows of portfolio investment represents a combination of greater institutional purchases of overseas assets and foreigners' reluctance to invest in UK assets, particularly equities. The 1988 and 1989 figures reflect the assumption that KIO will start to dispose of its excess BP stake from 1988Q4 onwards.

22. Transactions of general government include an underlying run-down on the reserves of £2½ billion per year, initially falling to £1 billion. The overseas sector are expected to dispose of £1 billion a year net of gilts. 'Other' government transactions include the aggregate effect of redeeming the 1985 FRN and setting up the ECU Treasury bill programme.

23. Banks' total financing of the current account is sizeable. Their net foreign currency inflows from overseas are assumed to match a corresponding foreign currency deficit position incurred by the domestic private sector.

Table 7: Overseas sector capital account

£bn	1986	1987	1988	1989	1990	1991
Direct investment						
inward	4.2	6.0	8.4	8.5	9.1	9.4
outward	-11.5	-15.4	-15.9	-15.6	-15.9	-16.8
Net	**-7.3**	**-9.4**	**-7.5**	**-7.2**	**-6.8**	**-7.4**
Non-bank portfolio						
inward (excl.gilts)	5.2	7.3	2.3	5.0	5.0	5.0
outward	-17.7	6.2	-9.2	-8.4	-9.3	-9.5
Net	**-12.5**	**13.5**	**-6.8**	**-3.4**	**-4.3**	**-4.5**
Banks: **Net sterling**	**-0.4**	**3.9**	**12.6**	**8.8**	**8.8**	**8.8**
Net FC	**2.6**	**-1.1**	**3.2**	**3.2**	**3.2**	**2.0**
General government						
gilts	2.1	4.1	1.4	-0.8	-1.0	-1.0
other liabilities	1.3	0.9	-0.4	0.2	0.0	0.0
reserves	-2.9	-12.0	-1.0	2.2	2.4	1.8
Net	**0.5**	**-7.0**	**0.0**	**1.6**	**1.4**	**0.8**
Other transactions, net	2.9	-0.9	2.7	2.0	2.0	1.8
Net capital flows	-14.2	-1.0	4.2	5.0	4.3	1.5
Balancing item	14.4	3.5	9.7	9.0	8.5	8.0
Current account	0.2	-2.5	-13.8	-14.0	-12.9	-9.5

BIF 15/10

PERSONAL AND CONFIDENTIAL

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David Norgrove Esq
10 Downing Street
LONDON
SW1A 0AA

7 October 1987

Dear David

RETAIL PRICE INDEX

I enclose a copy of our note and draft press release on the Index of Retail Prices due to be released at 11.30 pm Friday 9 October.

Numbered copies also go to Alex Allan (Treasury), Sir Peter Middleton (Treasury), Timothy Walker (Trade and Industry), Rachel Passmore (CSO) and Sir Brian Hayes (Trade and Industry).

Yours sincerely

Peter Baldwinson

PETER BALDWINSON
Private Secretary

PERSONAL AND CONFIDENTIAL

PERSONAL AND CONFIDENTIAL UNTIL 11.30 am ON FRIDAY 11 OCTOBER 1987

184/87 October 9, 1987

GENERAL INDEX OF RETAIL PRICES
SEPTEMBER 1987

The general index of retail prices for all items for September 8, 1987 was 102.4 (January 13, 1987 = 100). This represents an increase of 0.3 per cent on August 1987 (102.1) and an increase of 4.2 per cent on September 1986 (387.8, January 1974 = 100).

The rise in the index between August and September was mainly the result of increases in the prices of clothing, with the arrival of the new season's stocks, household goods, beer, and motor vehicles. There were falls in the prices of home killed lamb and fresh fruits.

The movements for the main groups in the index are shown in Table 2.

Table 1.

	All items				All items except seasonal food		
	Index Jan 13 1987 = 100	Percentage change over 1 month	6 months	12 months	Index Jan 13 1987 = 100	Percentage change over 1 month	6 months
1987							
April	101.8	+1.2	+3.4	+4.2	101.6	+1.0	+3.0
May	101.9	+0.1	+2.6	+4.1	101.7	+0.1	+2.2
June	101.9	+0.0	+2.3	+4.2	101.8	+0.1	+2.1
July	101.8	-0.1	+1.8	+4.4	101.9	+0.1	+1.9
August	102.1	+0.3	+1.7	+4.4	102.2	+0.3	+1.9
September	102.4	+0.3	+1.8	+4.2	102.6	+0.4	+2.0

TABLE 2

	Indices (13 January 1987 = 100)		Percentage change over the month
	August 11, 1987	September 8, 1987	
All items	102.1	102.4	+0.3
All items excluding food	102.4	102.8	+0.4
All items excluding housing	101.7	102.1	+0.4
Food	100.7	100.4	-0.3
Seasonal food	98.6	95.7	-2.9
Non seasonal food	101.0	101.2	+0.2
Catering	103.6	104.3	+0.7
Alcoholic drink	102.1	102.8	+0.7
Tobacco	99.5	99.7	+0.2
Housing	104.1	104.4	+0.3
Fuel and light	99.0	98.5	-0.5
Household goods	101.9	102.7	+0.8
Household Services	102.4	102.9	+0.5
Clothing and footwear	99.8	101.8	+2.0
Personal Goods and Services	102.4	101.9	-0.5
Motoring Expenditure	104.8	105.1	+0.3
Fares and Other Travel Costs	102.3	102.3	0.0
Leisure Goods	101.7	101.9	+0.2
Leisure Services	101.4	101.9	0.5

NOTES TO EDITORS

1 The General Index of Retail Prices (RP1) measures the average change from month to month in the prices of goods and services purchased by most households in the United Kingdom. The expenditure pattern on which the index is based is revised each year using information from the Family Expenditure Survey. The expenditure of certain higher income households and pensioner households, mainly dependent on state pensions and benefits, is excluded.

2 The index is compiled using a large and representative selection of more than 600 separate goods and services for which price movements are regularly measured in about 180 towns throughout the country. Approximately 130,000 separate price quotations are used each month in compiling the index.

3 The prices of some items of food show significant seasonal variation. A separate price index is compiled for these "seasonal foods", the expenditure on which accounts for around 2½ per cent of household expenditure. The variation caused by these items is removed from the series of indices for 'all items except seasonal food'.

4 Rates of change of indices can be calculated over periods of any length. Rates calculated over long periods are slow to detect changes in trend while calculations over very short periods give rather volatile results. To help in assessing what is happening to prices, rates of changes in the all items index and the index for all items except seasonal food are shown in Table 1 over successive periods of one month, six months and twelve months.

5 Following the recommendations which the Retail Prices Index Advisory Committee made in its report submitted to the Secretary of State for Employment in July 1986, the index has been re-referenced to make January 1987 = 100. Calculations of movements in the index over periods of time which span January 1987 are made as follows:-

The index for the later month (January 1987 = 100) is multiplied by the index for January 1987 (January 1974 = 100) and divided by the index for the earlier month (January 1974 = 100). 100 is subtracted to give the percentage change between the two months.

Using the all items index for example: take the index for September 1987 (102.4) and multiply it by the January index (394.5) then divide by the September 1986 index (387.8). Subtract 100 from the result which gives 4.2 as the percentage change in the index over the twelve months to September.

6 The index for September 1987, if translated to the old reference date (January 1974 = 100) would be 404.0.

7 Other changes made to the index in 1987 are given in an article in the April edition of Employment Gazette.

8 The Retail Prices Index Advisory Committee was first established in 1946 and advises on the methodology used for compiling the RPI. Committee members include representatives of consumers, employees, employers, retailing organisations, academic experts, government departments and other official bodies. The Committee's latest report - 'Methodological Issues Affecting The Retail Prices Index' Cmnd 9848 HMSO £6.50 - was published on 15 July 1986. The Government announced at the same time that all its recommendations were to be accepted.

9 The housing costs of owner-occupiers are reflected in the index using an indicator which represents mortgage interest payments. A weighted average of building societies base mortgage interest rates is used in the calculation.

10 The index is given in full in the Employment Gazette.

PERSONAL AND CONFIDENTIAL

GENERAL INDEX OF RETAIL PRICES : SEPTEMBER 1987

The annual rate of inflation, as measured by the 12-month change in the retail prices index, fell to 4.2 per cent in September, from the 4.4 per cent recorded for August.

2. The overall level of prices was 0.3 per cent higher in September than in August, less than the increase of 0.5 per cent recorded between the corresponding months last year when there was a sharp increase in petrol prices. Prices for clothing rose between August and September, with the arrival of new season's stocks, as did those for household goods, beer and motor vehicles. There were decreases in the prices of home killed lamb and fresh fruit.

3. In October the 12-month rate is expected to rise slightly into the 4¼-4½ per cent range, before dropping again in November. There is likely to be an increase in the overall level of prices of around 1/3 per cent between September and October replacing, in the 12-month calculation, the increase of 0.2 per cent between the corresponding months last year.

Producer Prices

4. The September figures on producer prices are not yet available. For August the annual change in the prices index for home sales of manufactured products was 3.6 per cent, much the same as in the previous five months. Although price rises in the food drink and tobacco industries had slowed down to 1.9 per cent per year in July and August, prices in the remaining sectors have been moving faster (their 12-month rate has risen from around 4 per cent in the second half of last year to 4.7 per cent in both July and August). This could lead to some upward pressure on retail prices.

5. Prices for materials and fuels purchased by manufacturing industry were 9.1 per cent higher in August than a year ago. A further indication of an some upward pressure on retail prices.

Tax and Prices Index

6. The tax and prices index increased by 2.4 per cent in the year to September compared with 2.6 per cent recorded for August.

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International comparisons

7. The latest 12-month percentage changes in consumer prices in the main OECD countries and the averages for all EEC and OECD countries are as follows:-

	UK	FRANCE	FEDERAL GERMANY	ITALY	NETHER -LANDS	JAPAN	USA	CANADA	OECD Averages	EEC
1986										
Q1	4.9	3.6	0.7	7.6	1.2	1.6	3.1	4.2	3.8	4.4
Q2	2.8	2.4	-0.2	6.1	0.4	0.8	1.6	3.9	2.5	3.2
Q3	2.6	2.1	-0.4	5.4	-0.4	0.2	1.7	4.2	2.5	3.0
Q4	3.4	2.1	-1.1	4.4	-1.8	-0.5	1.3	4.3	2.1	2.9
1987										
Q1	3.9	3.2	-0.5	4.1	-1.2	-1.3	2.2	4.1	2.3	2.2
Q2	4.2	3.1	0.1	4.2	-1.0	-0.2	3.8	4.6	3.5	3.0
March	4.0	3.3	-0.2	4.2	-1.1	-0.8	3.0	4.2	3.0	3.0
April	4.2	3.5	0.1	4.3	-1.1	-0.2	3.8	4.5	3.5	3.1
May	4.1	3.4	0.2	4.2	-1.1	-0.3	3.8	4.7	3.4	3.1
June	4.2	3.3	0.2	4.4	4.4	0.0	3.7	4.8	3.4	3.1
July	4.4	3.4	0.7	4.7	0.1	-0.4	3.9	4.7	3.5	3.3
August	4.4	3.4	0.8	4.5	0.2	-0.4	4.3	4.5		
September	4.2									

The figures for August are provisional except for the UK, and for the OECD and EEC figures are not available.

STATISTICS DIVISION
DEPARTMENT OF EMPLOYMENT

7th OCTOBER 1987

PH1/110

UNCLASSIFIED

FROM: J M G TAYLOR
DATE: 12 AUGUST 1987

MR S PRICE

cc Sir P Middleton
Sir T Burns
Mr Sedgwick
Mr S Davies
Mr Culpin
Mr Allan
Mr S Matthews

RPI AND MORTGAGE INTEREST PAYMENTS

The Chancellor was grateful for your minute of 10 August.

J M G TAYLOR

Papers
Pse

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FROM: S PRICE
DATE: 10 August 1987

1. MR S DAVIES
2. CHANCELLOR

cc: Sir P Middleton
Sir T Burns
Mr Sedgwick
Mr Culpin
Mr Allan
Mr S Matthews

RPI AND MORTGAGE INTEREST PAYMENTS

You asked (Mr Allan's minute of 5 August (attached)) why it is that since 1979 the all items RPI has more or less consistently risen at a faster rate than the RPI excluding mortgage interest payments.

2. Between the first quarters of 1979 and 1987 the all items RPI rose at an average rate of 8.1% per year; the RPI excluding mortgage interest payments rose at an average rate of 7.8%. The difference between the two indices is due to the mortgage interest payments component, which in 1987 has a weight of about 4½% in the total.

3. The mortgage interest payments component of the RPI has risen faster than the RPI itself, at 13.6% per year. The mortgage interest payments component equals the value of mortgage debt times the mortgage interest rate, net of tax relief. Mortgage debt has risen at an annual rate of 12.3%. Chart 1 graphs the rise in the overall index, mortgage interest payments and mortgage debt.

4. Mortgage debt is calculated by taking a weighted average of current and past house prices over the previous twenty five years, the typical mortgage repayment period. Thus past rises in house prices, notably in the 1970's, continue to affect the current rate of increase of debt. As house prices typically rise at a faster rate than other prices,

this explains most of the discrepancy between the two RPI figures. (The weight which this component has in total RPI has increased over time. This has been due in part to the rise in "equity withdrawal", or borrowing that is for purposes other than for house purchase. Following the RPI AC recommendation the calculation of the weight has been adjusted from 1987 onwards, so that it will not be further inflated by equity withdrawals).

5. The rise in house prices is not the only explanation, however. Chart 2 shows the gross and net interest rate over the period. The net rate has risen by about 10½% over the whole period, which can be explained largely by the progressive reduction in the standard rate of income tax from 33% to 27%. This has reduced the implicit subsidy to mortgage repayments.

Simon Price

S PRICE

Chart 1

Retail Prices and Mortgage Interest Payments: 1979Q1–1987Q1

(1979Q1=100)

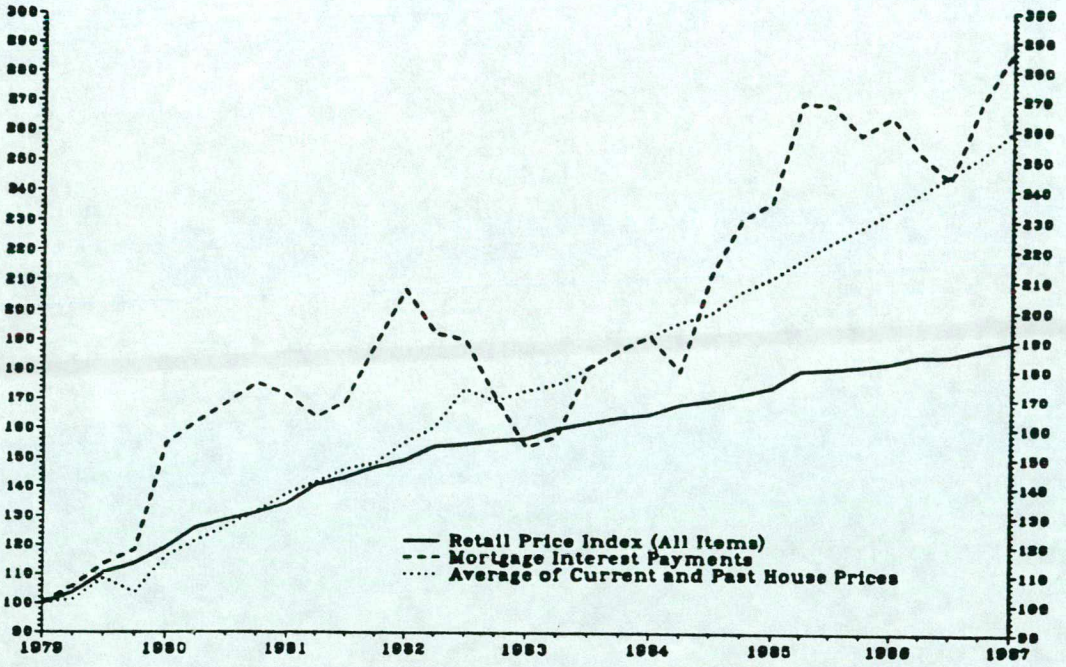
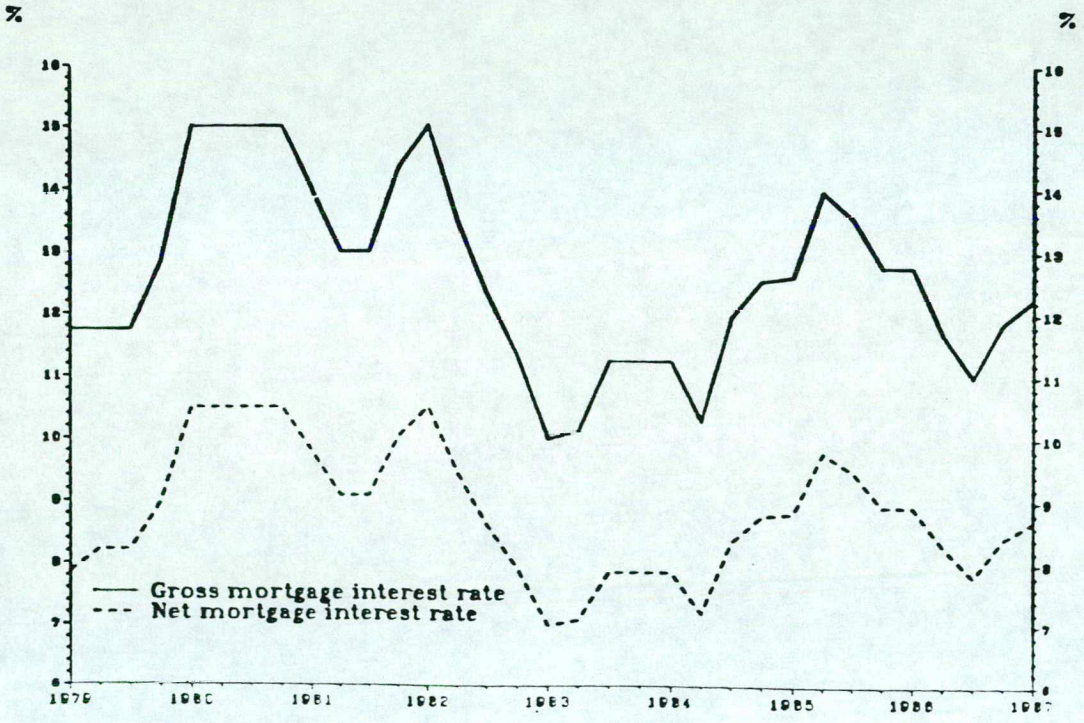


Chart 2

Mortgage Interest Rates: 1979Q1 to 1987Q1



PH1/54

UNCLASSIFIED

FROM: A C S ALLAN
DATE: 5 AUGUST 1987

MR ALLUM

cc Sir P Middleton
Sir T Burns
Mr Sedgwick
Mr Culpin
Mr S J Davies
Mr S Matthews
Mr S Brooks

RPI AND MORTGAGE INTEREST PAYMENTS

The Chancellor was grateful for your minute of 29 July. He notes that a comparison of the all items RPI and the RPI excluding mortgage interest payments reveals that the former seems to be systematically higher than the latter: it is higher in six out of the nine years, and on average is 0.3% higher. He would be grateful if you could explain how this has arisen.

ACSA

A C S ALLAN

PH1/54

UNCLASSIFIED

Bf to Calls 10/8

FROM: A C S ALLAN
DATE: 5 AUGUST 1987 BIF 14/8

MR ALLUM

cc Sir P Middleton
Sir T Burns
Mr Sedgwick
Mr Culpin
Mr S J Davies
Mr S Matthews
Mr S Brooks

RPI AND MORTGAGE INTEREST PAYMENTS

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ACSA

A C S ALLAN

3271/022/lm

CONFIDENTIAL

FROM: P F L ALLUM
DATE: 29 July 1987

MR A C S ALLAN

cc Sir P Middleton
Sir T Burns
Mr Sedgwick
Mr Culpin
Mr S J Davies o/r
Mr S Matthews
Mr S Brooks

RPI AND MORTGAGE INTEREST PAYMENTS

Your minute of 29 July requested figures for the annual average changes in the RPI, both including and excluding mortgage interest payments, for the years 1979 to 1987. These are provided below:

ANNUAL AVERAGE 12 MONTH CHANGES IN THE RPI (PER CENT)

	All items RPI	RPI excluding mortgage interest payments	
1979	13.4	12.6	−0.8
1980	18.1	16.9	−1.2
1981	11.9	12.2	+0.3
1982	8.7	8.6	−0.1
1983	4.6	5.2	+0.6
1984	5.0	4.5	−0.5
1985	6.1	5.2	−0.9
1986	3.4	3.6	+0.2
1987 (Jan-June)	4.1	3.7	−0.4
		aver	−0.3
1987 (forecast)	4.1*	3.7*	

* NOT FOR USE

P F L ALLUM

psl/43A

UNCLASSIFIED

FROM: A C S ALLAN
DATE: 29 July 1987

MR P F L ALLUM

cc Sir P Middleton
Sir T Burns
Mr Sedgwick
Mr Culpin
Mr S J Davies
Mr S Matthews
Mr S Brooks

RPI AND MORTGAGE INTEREST PAYMENTS

The Chancellor was most grateful for your minute of 27 July and for the table and colour chart. He spoke to Mr Fowler and gave him a copy of the note.

2. The Chancellor would be grateful if you could let him have the annual average 12 month changes in the RPI, both including and excluding mortgage interest payments, for each year from 1979 to 1987.

ACSA

A C S ALLAN

Alex

John Turner (D/Emp) rang.
Fowler wants to tell his chief statistician personally, after the summer break, of the RPI decision.
So pl cd we not spread it around here, so that the news gets back to D/Emp at official level first?

AWK

RA7.53

(gwe & N Fowler)

THE RPI AND MORTGAGE INTEREST PAYMENTS

The UK and Canada are now alone among major countries in including changes in mortgage interest payments in their consumer price indices. The US dropped them from its consumer price index in 1983, while other countries have never included them. But in the UK the RPI is liable to show significant fluctuations simply because of changes in short-term interest rates.

2. This is perverse: it means that if we tighten monetary policy so as to put downward pressure on inflation, the short term result is an increase in recorded inflation. And it clearly makes a nonsense of international comparisons of inflation.

3. It also makes the RPI path misleadingly volatile. In the 1970s, when inflation was high, the effect of changes in mortgage interest rates was a relatively minor matter. But with our success in reducing inflation to its current level of around 4 per cent, changes in mortgage interest rates can bring about quite disproportionate fluctuations. This is clearly demonstrated in the chart and table attached. The chart shows the monthly series, with and without mortgage interest payments, over the period since 1975; and the table gives figures for the two series over the four years from June 1983 to June 1987.

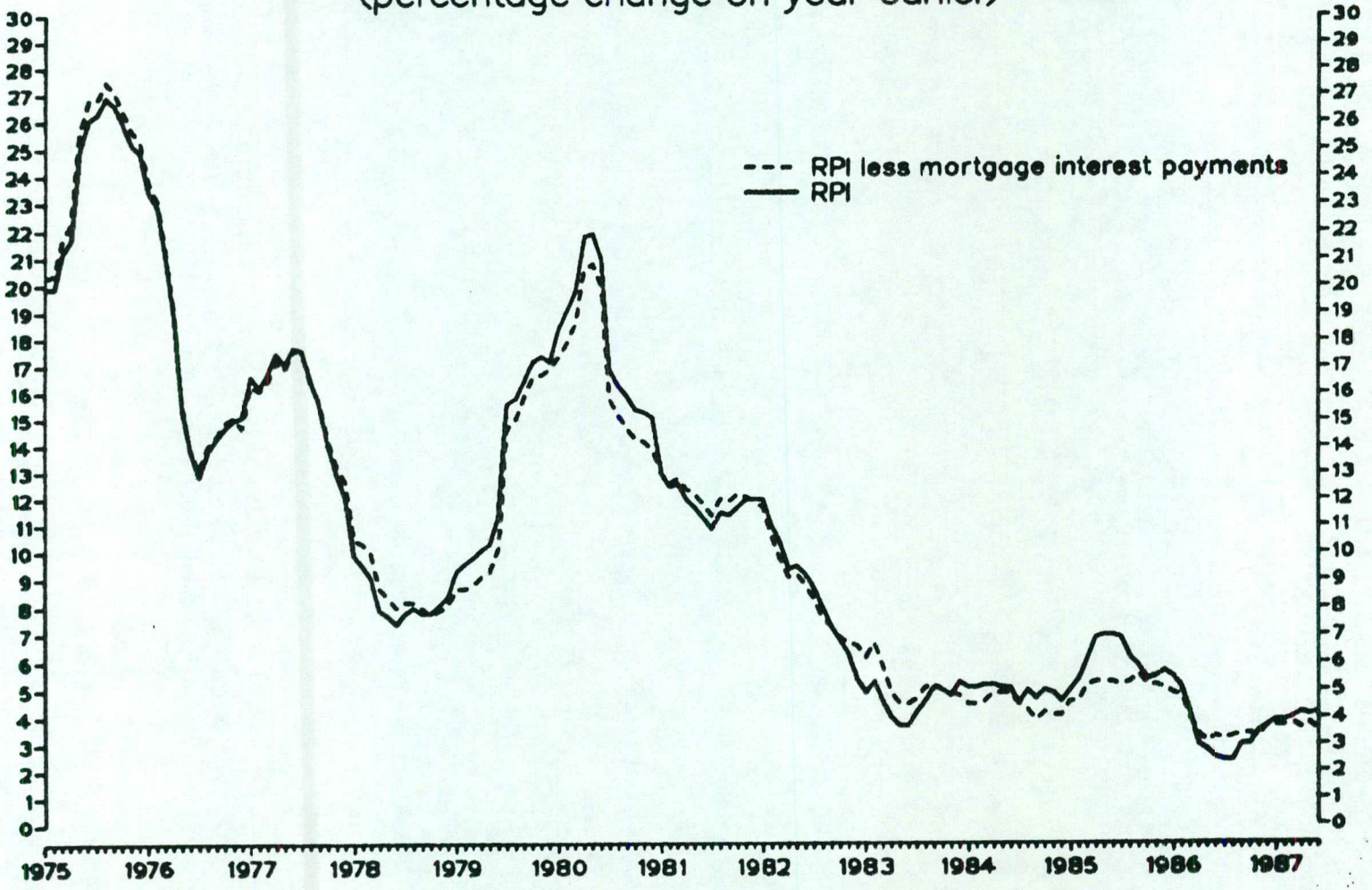
4. We are unlikely to be able to persuade the RPI Advisory Committee (RPIAC) to change the construction of the RPI itself: they recommended only last year that changes in mortgage interest payments should continue to be reflected in the RPI as a proxy for owner occupiers' so-called "shelter costs". But there is no reason why we should not use figures for the RPI excluding mortgage interest payments in our briefing. Indeed, the Treasury already does so, although Department of Employment have been resistent to this.

5. We used the figures for the RPI excluding mortgage interest payments, for example, in last year's Autumn Statement (paragraphs 1.45 and 1.51) to stress that the dip in RPI last summer exaggerated the underlying fall in inflation, and - conversely - we have pointed out that we have pointed out the rise in the RPI since then has provided a misleading guide to the trend of inflation. It is clearly most unhelpful to get a public perception that inflation is accelerating when the underlying path is in fact pretty stable.

HM Treasury
27 July 1987

RPI AND RPI LESS MORTGAGE INTEREST PAYMENTS

(percentage change on year earlier)

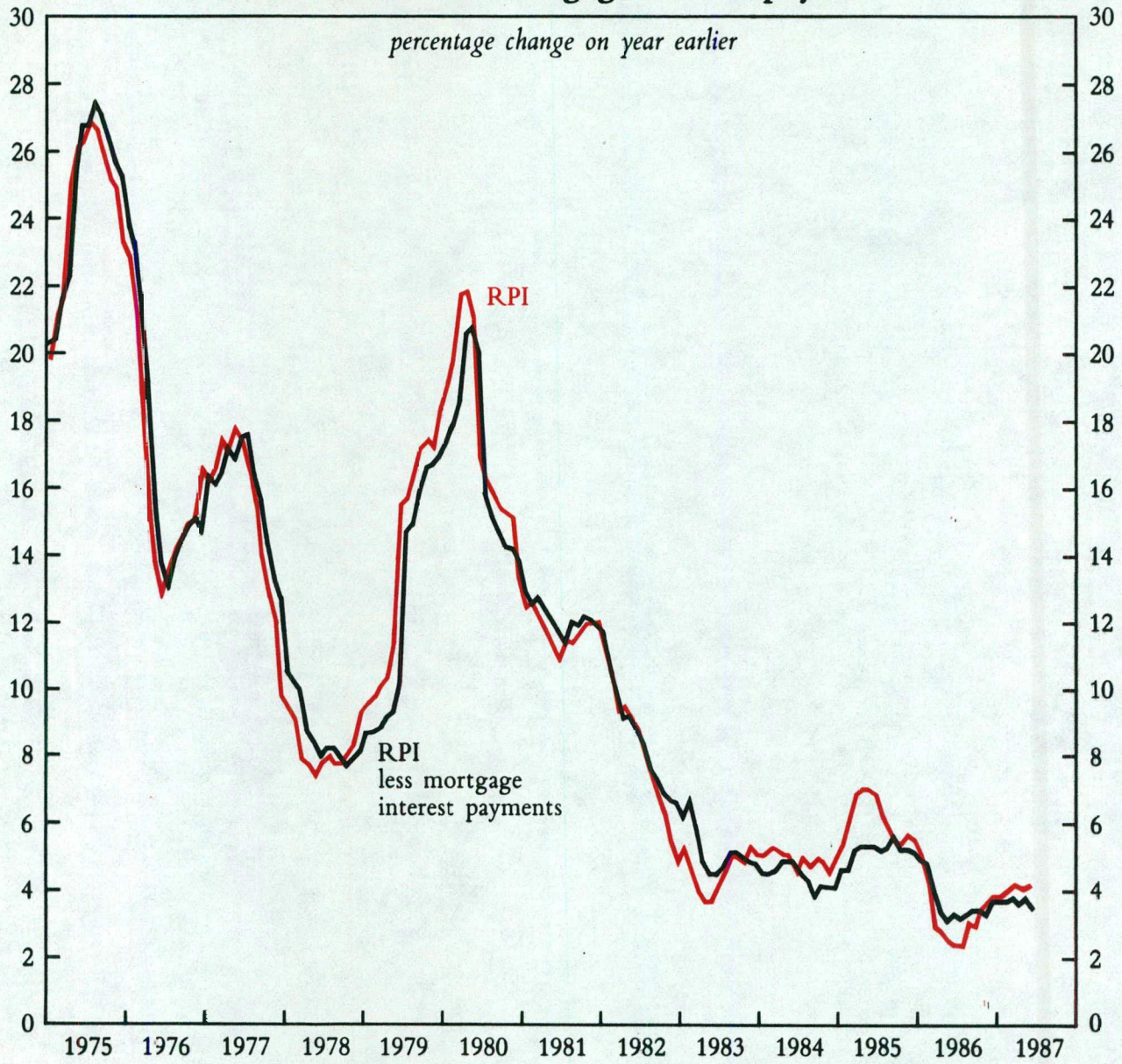


RETAIL PRICES INDEX

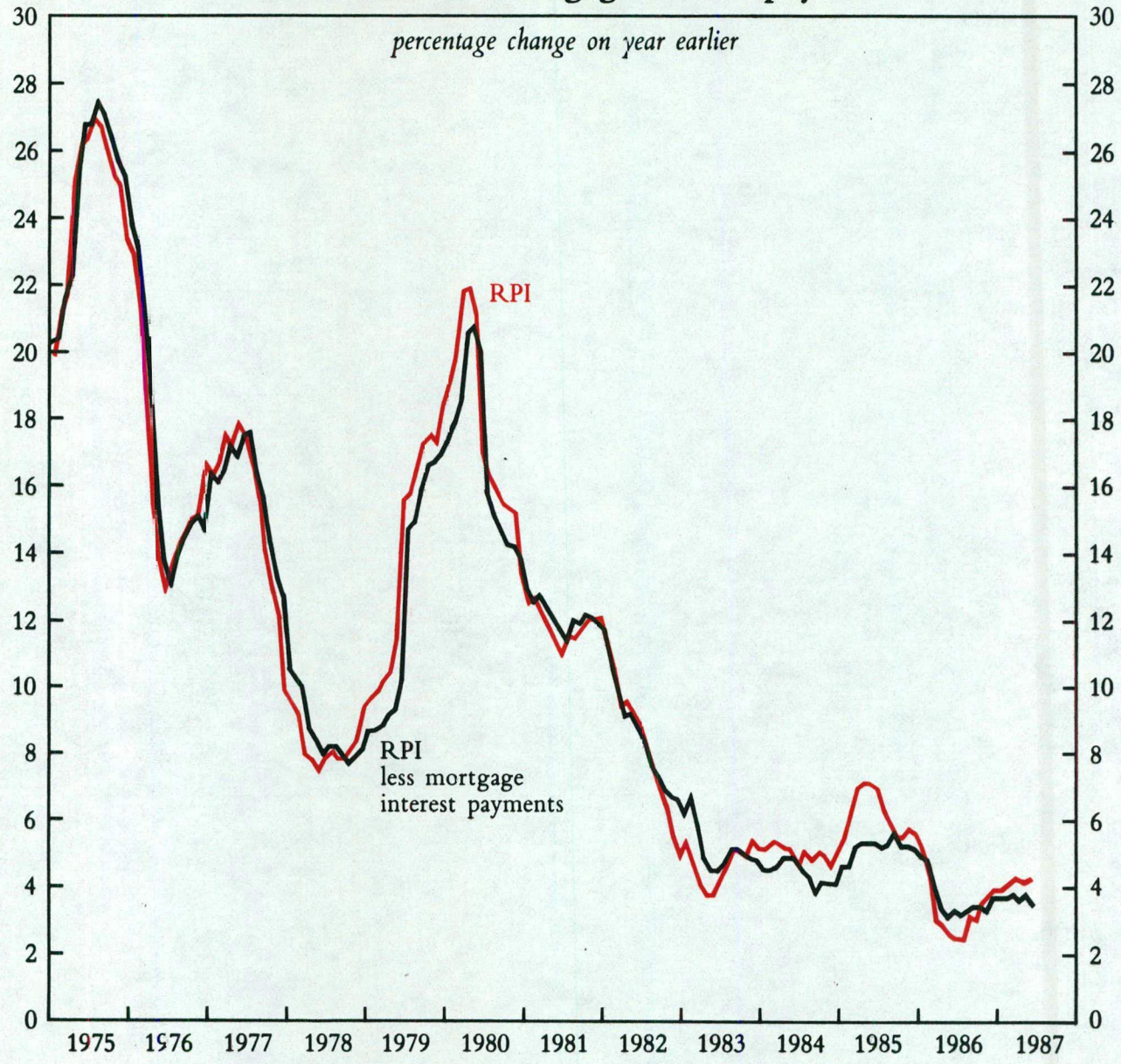
(Twelve month percentage change)

		All items	All items excluding mortgage interest payments
1983	June	3.7	4.5
	July	4.2	4.7
	Aug	4.6	5.1
	Sept	5.1	5.2
	Oct	5.0	5.0
	Nov	4.8	4.9
	Dec	5.3	4.8
1984	Jan	5.1	4.5
	Feb	5.1	4.5
	Mar	5.2	4.6
	April	5.2	4.9
	May	5.1	4.9
	June	5.1	4.9
	July	4.5	4.5
	Aug	5.0	4.3
	Sept	4.7	3.9
	Oct	5.0	4.2
	Nov	4.9	4.1
	Dec	4.6	4.1
1985	Jan	5.0	4.6
	Feb	5.4	4.6
	Mar	6.1	5.2
	Apr	6.9	5.3
	May	7.0	5.3
	June	7.0	5.3
	July	6.9	5.2
	August	6.2	5.3
	Sept	5.9	5.6
	Oct	5.4	5.2
	Nov	5.5	5.2
	Dec	5.7	5.1
1986	Jan	5.5	4.9
	Feb	5.1	4.8
	Mar	4.2	4.0
	April	3.0	3.4
	May	2.8	3.1
	June	2.5	3.3
	July	2.4	3.2
	Aug	2.4	3.3
	Sept	3.0	3.4
	Oct	3.0	3.4
	Nov	3.5	3.3
	Dec	3.7	3.5
1987	Jan	3.9	3.7
	Feb	3.9	3.7
	Mar	4.0	3.8
	Apr	4.2	3.6
	May	4.1	3.8
	June	4.2	3.5

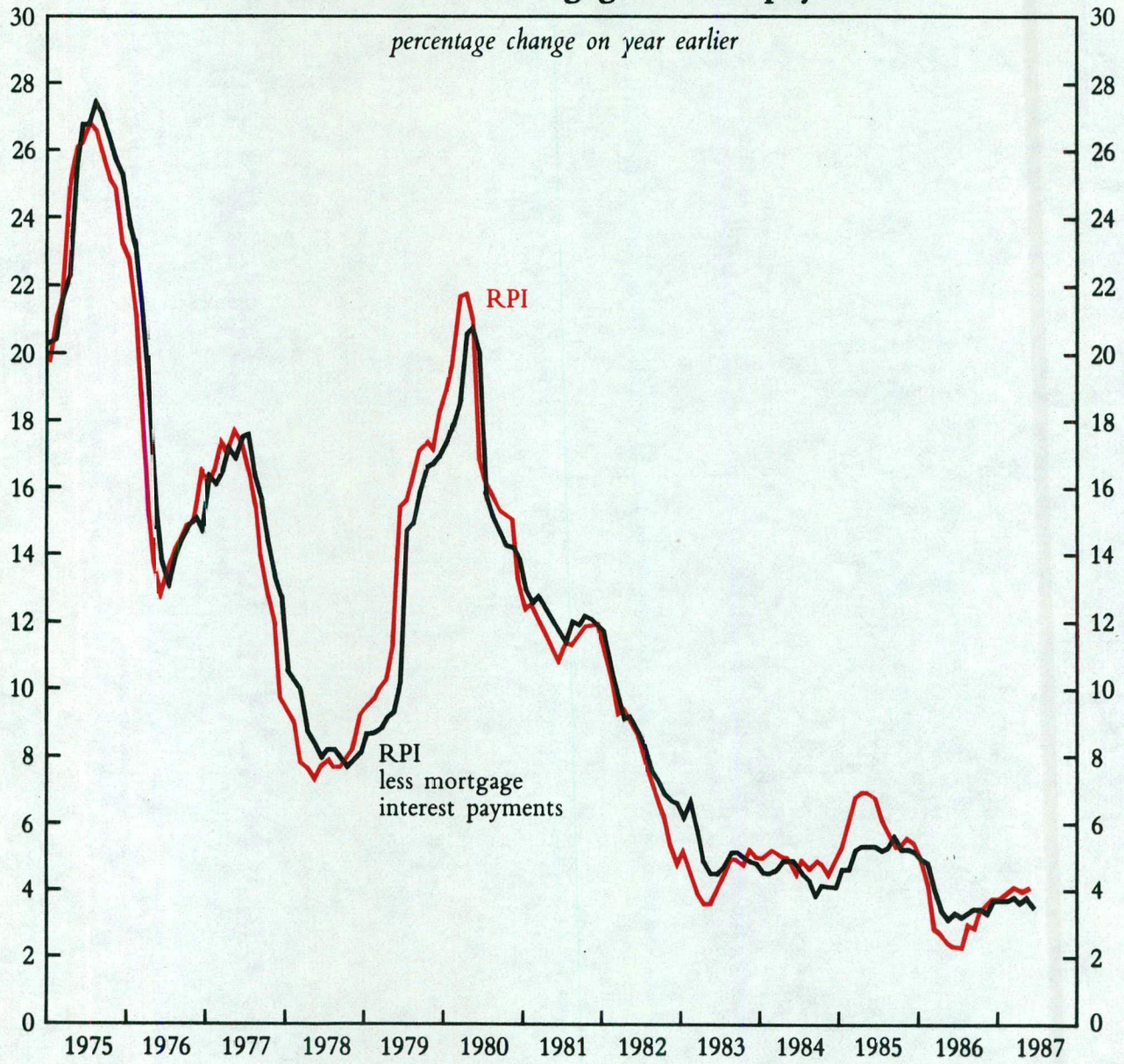
RPI and RPI less mortgage interest payments



RPI and RPI less mortgage interest payments



RPI and RPI less mortgage interest payments



Many thanks. PS6 left the Law Annual Accts, Ex MIPs, for each year 1979-1987 inc. Mc.

MR A C S ALLAN

FROM: P F L ALLUM
DATE: 27 JULY 1987

cc : Sir Peter Middleton
Sir Terence Burns
Mr Sedgwick
Mr Culpin
Mr S J Davies o/r
Mr S Matthews
Mr S Brooks
Mr Cavanagh (CSO)

RPI AND MORTGAGE INTEREST PAYMENTS

1. Your minute of 24 July on this topic asked whether we had any comments on the Chancellor's redraft. My only suggestion would be to include details of where we have used figures for the RPI excluding mortgage interest payments in our briefing. This could be provided as a footnote or, alternatively, the relevant sentence of paragraph 4 could be redrafted:

> "We used figures for the RPI excluding mortgage interest payments, for example, in last year's Autumn Statement (paras 1.45 and 1.51) to stress that ..."

2. The table requested by the Chancellor showing the monthly series for the RPI, with and without mortgage interest payments, over the four years June 1983 to June 1987 is attached.

3. The CSO graphics unit is producing a version of the RPI chart with a black and a coloured line. Copies of this will be forwarded to you when available - at the latest by early Tuesday morning.

I've asked for it by 9.30

P F L ALLUM

RETAIL PRICES INDEX

(Twelve month percentage change)

		All items	All items excluding mortgage interest payments
1983	June	3.7	4.5
	July	4.2	4.7
	Aug	4.6	5.1
	Sept	5.1	5.2
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	July	6.9	5.2
	August	6.2	5.3
	Sept	5.9	5.6
	Oct	5.4	5.2
	Nov	5.5	5.2
	Dec	5.7	5.1
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	Mar	4.2	4.0
	April	3.0	3.4
	May	2.8	3.1
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	July	2.4	3.2
	Aug	2.4	3.3
	Sept	3.0	3.4
	Oct	3.0	3.4
	Nov	3.5	3.3
	Dec	3.7	3.5
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	Feb	3.9	3.7
	Mar	4.0	3.8
	Apr	4.2	3.6
	May	4.1	3.8
	June	4.2	3.5

psl/17A

pup

FROM: A C S ALLAN
DATE: 13 October 1987

(do not show to any Ministers)

CHANCELLOR

PCC DISCUSSION OF FORECAST

The economists (Terry, Byatt and Smee) were relatively content with the picture and disinclined to do anything to disturb it; most of the rest were rather nervous about overheating/inflation with a gut reaction of wanting yet tighter fiscal policy; Peter saw himself as the guardian of the MTFS, but didn't offer any policy prescriptions.

2. Peter Sedgwick's introduction stressed that the "risks" were nearly all upwards: both consumers' expenditure and investment could well be higher next year than forecast, and it was not entirely clear where any deceleration of domestic demand was to come from. On public finances, the forecast was pretty cautious: the best individual judgments on each component produced an even larger fiscal adjustment, so they had made more cautious judgments on revenue and more pessimistic ones on expenditure.

3. Frank Cassell raised an interesting point about financial balances in Table IIA (right at the back of the Forecast Report). This shows a very large residual error (3 per cent of GDP), which seems to cast doubt on the other sectoral balances. The public sector balance was unlikely to account for much, so the alternatives were either a better current account position or (and this was generally thought more likely) an even sharper run-down in the personal sector surplus - ie still lower savings ratios. But Terry stressed that it was very unusual for the residual to be allocated to just one sector as new information arrived: it was much more commonly spread around.

4. Robin Butler and Andrew Turnbull both thought the forecasters had ~~not~~ been too pessimistic on public expenditure, particularly on

defence and other cash limited programmes, but also on social security: the latest figures for social security spending were surprisingly low, and it was possible that our natural pessimism over take-up was now overdone.

5. There was then an almost complete tour de table. Frank Cassell was uneasy about the forecast, though worried about taking too gloomy a view; he noted the real conflict between the present strength of sterling and the forecast weakness. Nick Monck was struck by the tight policy stance, both on the PSBR and on real interest rates, contrasting with the rise in inflation. Ian Byatt found the prospects pretty encouraging - high profitability, good performance on investment and productivity etc. It did look as if Say's law was really working, though there were some concerns about inflationary pressures. Peter Kemp was reasonably bullish on pay, while recognising the risks: he thought the position was fairly stable, and believed we could keep a hold on public sector pay. Tony Wilson was rather unfocussed, and concerned about excess capacity in the City and the "forthcoming agricultural revolution".

6. John Anson didn't share Peter Kemp's views about labour costs. And he was worried that the fiscal position would lead to large pay recommendations from the Review Bodies (especially for nurses) and to considerable pressure for more generous upratings of State pensions. John Odling-Smee (in one of the best interventions) noted the puzzle of a booming UK economy against the background of a tight policy stance and a sluggish world economy. The two most likely explanations were: first, the supply side, Say's law, etc.; and/or second, a temporary cycle in private sector spending. In neither case did we need to worry, except possibly if we thought the cycle in private spending was too long. He was not inclined to take risks in adopting any potentially de-stabilising policy, and in particular wouldn't want to cut the fiscal deficit further.

7. Michael Scholar noted that many people felt policy needed a slight tightening; it was clearly difficult to do much on monetary policy, and that was why people were looking to fiscal policy. Was what was in the forecast already a tightening? He was forced to conclude it was. So he was not necessarily looking for a further tightening in the Budget, but was concerned that the tax package should not grow in size. Andrew Turnbull presented a more sophisticated rationale for a further tightening of fiscal policy: he thought the big changes in the private sector financial balance meant that we should rethink what we meant by a "tight" fiscal policy. What looked a tight policy when seen against a personal sector surplus of, say 3 per cent of GDP, looked a lot less tight against a personal sector in balance (but this ignores crowding-in). Andrew was also more inclined to take account of some sort of cyclically adjusted fiscal position, and would be more ambitious in going for a larger surplus - noting that the PSBR was still in deficit with privatisation proceeds added back. Robin Butler thought the main dilemma was did we believe in the MTFS any more? Could we keep galloping along at this rate, or did we need to rein back? But while he agreed with Andrew Turnbull's general thesis, he did not believe we could realistically tighten the fiscal stance further.

8. Terry supported Ian Byatt and John Odling-Smee. For 1987, successive forecasts had revised up GDP growth, productivity and domestic demand; but for given domestic demand the balance of payments was no worse than expected earlier. He saw nothing alarming in the picture: indeed he thought it was difficult to imagine a more satisfactory set of events. For 1988, he thought the forecast had been cautious in carrying forward the changing picture emerging for 1987. So it had domestic demand slowing, productivity growth slowing etc. He thought it was quite likely that the economy would be rather stronger. But he was not greatly concerned by this: it was very difficult to know how to slow down the growth of the private sector demand; and he was disinclined to

do too much fine tuning or to argue that we should drive the budget still further into surplus. It was very difficult to sustain an argument that the economy was overheating; and the current account deficits were very uncertain and should in any case be perfectly manageable. So he was content to leave things as they were. He was not convinced we could get inflation down in the medium-term given these sorts of growth rates.

9. Peter started by saying he didn't know whether to be gloomy or optimistic! His main concern was about money GDP, where "since Geoffrey Howe left" (!) we had not been pursuing policies consistent with the paths set. We had now settled down with inflation steady at 4-5 per cent, which made him uncomfortable since it could all too easily slide up again. But it was not at all clear exactly what his policy prescription was.

10. Most of the rest of the discussion concerned exchange rate policy. Terry's view was that if we stuck to the present policy, it was very likely that this would in time imply a tightening of the policy stance. This was generally agreed, but Peter was concerned that this put off a further fall in inflation to the much too distant future. John Odling-Smee said he wasn't particularly concerned about inflation continuing to run at 4-5 per cent with growth at the sorts of levels we were seeing; his only concern was trying to justify this within the context of the MTFS, and then having to explain it to the TCSC!

A C S ALLAN

cc PS/MST
ACSA
13/10.

1 STANHOPE GATE - LONDON - W1A 1EH
Telephone: 01 - 493 8484

13/10

Dear Nigel,

I meant to mention to you on Thursday evening a contract which G.E.C Reliance is hoping to obtain for the central Whitehall switch. We are very keen to get this and have been worried that news has been slow to reach us.

The contract is important for a number of reasons. We are in competition with Northern Telecom, a Canadian company, with whom we are negotiating an agreement at the moment. If we win the contract this strengthens our position and conversely if we lose it.

We believe our system is better and that Marconi Telecoms cannot demonstrate its superiority, the CCTA will guide you on this.

Contracts of this nature are of enormous importance to British manufacturing industry. If you have any doubts I hope you will come back to me before deciding.

I thought Ridley was decisively beaten on Tuesday evening.

Yours ever

Ian

SECRET AND PERSONAL until release of press notice
on 23 October 1987 at 11.30 am and thereafter unclassified

prep

To Minister for Trade

Copy No. 3 (28)

From Peter Stibbard
US/S2
V/260 Ext. 4872

14 October 1987

OVERSEAS TRADE FIGURES FOR SEPTEMBER: EXPORTS

1 The value of exports in September, seasonally adjusted on a balance of payments basis, is estimated at £7.0 billion, £0.4 billion (6½ per cent) higher than in August. Exports of oil fell by about £0.1 billion but exports of the erratic items rose by £0.1 billion. Excluding oil and the erratic items exports rose by 7½ per cent between August and September.

2 In the three months ended September the total value of exports increased by 4½ per cent compared with the previous 3 months; excluding oil and the erratic items the increase was 6 per cent.

3 In the three months ended September, total export volume was 3½ per cent higher than in the previous three months and 6½ per cent higher than in the same three months a year ago. Excluding oil and the erratic items export volume grew by 6 per cent to be 9½ per cent up on a year earlier. The trend of non-oil export volume now seems to have been rising in recent months and is above the high level reached at the end of last year.

4 Recent export figures are shown in the attached table; charts plotting the main aggregates are also attached. A note describing imports and the current account will be circulated on Monday 19 October. The monthly press notice for September is scheduled for release on Friday 23 October.

5 The September export figures reported in this note are at a record level, at least in value terms - slightly above the previous record in February of this year, which was inflated by catching-up from the effects of the bad weather in January. As when the figures are exceptionally bad, in press briefing we will stress the usual warning about overrating the importance of a single month's figures. The extent to which this will be necessary is, of course, dependent on the import figures.

P J STIBBARD

999-80

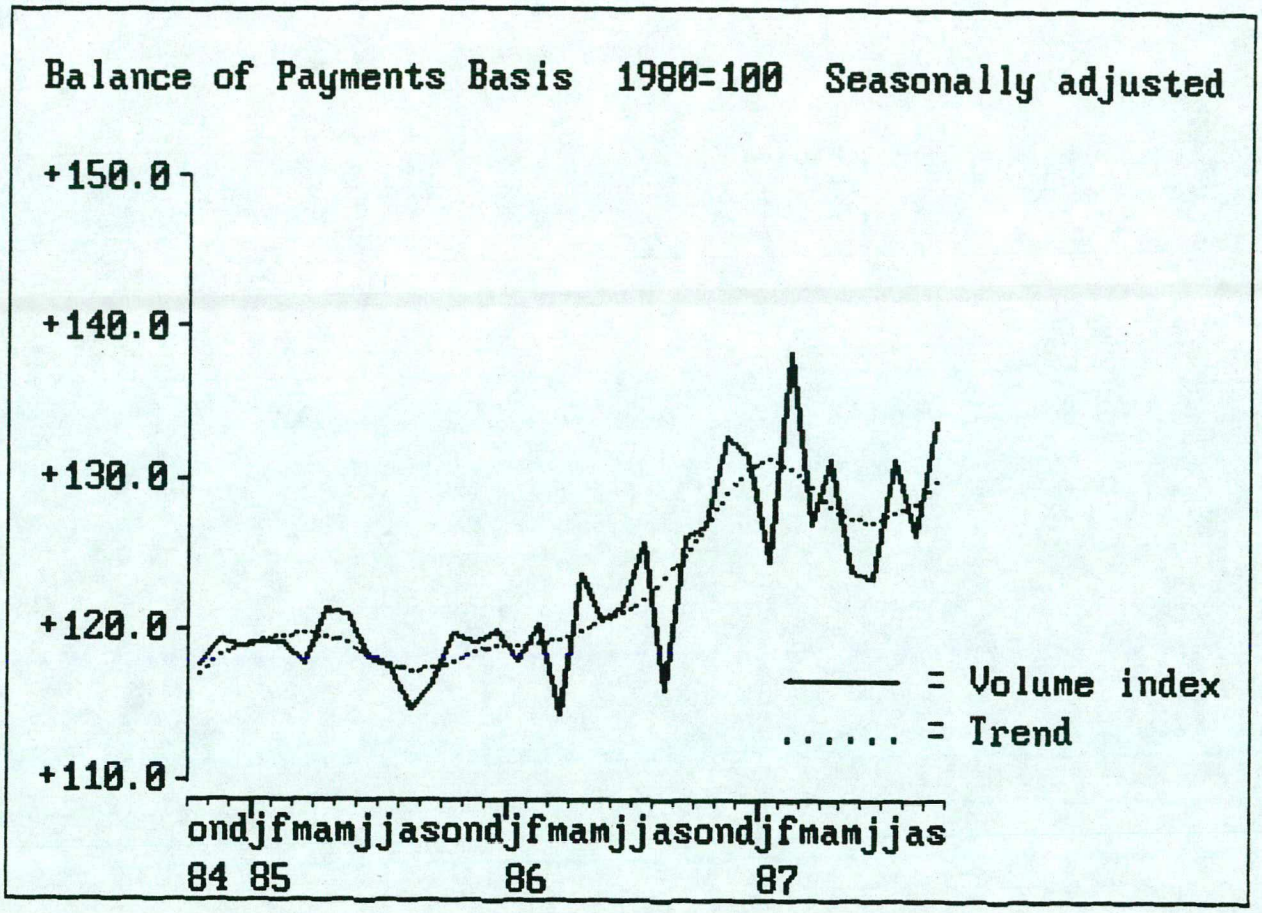
SECRET and PERSONAL until release of press notice on 29-OCT-87 at 11.30am and thereafter unclassified

Copy No...( )

EXPORTS
(Balance of payments basis; seasonally adjusted)

		---TOTAL TRADE---		EXCLUDING --OIL & ERRATICS--	
		VALUE £m	VOLUME (1980=100)	VALUE £m	VOLUME (1980=100)
1986	Q3	17553	122.6	14839	118.5
	Q4	19340	130.5	15873	125.3
1987	Q1	19637	130.0	15899	124.4
	Q2	19381	126.3	15885	122.4
	Q3	20301	130.5	16841	129.6
1987	APR	6610	131.4	5312	123.6
	MAY	6372	123.9	5270	121.6
	JUN	6399	123.5	5303	122.1
	JUL	6776	131.3	5564	129.3
	AUG	6545	126.4	5430	125.1
	SEP	6980	133.9	5846	134.4

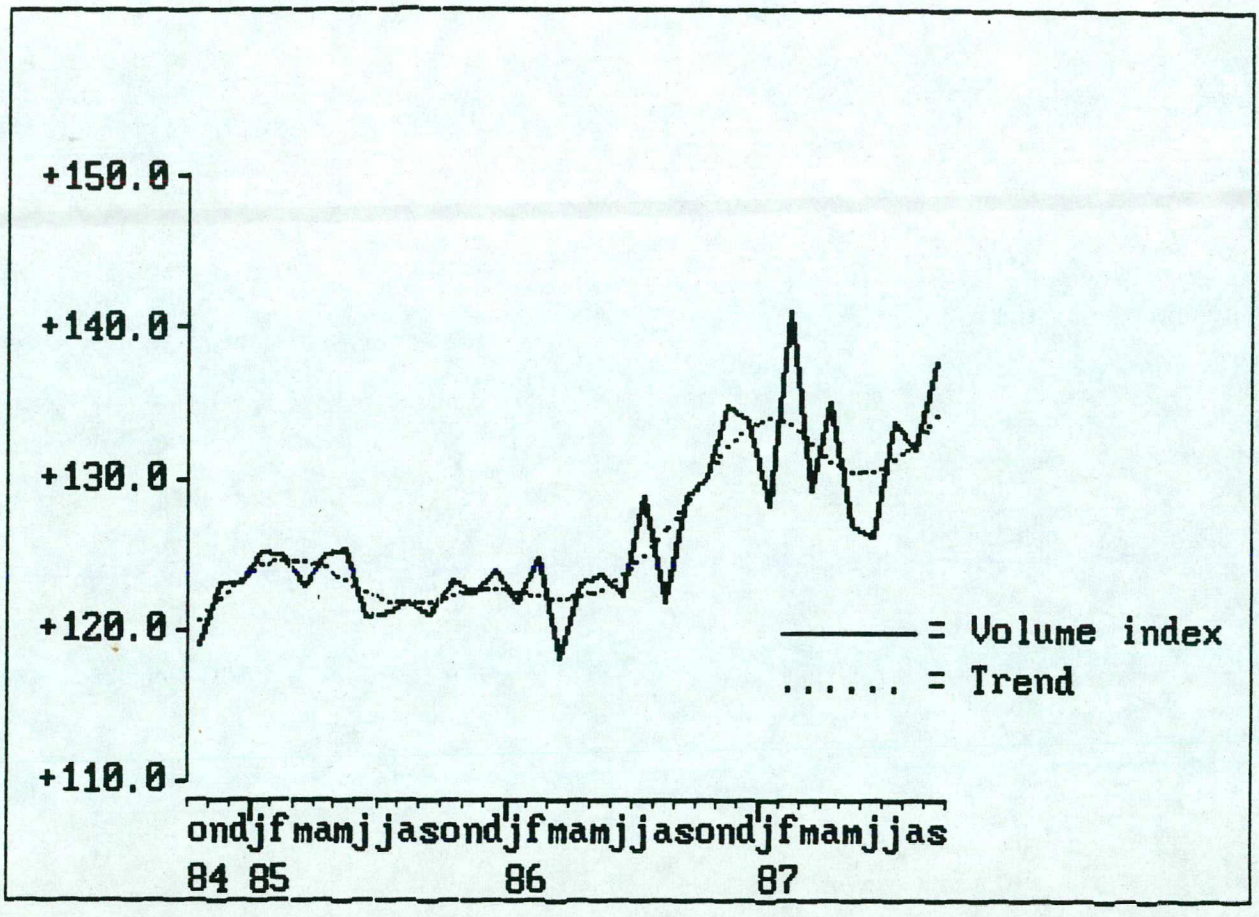
TOTAL EXPORTS



SECRET & PERSONAL UNTIL RELEASE OF PRESS NOTICE ON 23.10.87

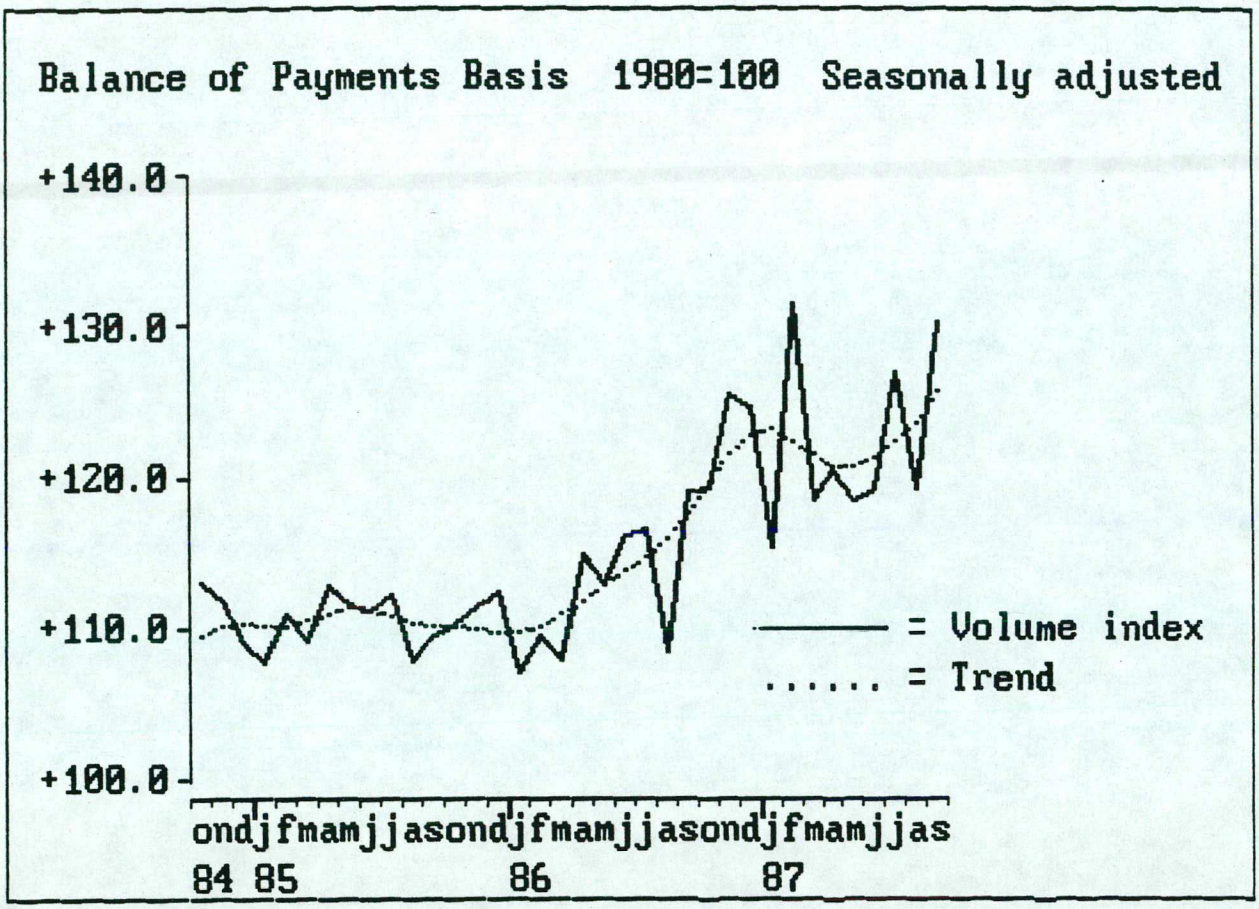
SECRET & PERSONAL UNTIL RELEASE OF PRESS NOTICE ON 23.10.87

EXPORTS LESS ERRATICS *



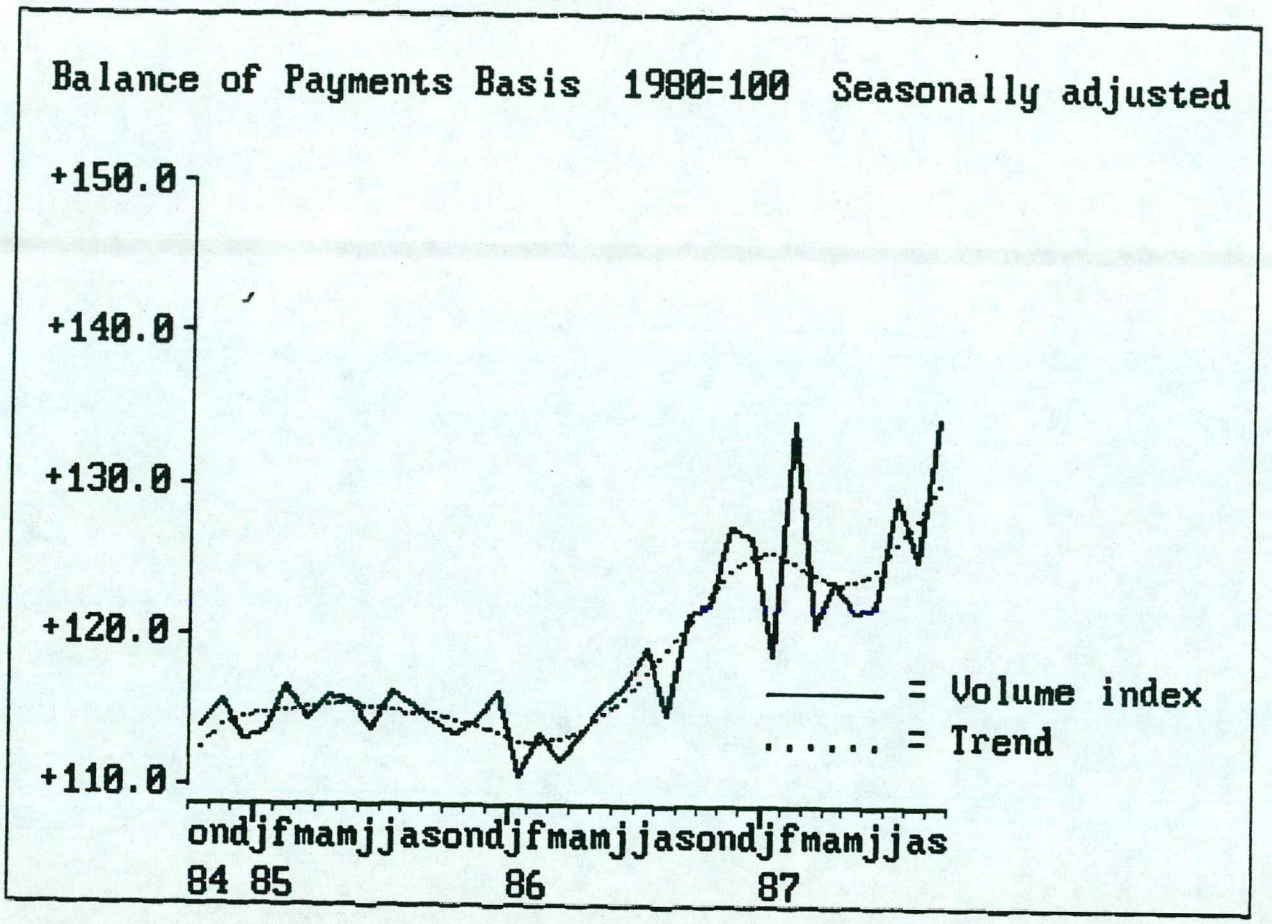
* = Ships, North Sea Rigs, Aircraft, Precious Stones & Silver

EXPORTS LESS OIL



SECRET & PERSONAL UNTIL RELEASE OF PRESS NOTICE ON 23.10.87

EXPORTS LESS OIL & ERRATICS



SECRET & PERSONAL UNTIL RELEASE OF PRESS NOTICE ON 23.10.87

CIRCULATION LIST

Copy No	1	Minister for Trade	
	2	Prime Minister	
	3	Chancellor of the Exchequer	
	4	Secretary of State for Trade and Industry	
	5	PUSS for Trade and Industry	
	6	Sir Robert Armstrong (Cabinet Office)	
	7	Sir Brian Hayes (Dept. of Trade and Industry)	
	8	Sir Peter Middleton (HM Treasury)	
	9	Governor of the Bank of England	
	10	Chairman of the Board of HM Customs & Excise	
	11	Mr J Hibbert (CSO)	
	12	Mr **Pratt** (HM Customs & Excise)	
	13	Mr B Buckingham (CSO)	
	14	Mr Davies (HM Treasury)	
	15	Mr Barrell (HM Treasury)	
	16	Mr P Sedgwick (HM Treasury)	
	17	Mr D Owen (HM Treasury)	
	18	Mr A McIntyre (CSO)	
	19	Dr P Rice (Dept. of Energy)	
	20	Mr Bottrill (HM Treasury)	
	21	Mr H H Liesner)	
	22	Mr P J Stibbard)	
	23	Mr W E Boyd)	
	24	Mr E J Wright)	Dept of Trade and
	25	Mrs A Brueton)	Industry
	26	Miss C Siddell)	
	27	Miss H Chapman)	
	28	Mr D Packer)	

PC6.28

CONFIDENTIAL

FROM: CATHY RYDING
DATE: 14 October 1987

SIR T BURNS

cc Sir P Middleton
Mr Sedgwick
Mr Davies
Mr Allum
Mr Hudson (with previous papers)
Mr S Price

RPI AND GDP

The Chancellor was grateful for your minute of 13 October and has commented that this is a possible point for the Budget speech.

CR

CATHY RYDING

CONFIDENTIAL

FROM: SIR T BURNS
DATE: 13 OCTOBER 1987

CHANCELLOR

cc Sir P Middleton
Mr Sedgwick
Mr Davies
Mr Allum
Mr S Price

RPI AND GDP

You asked what was the last year for which GDP growth exceeded the increase in the RPI; and what are the prospects of it doing so this year.

2. The last year when GDP growth exceeded inflation was 1964 (although there was only a 0.3 per cent gap last year, which could possibly be whittled away by revisions to GDP still to come). Figures for the eleven years to 1973 and the most recent years are as follows:

Per cent change on previous year in

	RPI	GDP
1963	2.0	4.4
1964	3.3	5.5
1965	4.8	2.7
1966	3.9	1.6
1967	2.5	2.2
1968	4.7	4.2
1969	5.6	2.5
1970	6.3	1.9
1971	9.4	1.5
1972	7.3	2.4
1973	9.1	7.3
1985	6.1	3.6
1986	3.4	3.1
1987 (Estimated)	4.1	4.1

3. **1987 Forecast.** The forecast for this year shows GDP growth equal to the increase in the RPI. Given the margins of error this means that - if the forecast is central - there is almost a 50 per cent chance that GDP growth will exceed the RPI increase for 1987. As GDP figures tend to be revised up and the RPI is not the odds in practice are maybe a little better than evens.

T BURNS

RC6.11

UNCLASSIFIED

BIF 14/10

FROM: CATHY RYDING
DATE: 12 October 1987

SIR T BURNS

RPI

The Chancellor will be grateful to know when the annual (ie. year-on-year) rate of inflation was last no higher than the corresponding real rate of growth. He would also be grateful to know what chance you believe there is of such a rare phenomenon occurring in 1987.

CR

CATHY RYDING

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and thereafter unclassified.

CSO(87) 94

9 October 1987

TAX AND PRICE INDEX, SEPTEMBER 1987

The Tax and Price Index (TPI) for September was 100.4 based on January 1987 = 100. Over the twelve months to September the increase in the TPI was 2.4 per cent, compared with an increase of 4.2 per cent in the Retail Prices Index (RPI).

TAX AND PRICE INDEX

	TPI (Jan 1978=100)	TPI (Jan 1987 = 100)	Percentage change in TPI over 12 months	Corresponding change in RPI	
1986					
January	192.9		4.4	5.5	
February	193.7		3.9	5.1	
March	194.0		3.0	4.2	
April	192.5		1.2	3.0	
May	192.9		0.9	2.8	
June	192.8		0.6	2.5	
July	192.1		0.4	2.4	
August	192.9		0.6	2.4	
September	194.0		1.2	3.0	
October	194.3		1.5	3.0	
November	196.3		2.2	3.5	
December	197.1		2.4	3.7	
1987					
January	198.0	100.0	2.6	3.9	3.9
February		100.5	2.7	3.9	
March		100.7	2.8	4.0	
April		99.7	2.5	4.2	4.2
May		99.8	2.4	4.1	
June		99.8	2.5	4.2	
July		99.7	2.8	4.4	4.3
August		100.0	2.6	4.4	
September		100.4	2.4	4.2	

Press ask Sir TB (a) When the annual (or year-on-year) rate of inflation was last as high as now? Was the corresponding rate of real growth then as now? (b) What changes do he foresee there will be of such a rate of fluctuation occurring in 1987. MC

Notes to editors

1. The purpose and methodology of the TPI were described in an article in the August 1979 issue of Economic Trends, and the series from January 1979 is published regularly in the Monthly Digest of Statistics. Figures from January 1976 are available from the CSO.

What the TPI measures

2. The TPI measures the increase in gross taxable income needed to compensate taxpayers for any increase in retail prices. The RPI measures changes in retail prices; the TPI also takes account of the changes to direct taxes (and employees' National Insurance contributions) facing a representative cross-section of taxpayers. It is thus an additional, more comprehensive, index.

3. The TPI increased by 2.4 per cent over the twelve months up to September 1987 while the RPI increased by 4.2 per cent. The increase in the TPI was smaller because of the increase in personal income tax allowances and the reduction in the basic rate of income tax in the 1987 Budget. The effect on the TPI of the changes in National Insurance contributions, which took effect in April 1987, was negligible.

4. When direct taxation or employees' National Insurance contributions change (usually at Budget time) the TPI will rise by less than or more than the RPI according to the type of changes made. Between Budgets the monthly change in the TPI is normally slightly larger than that in the RPI (a more than proportionate increase in gross income is needed to offset any rise in prices, since all the extra income is fully taxed). Consequently there was a 0.4 per cent rise in the TPI between August and September compared with an increase of 0.3 per cent in the RPI. However, the focus of attention should be the changes over twelve months.

Coverage and calculation of the TPI

5. Non-taxpayers and those with incomes over £22,415 a year at January 1987 are excluded from the TPI. Non-taxpayers are excluded because the RPI already provides a measure of the change needed to maintain the purchasing power of their incomes. Those with high incomes are excluded because the changes in their tax liabilities are not necessarily representative of the majority of tax-payers, and because broadly the same percentage (the top 4 per cent) is already excluded from the households on whose expenditure patterns the RPI is based. Otherwise everybody is included, whether working, unemployed or retired, so long as they pay tax.

6. The TPI reflects changes in people's tax and National Insurance contribution liabilities. If the index were instead to reflect actual payments it would be subject to highly erratic movements, which would be difficult to interpret and could be misleading.

7. The current composition and distribution of gross taxable incomes are estimated from Inland Revenue's Survey of Personal Incomes in 1984/85, updated by later aggregate data on incomes. With the exception of housing benefit, non-taxable income, (and in particular child benefit), is not covered. From February 1987 onwards, housing benefit is included in the income base for calculating the TPI because of changes made to the RPI as a result of the RPI Advisory Committee's recommendations. The RPI now reflects changes in gross housing costs which, for a substantial minority of tax-payers, are partially offset by receipts of housing benefit. After excluding those with high incomes, the sample comprises 32,037 tax units (single people or married couples). The change in tax and National Insurance contribution liability resulting from any uniform increase in gross incomes can be estimated from this. So the change in gross income needed to offset a particular RPI increase can be found.