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PART F

1986 BUDGET AUTUMN STATEMENT

DD'S 25years 2-02-95 N.Aziz.

STARTS:- 19-11-86
ENDS:- 01-12-86

CLOSED

CONTINUED ON:-

PART G

Autumn Statement
Budget 1986.
Part ~~E~~ F

Wednesday, 19 November 1986

FINANCIAL TIMES

2

Thatcher rules out EMS entry until economy is stronger

BY PETER RIDDELL, POLITICAL EDITOR

MRS THATCHER has firmly ruled out full UK membership of the European Monetary System until the economy is "stronger." She says she would expect to reconsider the issue after the next general election.

The Prime Minister's comments were made during an hour-long interview with the Financial Times at 10 Downing Street. She was at her most confident, looking forward to at least another term in office and "geting rid of socialism as a second force."

Among a wide range of points, Mrs Thatcher expressed her support for the privatisation of the electricity industry after the election, for concentrating tax cuts at the lower end of the range, and for building more nuclear power stations — she hopes to read the long-awaited report on Sizewell over Christmas.

The Prime Minister gave the most explicit statement of her doubts on EMS membership which contrast with the support for entry expressed by the Treasury, the Foreign Office and the Bank of England.

She said the economy was not "quite strong enough yet" for EMS. "We are getting stronger and one day we will go in," she added, saying she would expect to reconsider the issue after the election.

Mrs Thatcher stressed throughout the interview that she wanted to go into EMS from strength.

"I want to be absolutely certain that there can be no repetition of what happened before, when we came out of the snake," (the linking of European Community currencies which sterling left in 1972 after a couple of months). "When we go in, we will go in strong and stay in." She said repeatedly that entry would not be an easy or soft option.

Mrs Thatcher also argued that other EEC countries should reconsider the rules, particularly the retention of exchange control in most cases.

She also expressed concern about "hitching our wagon to a Deutsche Mark standard and all the problems we used to have with devaluation if it comes." She thought the pound would be tested and that would mean "swinging up interest rates very sharply" since "there is no way you can intervene to any great extent."

Mrs Thatcher thought the pound had gone low enough against the D-Mark. She underlined her dislike of increasing interest rates and market intervention. "We may believe it (thet pound) has gone enough but it is what the market believes and you know what the market is: 95 per cent of the movement is speculation and the other 5 per cent is trade."

On other economic issues Mrs Thatcher expressed caution about the scale of any tax cuts. She argued the public spending planned for next year—higher than "we wished"—must be "honestly financed" as in 1981. She underlined the public borrowing target for next year of 1¾ per cent of gross domestic product.

The Prime Minister said tax reform was still on the agenda. "At the moment the most urgent thing is people at the bottom, because I think they pay far too much." She said the feeling of the country was that further cuts in the higher marginal rates were not the top priority but, referring especially to scientists, "I do have to watch and see that people are not leaving the country."

She expressed great confidence in Mr Graham Day, chairman of Rover Group, and said the Government would probably be reaching decisions on his corporate plan after Christmas. She stressed that Rover Group could not carry on indefinitely alone as a volume car producer without having an arrangement with someone else.

Mrs Thatcher said that on her forward agenda were the the need to re-examine the cities, with the increased use of urban development corporations, the need to reexamine the structure of local authority finance and the extension of denationalisation and share ownership.

The Thatcher interview, Page 24

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Wednesday, 19 November 1986
FINANCIAL TIMES

6

An interview with the Prime Minister

Two more terms to eliminate socialism

By Geoffrey Owen and Malcolm Rutherford

24

MRS Margaret Thatcher hopes to "get rid of socialism as a second force" in British politics in the course of one or perhaps two more terms of Conservative government.

The Prime Minister told the Financial Times in an interview on Monday that the main themes for the Tory manifesto at the next election will include reforms in education, more initiatives to renovate the inner cities, investment in nuclear power and more—much more—privatisation.

She remains committed to cutting taxes, especially at the bottom end of the income scale, but warned that if public expenditure looks like getting out of hand, the Government is prepared "to do another 1981"—when taxes went up.

Mrs Thatcher said that she was "quite pleased" with the economic growth prospects at the moment — 3 per cent next year on the Treasury forecasts — and "quite pleased with the steadily improving performance of manufacturing industry." But: "We are not quite the same as West Germany yet. I wish we were."

In a central part of the interview she argued that the economy will have to become stronger before she is ready to commit Britain to full membership of the European Monetary System, and that time will come almost certainly after the general election. Although "one does not rule out anything at the moment, that is when I would expect to have to reconsider it," she said.

The Prime Minister's main arguments against full membership at present were as follows.

First, she thinks EMS members ought to observe the same rules. "For example, some of them have exchange control . . . That obviously gives them a control mechanism, which we do not have."

Secondly, while Germany does not have exchange controls, it also does not have the petro-currency problem. "When the price of oil goes down it is 100 per cent benefit to Germany and only 50-50 to us."

"Thirdly, people think of going into the EMS believing . . . that somehow you go in and everything in the garden will be lovely without you having to make so much effort. That is just not true."

If Britain went in along those lines, Mrs Thatcher said: "The speculators will come in." To resist them, "you have to do one of two things—you have got interest rates or intervention. There is no way in which you can intervene to any great extent." Support operations from other central banks, she added, amounted only to other people lending you money.

Asked whether full membership might not lock in a low inflation rate, the Prime Minister replied: "Ah, but that means then that I have to swing up interest rates very high regardless. They might fluctuate much more because we would be tested . . . I do not want interest rates any higher. I have to put them up in order to keep a limit on inflation."

Mrs Thatcher no longer refers very much to the sterling/dollar rate. "What we are talking about," she said, "is a D-mark standard, and then you have all the problems that we used to have with devaluation, if it comes. We are getting stronger and one day we will go in."

She then gave a further reason for her reluctance to go in now. "You know, we came out of the snake" (a forerunner of the present European monetary system). "It is etched on my mind. We went in and we came out. When we go in (to the EMS) we will go in strong and stay in."

To a question about the current sterling D-mark rate, the Prime Minister said: "I think it has gone low enough." However, she refrained from making any pledge that the rate will be supported. "We may believe it has gone enough," she went on, "but it is what the market believes and you know what the market is: 95 per cent of the movement is speculation and the other 5 per cent is trade. That is why I said to you earlier that if we had confidence that we will have a clear run—you will have alternative governments to this one, but if they were not socialist governments—then I do think that the prospects for this country would be transformed."

Mrs Thatcher was harking back to what she said at the start of the interview about the need for a third term: "If people could be sure that we would never have another socialist government, increasing control of state, increasing control of ownership . . . then I think the prospects for this country would be really bright . . . and if only we could get rid of socialism as a second force and have two (parties which) fundamentally believed that political freedom had to be backed by economic freedom and that you get the best out of a people when you delegate power down — it is not really ours to delegate; the history of democracy is the history of increasing liberty from the power of the state."

She is undecided on whether to accept the terms of the teachers' agreement reached last weekend, mainly on the grounds that the best may not be sufficiently rewarded. "Differentials matter, what your top teachers are paid matters and it matters to your mathematicians and physicists that they have a chance, if they are good teachers, that they get a reasonable salary in a reasonable time, so the pay structure is absolutely critical."

Whatever the decision here, education is part of what the Prime Minister called "very much a forward movement" for the next manifesto. Inner cities will feature prominently there will be more Urban Development Corporations, with powers over the heads of the local authorities.

Nuclear power is another priority, though what kind of reactors and whether any are commissioned before the election depends on the Sizewell Report which Mrs Thatcher may have to use as her Christmas reading. (Two Christmases ago, it was the report on the fourth London airport.)

On the basic principle she is adamant: "You cannot do without nuclear power and more nuclear power . . . oil is at a low price at the moment. It is only a question of time as to when it goes up. Some people say five years, some would say 10, but it takes about 10 years to build and commission nuclear power stations."

Much of the rest is privatisation, and the only question is the order and the form. "The longer I am in government," the Prime Minister said, "the more I know that governments ought not to have to make some of the decisions that they do on nationalised industries. If you look to see why an industry is nationalised, the only reason that I can really work out is so that government can interfere."

She was asked to be more specific. That, she replied, was not possible at present. "You look and see which are the best ones to take first and also how best to do it, because sometimes you do it piecemeal, sometimes you will take a whole industry. Sometimes you will do it with 50 per cent and then . . ." In various ways, the electricity, coal and steel industries are all possibilities.

The coal industry, she said, "really is getting into a much healthier state than it has ever been and I find myself saying in some speeches: 'Do you realise that under a Conservative Government even the nationalised industries run better?'"

It was, she said, a question of delegating power and responsibility and of spreading both ownership and management. Mrs Thatcher went to the Nissan plant in the North Eeast

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Cont...

the other day. What struck her was "the attitude of the people there; because of the way in which they had been treated by management every single person knew that his job was significant."

One of them told her: "We do not have to call in the unions very much, because if we have a problem it is sorted out there and then on the shop floor between whoever is responsible and the next management up."

She made a speech saying that within a few years our standards and quality would be every bit as good as the Japanese and the workers interrupted and said: "No, ours will be better."

The Prime Minister also scattered praise on some British companies, and not only Jaguar: Carrington Viyella, for instance. "Manufacturing raw materials, like polyester cotton," she said, "is now done so much by big machines that there is no earthly reason why we cannot repatriate it here from the Far East." Mr Peter Black who makes goods for Marks and Spencer and Sir Ralph Halpern of the Burton Group received further plaudits. What they have in common is that they are "all companies which were at one with their people."

Jaguar apart, she sees the British car industry as a problem expressing her disappointment at the successful opposition to the deals involving General Motors and Ford earlier this year.

"Ford," she said, "has done a lot for this country. Ford actually contributes to the revenue of this country. . . . It contributes to the money that we have been paying to British Leyland. . . . What was terribly difficult to get over to people was that BL was no longer a big volume car manufacturer . . . whereas we had 4 per cent of the cars of the European market, the others had 11-13 per cent . . . there is no way in which you can spread your overheads over 4 per cent, no way in which you can do your new models."

Mrs Thatcher thought that she might have handled the matter better if she had been in power longer. "We came across—sometimes you get it in politics—a political feeling which you just cannot, at that moment, overcome, and then you have to say: 'All right, we will just have to put it on one side at the moment'." With the assistance of Mr Graham Day, she will try again in the New Year.

The Prime Minister seemed rather less happy about tax and public expenditure than the public persona at the time of the autumn statement two weeks ago. "We have got higher public expenditure than we would have wished," she said. "Insofar as money has been spent, it is not available for tax relief. . . . When we get that higher expenditure, as we have, then the only thing that I can do is as we did in 1981: insist that it is soundly financed."

On tax cuts, she went on: "The most urgent thing at the moment is the people at the bottom." However, she is also giving consideration to cutting the top rate of income tax from 60 to 50 per cent, if only because lower tax rates and higher salaries in the US could induce a further brain drain from Britain. She added: "I cannot promise that that would be top priority," though she said she was concerned about the position of scientists.

"The fact that the American top rate is coming down so much," she claimed, "will affect some of our top people and that does give me cause for concern because to our top scientists they can offer both a fantastic laboratory facility as well as fantastic salaries and most people do work for their family, and that is not a bad thing.

"So we will have to watch that, particularly the science and technology side because so much industry is science-based and so much of the future is going to be science-based."

Mrs Thatcher also referred to—as is the habit of Chancellor Nigel Lawson—the problem of high unit labour costs in Britain.

Asked what could be done about it, she said only: "I can only point out . . . look, if you lose business, people must be intended to presume the consequences of their own action."

The political sting in the interview came at the end when she returned to the need to eliminate socialism as the alternative government. "I think you could get another realignment in British politics," she said. After another Tory victory? "After two more victories," she concluded.

2/3.

CONFIDENTIAL

FROM: S J DAVIES

DATE: 19 NOVEMBER 1986

MORTGAGE INTEREST PAYMENTS + FORECAST FOR INTEREST RATES

CHANCELLOR OF THE EXCHEQUER

cc : Sir Peter Middleton
Sir Terence Burns
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Culpin
Mr Brooks

MORTGAGE INTEREST PAYMENTS AND THE FORECAST FOR INTEREST RATES

I attach a brief on the relation between the Autumn Statement RPI forecast and the interest rate assumption underlying it, a topic which came up at Monday's questioning of officials.

S J DAVIES

Ch

Main points to make are

– RPI treatment of mortgages a nonsense;

– Not prepared to give disaggregation of housing component of RPI. But figures affected by increases in house prices over the last 25 years; high figures do not necessarily imply there is an assumption of a further rise in mortgage rates.

AA

cm
mrgeint

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Effect of mortgage interest payments on the forecast for the RPI

Paragraph 1.51 of the Autumn Statement says:

> "The increase in retail prices excluding mortgage interest payments over the next year is not likely to be very different from what it has been over the last year. However, the increase in mortgage interest rates in the second half of October will add just over ½ a percentage point to RPI inflation"

2. Table 1.7 of the Autumn Statement shows figures for the housing component of the RPI. These show an increase of 6½ per cent in the year to 1986 Q4, and an increase of 10¼ per cent in the year to 1987 Q4.

3. At Monday's TCSC appearance these figures led to the following line of comment:

> "The mortgage rate increase announced in October, and generally effective as from November, will have more than half of its total impact on the 1986 Q4 RPI. Therefore it cannot explain why the rise in the housing index is greater in the year to 1987 Q4 than in the year 1986 Q4, nor why the gap between the all items RPI and the RPI excluding mortgage interest payments goes from 0 to ½. The forecast must include a further rise in interest rates."

4. It is not difficult to explain what is wrong with this argument; it is more difficult to explain the forecast without giving away the fact that the forecast assumes precisely no change in mortgage interest rates over the next year. We would not want to give away our precise assumption on interest rates.

cm
mrgeint

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I have copy if needed (not attached)

5. The construction of the price indicator for the mortgage interest rate component of the RPI is explained in detail in paragraphs 119ff of the report of the RPI Advisory Committee that was published in July. As paragraph 121 of that report notes, the price indicator for mortgage interest payments responds to "two influences: the current interest rate and the past sequence of house prices".

6. The amount of mortgage interest payments that people have to make reflects both the level of interest rates and the size of the mortgage they have taken out. Mortgage interest payments currently being made relate to mortgage loans taken out at various times in the past twenty five years (assuming a normal maximum repayment term of twenty five years). As the size of past loans is related to past house prices, the mortgage interest payment component of the RPI is constructed so that it reflects house price changes over the last twenty five years as well as current changes in house prices.

7. Since the mortgage interest payments indicator is still picking up the effects of the house price booms in the seventies, as well as more recent increases in house prices, it rises at a relatively fast rate, currently around 10 per cent a year, when interest rates are constant. This means that if there is no change in interest rates, the RPI all items index will rise faster than the RPI excluding mortgage payments: it actually requires a fall in interest rates for the all items index to move in line with the index excluding mortgage payments.

8. Building society mortgage rate changes relevant to the change in the indicator over the years to 1986 Q4 and 1987 Q4 are given below:

April 1986	Rate reduced from 12.75 to 12.
June 1986	Rate reduced from 12 to 11.
November 1986	Rate increased from 11 to 12.25.

9. In 1985 Q4 the mortgage rate stood at 12.75 on average; in 1986 Q4 it should average around 11.8; in 1987 Q4, if there were no further change in mortgage rates, it would average 12.25. Thus the comparisons between 1985 Q4 and 1986 Q4, and between 1986 Q4 and 1987 Q4 (relevant to measured inflation in the years to 1986 Q4 and 1987 Q4 respectively) are as follows:

CONFIDENTIAL

1985 Q4 to 1986 Q4 Interest rates fell by almost 1 point.

1986 Q4 to 1987 Q4 Interest rates assumed to rise by almost ½ point.

Thus, with no further change in interest rates from now on, the difference between the year to 1986 Q4 and the year to 1987 Q4 is a little under 1½ points. While the fall in interest rates in the year to 1986 Q4 was enough to offset the rise in house prices, so that the all items RPI rose at the same rate as the RPI excluding mortgage interest interest payments, in the year to 1987 Q4 the small rise in interest rates compounds the influence from rising house prices.

10. This change of almost 1½ point is worth about ½ per cent on the RPI all items index; ie in itself it would lead to the increase in the RPI being about ½ point higher in the year to 1987 Q4 than in the year to 1986 Q4, without any change in the increase in the RPI excluding mortgage interest payments.

Points to make

11. The mortgage interest payments component of the RPI reflects two influences: the level of mortgage interest rates and the history of the last twenty five years house prices. Because of the relatively high rate of house prices inflation in the last twenty five years, the mortgage interest rate component of the RPI rises by roughly 10 per cent a year when interest rates are unchanged. With other prices rising by only just over 3 per cnet, the RPI including mortgage interest payments is bound to rise by more than the RPI excluding mortgage interest payments, unless interest rates actually fall, as they did between 1985 Q4 and 1986 Q4. It is plain wrong to say that because the all items RPI payments is forecast to increase more than the RPI excluding mortgage interest payments interest rates must be rising.

11. If members of the TCSC don't understand how the mortgage interest payments component of the RPI is constructed, the recent report of the RPIAC (Cmnd 9848) sets out the details, in non technical terms, in Section G, paragraphs 119ff.

DEBT INTEREST

3693/49

FROM: COLIN MOWL
DATE: 19 November 1986

PPS/CHANCELLOR

cc Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Scholar
Mr Sedgwick
Mr Turnbull
Miss O'Mara

TCSC APPEARANCE: 20 NOVEMBER

I attach a revised version of the debt interest brief attached to Miss O'Mara's minute to the Chancellor of 18 November. Changes from the earlier version are side-lined.

2. The changes involve the inclusion of, firstly, a reference to the recently published Treasury Working Paper on debt interest and, secondly, a section on interest rate reckoners. We have in the past resisted the Committee's requests for an interest rate ready reckoner. We have now however published ready reckoners, suitably qualified, in the working paper.

Colin Mowl

COLIN MOWL

DEBT INTEREST

Published forecasts of general government gross debt interest payments:

	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90
					£ billion	
1985 AS		18.0	-	-	-	-
1986 PEWP		18.0	18.5	18.5	19.0	-
1986 FSBR+		17.7	18.2	19	19	19
1986 AS*+	16.1	17½	17½	[18]	[18]	[19]
Changes between 1986 FSBR and 1986 AS+		0	-¾	[-1]	[-1]	[-½]

* figures in square brackets not published but implicit in Autumn Statement GGE figures.

+ FSBR and AS rounded to nearest £ billion. Changes calculated from unrounded numbers and rounded to nearest £½ billion.

General

As explained in recently published Treasury Working Paper (No.42) on debt interest, forecasting debt interest payments is complex matter. The debt comes in many different forms.

When forecasting necessary to make number of simplifications of the complex structure of debt and this inevitably introduces element of error. Forecasts dependent on many, often very uncertain, assumptions: levels and paths of interest rates, inflation, new borrowing and the structure of the new borrowing. Forecasts subject to wide margins of error. Hence published forecasts heavily rounded.

Debt interest payments in 1986-87

Payments expected to be £¾ billion lower than forecast at Budget time.

About half of downward revision reflects lower than expected interest rates and inflation (reduces accrued interest on indexed securities).

Rest of revision due to variety of factors including changes in composition, and profile and amount of GG borrowing, (GGBR lower in 1985-86 than assumed in FSBR reduces debt interest payments this year).

Debt interest payments in Survey years

Projections subject to wide margin of uncertainty.

Projections revised down since Budget broadly in line with revision to 1986-87 - ie £½-£1 billion a year.

Debt interest receipts in 1986-87

Figures for 1986-87 not shown separately in Autumn Statement but grouped with other receipts in table 1.11. No figures at all for later years.

Interest receipts largely subject to same influences as payments. Thus interest receipts down in 1986-87 compared with FSBR but offset by higher 'other receipts' (eg. higher trading surpluses of LA bodies).

Interest Rate Ready Reckoner

Ready reckoners recently published in Treasury Working Paper (No.42) but ready reckoners, like forecasts, subject to wide margin of uncertainty.

3463/00

6/42

FROM: R M PERFECT
DATE: 19 November 1986

1. MR PIRIE ✓ 19/11
2. CHANCELLOR

cc Chief Secretary
Sir P Middleton
Mr F E R Butler
Mr Hawtin
Mr Scholar
Mr Turnbull
Miss O'Mara

LA CAPITAL

TCSC AUTUMN STATEMENT HEARING: LA CAPITAL

The PAC report on LA capital will be published at noon tomorrow.

2. I attach some question and answer briefing, as requested.

R. M. Perfect.
R M PERFECT

Ch
It's just possible a TCSC member might pick this up. Main point is defensive (11) (as amended). Can leave technical questions to officials (or DOE).

AA.

PAC REPORT ON CONTROL OF LOCAL AUTHORITIES CAPITAL SPENDING

Factual

i. PAC report published at noon Thursday 20th November.

ii. Follows earlier reports by Audit Commission (April 1985) and Comptroller and Auditor General (May 1986).

iii. Secretary of State for the Environment announced on 15th October 1986 that reform of local authority capital control system was now best considered alongside the other proposals in "Paying for Local Government". Proposals for early reform of capital control system were not liked by local government.

Positive

i. Advantages of delaying reform

Postponing reform of LA capital control system until next Parliament will enable Government to allow as fully as possible for interactions between control arrangements for capital and current spending. PAC report notes there is no firm dividing line between the two (paragraph 43 (vi)).

But taking action to block major loopholes (eg deferred purchase).

Defensive

i. Does Government agree existing arrangements ineffective in achieving the Government's objectives and have adverse effects on local authorities?

Government accepts there are shortcomings in present arrangements. That is why we brought forward proposals for early reform of the capital control system that tackled many of the problems identified in the PAC report - such as taking account of spending power from receipts when distributing allocations to meet needs. Unfortunately proposals unwelcome to local authorities. Further consideration needed. Government has now decided that proposals need further consideration alongside other reforms to local authority finance proposed in Green Paper.

ii. Is aggregate net local authority capital spending under effective control?

Overall it took longer than expected for English local authorities to respond to the Government's encouragement to spend issued in 1982. That lead to substantial overspending in 1983-84 and 1984-85. Subsequently local authorities have failed to reduce spending as quickly as expected - hence the continued overspending on plan. But overall gross spending on local authority capital has not risen substantially since the current arrangements were introduced (1981-82 to 1986-87 DOE/LA1 gross spending up 35 per cent cash, 5 per cent real terms).

ii. Why give out more spending power to local authorities than allowed for in the cash limit?

Local authorities do not use all their capital spending power. If we failed to allow for that there would be massive underspending every year. We now make explicit assumptions as to what percentage of spending power will be used (for 1987-88 assumed to be 82 per cent compared to 79 per cent actual in 1986-87).

iv. Did Government fail to see consequences of its own legislative proposals?

In 1980 had little idea how slow local authorities would be to use spending power from receipts or what loopholes they would find in the law. Resulting growth in accumulated receipts and non-prescribed spending to blame for lack of room for allocations (to match needs and resources).

v. Why has Government given most weight to aggregate spending control and encouraging sales of assets, rather than matching resources to needs and promoting value for money?

Disagree. Have not sought to impose moratorium in 1985-86 or 1986-87 to stop capital overspending because it would be wasteful in value for money terms. Limited scope for matching needs to resources due to growing spending power from receipts. Welcome PAC's recognition that constraint of this spending power needed.

vi. Why are Government objectives not clearly stated?

They are. Government objectives set out in paragraph 16 of the Report. Difficult to list them in order of priority - when they clash trade offs have to be made. Recognise balance needs adjusting from time to time.

Extracts from PAC report on

Control of Local Authorities' Capital Spending.

GOVERNMENT'S OBJECTIVES

C&AG's Report Para 3.1

16. The Government's objectives in the operation of the capital expenditure controls were explained to the local authority associations as follows:

(a) to control aggregate local authority capital expenditure within the year in line with the Government's public expenditure plans;

(b) to help reduce the role of the public sector by encouraging the disposal of assets by local authorities;

(c) to promote a good match between the availability of resources and the incidence of need, taking into account Government priorities for the services concerned; and

(d) to provide local authorities with a workable system which promotes cost effective capital programmes and maximises freedom within the limitations necessarily imposed in pursuit of the other objectives.

SUMMARY OF MAIN CONCLUSIONS AND RECOMMENDATIONS

43. (i) The statutory arrangements introduced in 1981–82 have signally failed to bring the aggregate net capital expenditure by local authorities under effective control (paragraph 11).

(ii) We do not find wholly convincing DOE's claim that the present system had helped to contain the level of capital expenditure, and we question the value of continuing to treat as Cash Limits the global provisions for capital expenditure by local authorities which DOE cannot effectively control—or even accurately measure after the event (paragraph 14).

(iii) We note the further steps being taken by DOE to improve their forecasting and monitoring information and trust they will prove effective in practice (paragraph 15).

(iv) We find it disturbing that of its four objectives in operating expenditure controls the Government has given the least weight to the matching of resources to needs and the promotion of cost effectiveness in the use of resources by local authorities; we hope that it will now seek to redress the balance (paragraph 18).

(v) We would also urge that the Government's aims and objectives be adequately defined and its priorities clearly explained to the local authorities so that there may be no misunderstanding between central and local government as to where the balances should be struck between these objectives (paragraph 18).

(vi) We note that there is no firm dividing line between expenditure subject to the RSG system and capital expenditure subject to direct control; this weakens the effectiveness of any control over capital expenditure as such, and undermines any intended link between such expenditure and the LABR (paragraph 23).

(vii) It seems to us that the LABR, as presently defined, can provide no more than an imperfect measure of the true economic effects of local authorities' capital expenditure (paragraph 24).

(viii) We recognise the continuing need for redistributive measures relating to capital receipts from sales, even though such measures may disappoint the present expectations of some authorities; the objectives and likely effects of the arrangements should be fully and clearly explained to all local authorities (paragraph 26).

(ix) We consider that the Government's main objective for capital expenditure control should be better defined and suggest that in considering possible alternative control arrangements it should have regard to the totality of local authority spending and the division of its financing between rates, grants and receipts and net borrowing (paragraph 27).

(x) We recommend that DOE make some systematic attempt to assess the true effectiveness of the incentive to maximise disposals before reaching any decision on its continuance in any alternative future control arrangements (paragraph 30).

(xi) As the present arrangements have not fully achieved the objective of matching resources to needs we would urge that any new control arrangements should contain measures to maximise such matching rather than compromise it (paragraphs 31 and 32).

(xii) We fail to understand why the Government should continue to go to such lengths in the preparation of detailed spending programmes which it does not seek to have implemented (paragraph 33).

(xiii) We hope that all the Departments concerned will keep under review the continued need for any project controls which are still applied and the scope for simplifying their procedures (paragraph 35).

(xiv) We believe that, to secure good value for money, local authorities should take account of the backlog of work necessary on existing assets in considering the undertaking of new projects (paragraph 37).

(xv) We acknowledge the difficulties but recommend that DOE tak all possible steps to limit the use of any techniques to avoid capital expenditure controls which are clearly undesirable (paragraph 38).

(xvi) There are possible options which are not pursued in the Green Paper; it seems to us that DOE should examine all these possibilities (paragraph 40).

(xvii) To be successful any new arrangements for control of local authority expenditure must command the confidence of the local authorities as well as the Government (paragraph 41).

(xviii) We welcome the steps being taken to devise suitable alternative arrangements; we think the pre-requisite for this is a clear and adequate definition of the objectives to be pursued; the revised arrangements should be supported by reliable and timely forecasting, monitoring and reporting procedures; and once determined they should be implemented as speedily as possible (paragraph 42).

COMMENTS ON MARTIN'S BUDGET ARITH-METIC

FROM: **P N SEDGWICK**
DATE: 19 NOVEMBER 1986

CHANCELLOR

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Turnbull
Miss O'Mara
Mr Bottrill
Mr S Davies
Mr Mowl

not cst.

TCSC: COMMENTS ON BILL MARTIN's MEMORANDUM FOR THE COMMITTEE

(covered in Turnbull)

?!

You asked for comments on Bill Martin's numbers. Messrs Turnbull ~~and Mowl~~ will let you have comments on the assessment of public expenditure. The attached note provides brief comments on the section on budget arithmetic (half way down P.3 of Bill Martin's note) onwards.

P.N.S
P N SEDGWICK

Turnbull comments below.

Budget arithmetic

Bill Martin's assertion that the 'Budget arithmetic' is a wholly inadequate way of assessing the prudence of the overall fiscal stance is not dealt with in this note which concentrates on the numbers.

Martin's guestimates of the Treasury's internal forecasts for general government receipts shown in his table 2 covering 1987 and 1988 are fairly accurate for 1987-88 but rather wide of the mark for 1988-89. For what it is worth at this stage our current internal forecast has higher expenditure and revenue in 1988-89, but we certainly do not want to reveal this.

Bill Martin's assessment of the fiscal adjustment in 1987-88 at £1 billion is not too bad a guess, though you will certainly not want to admit this at the TCSC.

Supply constraints

Bill Martin's assessment of the evidence on supply constraints (bottom of page 5) is not balanced. The message on spare capacity depends on which indicator you look at. In the CBI October Survey, the proportion of firms quoting capacity as a likely constraint on output was virtually equal to the average proportion recorded since the early sixties, and slightly below the proportion recorded in early 1985. On the other hand the proportion of firms working below normal capacity is - as it has been off and on for nearly two years - close to the level experienced in the 1960s and 1970s when there appear to have been capacity constraints.

As far as the labour market is concerned it is true that vacancies have risen sharply. Against this the proportion of firms in the CBI survey quoting lack of skilled labour as a constraint on output has also fallen since 1985, and is well below proportions recorded in most years of the 1960s and 1970s.

Investment

Bill Martin claims that investment has been weak relative to consumption and is forecast by the Treasury to remain so.

We always recognised that the effect of the 1984 Budget tax reforms would be to raise investment in 1985 and reduce it in 1986. Next year we expect investment to rise only a little less than GDP, in spite of a fall in NS investment which knocks no less than ½ percentage point off total investment growth.

Unit wage costs and manufacturers' prices

Bill Martin claims (top of page 6) that unit labour costs are stuck at 5 per cent growth and that this together with a turnaround in import prices implies a rise in inflation.

The effect of cyclical movements in output and therefore productivity, has been to raise the growth of actual unit labour costs in 1986, and is likely to reduce growth in 1987 (as table 1.6 in the AS shows). However the rise in manufacturing output over the two years averages 2½ per cent a year. This means there is no large net cyclical contribution to productivity taking the two years together. (The IAF has labour costs in manufacturing rising at just over 4 per cent in 1986 and 1987 rather than being stuck at 5 per cent.) The IAF, not unrealistically, assumes a modest (3/4 of a percentage point) decline in settlements and earnings in 1987, which presumably Bill Martin does not.

As table 1.6 in the IAF shows, the rise in domestic prices has been well in excess of total costs in 1986. In other words prices have not yet fully responded to lower input costs this year. The implication of this is that if the exchange rate had not fallen recently we would have expected a further fall in price inflation. The recent fall in the exchange rate will prevent this further fall.

The IAF has - as the previous paragraph shows - very generous profit margins in 1986, and perfectly adequate ones in 1987. <u>Pace</u>

Bill Martin weak profitability is not one of the problems of the recent past, nor a realistic prospect next year.

The balance of payments

Bill Martin criticises the Industry Act current account forecasts for being too optimistic on invisibles and questions the ability of UK manufacturers to take advantage of the rise in world trade projected for 1987.

Bill Martin argues that the invisibles surplus in the first nine months has been only £5.8 billion, and that in any case this includes an exceptionally large rebate of almost £½ billion from the EC in the first quarter. He argues therefore that it is unreasonable for the Treasury to forecast an £8½ billion surplus for 1986 as a whole, rising to £9 billion in 1987.

This presentation of the position is unbalanced and in particular neglects three factors.

First the recorded surplus on invisibles in the first half of 1986 was just over £4 billion - half the total we are projecting for the year. Although it is true that the invisibles surplus benefited from EC rebates in the first quarter, the second quarter surplus was also close to £2 billion in spite of an exceptional £0.3 billion write-off by BP against the earnings of its US subsidiary Standard oil (this figure is not commercial in confidence and has been referred to by the CSO in their press notice) and a probable adverse effect on travel credits from the terrorism scare (an effect we think will wear off).

Second, payments of North Sea profits and dividends to foreign companies are likely to be £2 billion lower this year than in 1985 and this effect will show up fully only in the latter part of the year.

Third, sterling's depreciation during 1987 will increase the sterling value of foreign currency IPD earnings on the UK's large stock of overseas assets.

Both the oil price and exchange rate effects will be shown more fully in 1987 when the full year impact is felt. It should also be noted that the £600 million a month invisibles surplus projected for the third quarter is only a CSO estimate, and probably a cautious one at that. (The third quarter invisibles figures will not be published until December 4).

Bill Martin appears to accept that we have been relatively conservative in our forecast of the demand for UK manufactured exports. In the published AS we project the volume of visible exports (less oil and erratics) to increase by 5½ per cent in 1987 compared to a 4½ per cent rise in world trade in manufactures (UK weighted). (See above for our comments on Bill Martin's assessment of industrial capacity.)

<u>The effects of policy changes</u>

Bill Martin's simulations of the effects of exchange rate depreciation on the current account with accompanying fiscal measures appear pessimistic to us. Published results from the Treasury model suggest that an increase of approximately 3-4p in income tax rates would secure a greater cumulative improvement in the current account. We recommend against becoming involved in discussion of simulations, which are sensitive in particular to the monetary and fiscal policy assumptions as well as the precise characteristics of different models.

2136/019

POINTS BY TURNBULL

BILL MARTIN'S ASSESSMENT FOR TCSC

(i) Martin is arguing for excluding asset sales and allowing for the coal strike effects in 1985-86, the real growth in 1986-87 is over 4 per cent. He seeks to portray this as a return to the existing trend.

Comment

- year to year movements in real terms are product of cash plans deflated by movements in GDP deflator. The latter can move differently from what was expected when plans were set. Ex/post the change can vary from expectation. In 1985-86, the GDP deflator grew faster than expected, exaggerating the fall in real terms in that year; 1986-87 the GDP deflator grew more slowly, producing a faster real terms increase. Neither year can be taken as a measure of trend.

- Excluding privatisation and the coal strike, if the latter is assessed at £1¼ billion does produce a real increase of 4.3 per cent. But coal strike costs even more difficult to estiamte as return to normal was mixed up with continuing costs. But we now estimate at £¾ billion in 1985-86 rather than £1¼ billion given to Committee this time last year. (Not yet been possible to work out effect on GGE which may be different.) There is little advantage producing new estimates. It is better to take the average 1983-84 to 1986-87 which cuts through coal strike and inflation effect. Excluding privatisation this is 1¾ per cent.

(ii) Reserve in 1987-88 may be too low.

- But still higher absolutely and as proportion of planning total than in any previous plans. except last year.

(iii) There is a change in 1988-89 in real terms growth.

- In part reflects cash profile eg low EC contributions, a drop from 1987-88 in cash of £430 million; and improvement in nationalised industry EFLs of £340 million.

BILL MARTIN'S ASSESSMENT FOR TCSC

iv) Relative price effect will be more adverse than in the past producing an unsustainable cut in volume.

- This depends on Martin's inflation forecast which Chancellor does not accept. (Internal forecast which projects inflation closer to Martin's in later years comes to a similar conclusion.)

MR 3/85

FROM: CATHY RYDING

DATE: 19 NOVEMBER 1986

SIR T BURNS

cc: Sir P Middleton
Mr Scholar
Mr Sedgwick
Mr Turnbull
Miss O'Mara

THE 1986 AUTUMN STATEMENT - BILL MARTIN'S ASSESSMENT FOR TCSC

I attach an assessment of the 1986 Autumn Statement for the TCSC by Bill Martin. The Chancellor would be grateful for a point-by-point commentary on the figures in this paper, plus any other comments you care to make.

C.R

CATHY RYDING

Phillips & Drew

ECONOMICS UNIT

Sir TB

PEM.
Scholar
PNS
Turnbull
O'Mara

MARTIN
ASSESS-
MENT
TEXT

PST ask Sir T Burns to have a point-by-point commentary on the ~~[illegible]~~ figures in this paper plus any other comments he cares to make.

THE 1986 AUTUMN STATEMENT

An assessment for the House of Commons Select
Committee on the Treasury and Civil Service
submitted by
Bill Martin, Specialist Adviser to the Committee
on 13 November 1986

The paper expresses the personal views of the
author and not those of Phillips & Drew.

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THE 1986 AUTUMN STATEMENT

An assessment for the House of Commons Select Committee
on the Treasury and Civil Service
by Bill Martin, Specialist Adviser to the Committee

The Autumn Statement forecast is based on one key proposition. Fiscal policy, relaxed in the last Budget, is to remain lax, but interest rates are to remain high. The aim is to stabilise sterling while generating a pre-election boomlet. The short term risks are obvious. Another sterling crisis and a further hike in interest rates. But the longer term risks are of greater concern. The sustainability of policy is now in doubt, adding to uncertainty - something the Medium Term Financial Strategy was supposed to avoid. Meanwhile, the imbalance between booming consumption and weak investment growth is damaging the economy's productive potential. Despite the attempt to cheer us up, the Autumn Statement is a depressing read.

Public spending

The planning total has been raised by £4 3/4bn in 1987/88, following a £1 1/4bn upward revision to the estimated outturn for this financial year. £5 1/2bn has been added to the old 1988/89 plans. The planned cash increase is worth nearly 6% in 1987, falling to less than 4% in 1988. A further 4 1/2% rise is pencilled in for 1989. The increments to the old plans are fairly fiddle-free. £1/4bn each year has been added to planned privatisation receipts - now £5bn pa from 1987 - and a similar amount has been added to projected receipts from council house sales. Both items are treated best as financing items rather than as negative public expenditure.

If met, the new plans would have the effect of restoring expenditure back to its previous inexorable growth trend in 'real terms', that is, cash spend excluding the effects of economy-wide inflation. On the Chancellor's inflation forecast, spending on the planning total measure will rise by 2% this year and next, substantial upward revisions on the previous plans (Table 1 and first graph).

Table 1 : Public spending planning totals#

		% growth pa, real terms**		
	Est outturn	plans		
FY	1979-85	1986	1987	1988
(a) Unadjusted	1.1	2.2(0.5)	2.1(-0.3)	0.2(-0.2)
(b)(a) ex asset sales*/ coal strike	1.3	4.3(2.5)	1.8(-0.5)	0.0(-0.4)

* Privatisation proceeds and council house sales.

\# 1986 White Paper/Budget plans in parentheses.

** Cash spend relative to official projected increase in economy-wide inflation as measured by the GDP deflator: currently 3% in 1986/87 and 3 3/4% in 1987/88. The Budget projection of 3 1/2% inflation is taken for 1988/89.

The underlying increase this year is a great deal more. Spending in 1985/86 was bloated by the once-off costs of the coal strike - worth about £1 1/4bn - while asset sales will be some £2bn higher in 1986 than last year. Together these factors add 2% to underlying growth in expenditure, giving over 4% in all. This surge probably reflects the reaction of budget managers to their unhappy experience in 1985 when real spending was squeezed out by the operation of cash limits and an unexpected pick up in inflation (the Treasury forecast 5%, the outcome was 6%).

At first sight then, the new spending targets appear to accommodate the normal kind of upward pressure on real spending with a further allowance for catch up this year. Such apparently generous targets should be hittable. But doubts arise on several counts:

* The reserve for 1987 (£3 1/2bn) is below this year's allowance (£4 1/2bn) which has proved inadequate.

* Although real spending is set to rise by an average 1 1/4% pa, as the Chancellor said, the profile is heavily front-loaded. For 1988, planned real growth is only 1/4%, well below trend.

* Prices for public sector goods and services are likely to be rising faster than inflation economy-wide (as measured by the GDP deflator).

* The Treasury's forecast that economy-wide inflation will stay below 4% may well prove too optimistic.

On our estimates, the relative price of public provision will be rising at around double its trend rate of increase (of 3/4% pa) over the next two years (second graph). Public sector pay, around a third of total spending, will probably rise by 7 1/2-8% pa allowing for the cost of the likely teachers' settlement. Relative prices will get a further boost from the prospective increase in import prices which are excluded as a matter of definition from the GDP deflator. Meanwhile, inflation economy-wide looks set to bounce along in a 4 1/2-5 1/2% band, thanks to the strong underlying trend in unit wage costs. The result is that the average price of all public provision may well be advancing at 6% or more over the next two years.

By excluding these price rises from cash plans, we derive the implications for the 'volume' of public expenditure. The implications do not make joyful reading. For 1987, we find a fall of 1/4% in public spending volume, followed by a remarkable 3% decline in 1988, if the plans are met. Is that credible? We have argued that spending this year is inflated to an extent, reflecting a catching up process after the unaccustomed belt tightening of 1985. For this reason, we give the Chancellor the benefit of doubt on 1987 plans. We withdraw support in 1988, however. Usual pressures for volume increases indicate the likelihood of a massive spending overrun, perhaps up to £6bn, that year in the absence of a sharp shift in policy. This is our first worry.

Budget arithmetic

The burgeoning bill for public spending is being paid for out of buoyant non-oil tax receipts. As a result, the Treasury's conventional budget arithmetic probably shows that the Chancellor could still deliver tax cuts and stick to his £7bn PSBR figure next year and thereafter. Apparently, he can spend extra billions but claim to be fiscally prudent. It's all done with mirrors, of course. Budget arithmetic is a wholly inadequate way of assessing the prudence or otherwise of the 'Government's overall fiscal stance'. This is our second worry.

We start with the usual sums.

Table 2 shows our guesstimates of the Treasury's internal forecasts for non-oil taxes (including national insurance) on income, expenditure and capital. This component of tax take can be related to projections of non-oil money GDP built up from the few clues scattered through the Autumn and Budget Statements.

Table 2 : Guesstimated Treasury revenue forecast - £bn unless stated

FY	1985	1986	1987	1988
Money GDP	360.5	380	406.5	431
Oil value added	17	8	7	7
Non-oil money GDP	343.5	372	399.5	424
Non-oil tax take	127.5	140	151	161
(% of non-oil GDP)	(37)	(37.5)	(38)	(38)
Oil revenue	11.5	4.5	4	4
Other receipts	12.5	12	12	13
General Govt receipts	151.5	156.5	167	178

Figures rounded to nearest £1/2bn.

This year the Treasury has discovered an extra £2bn of non-oil revenue compared with the Budget forecast, despite a probably modest downward revision of estimated non-oil money GDP. Revenue forecasts for 1986 have been boosted by the upward revision to tax take in 1985. That raised the base level for future projections. But revenues are also rising faster than incomes, thanks in part to the progressive nature of the tax system. On this basis, the Treasury have probably increased its Budget forecasts for non-oil tax take by £3bn in 1987 and by £4bn in 1988. We reckon these revisions carry straight through to overall government receipts with oil prices steady at $15 a barrel.

Table 3 gives our reconstruction of the Treasury's familiar PSBR table. On these tentative numbers the net effect of extra spending and extra tax take is to reduce the scope for tax cuts in 1987 from £2bn, projected in the Budget, to £1bn. Such parsimony pays off in 1988, however, assuming public spending stays on target. Here we see a bountiful £4 1/2bn 'fiscal adjustment' - higher even than in the Budget projections.

Table 3 : Guesstimated Treasury PSBR forecast £bn, unless stated

FY	1987		1988	
	Before	Now	Before	Now
General Government:				
expenditure	170	173.5	175	179.5
receipts	164	167	174	178
Fiscal adjust previous	-		2	1
annual	2	1	4	4.5
GG borrowing	8	7.5	7	7
Public corps borrowing	-1	-0.5	-	-
PSBR	7	7	7	7
(as % money GDP)	(1.75)	(1.75)	(1.5)	(1.5)
Money GDP	407	406.5	431	431

Figures rounded to nearest £1/2bn. "Before" = 1986 Budget projections.

Prospects and policy

Our concern is that this kind of figuring will be used as justification for tax cuts. In truth there is no such justification. The Chancellor's borrowing plans were laid down before he or the Treasury realised the full enormity of Britain's looming balance of payments problem. The Treasury has had to scale down its March Budget forecast from a £3 1/2bn surplus on current account to a nil balance in 1986. Next year, where it once anticipated surplus (£1 1/2bn at an annual rate in 1987H1), it now sees deficit (£1 1/2bn). Plans for borrowing set on the basis of the Budget computer prints cannot be right in the Autumn Statement printouts. The right plans must be based on a realistic assessment of Britain's economic problems.

The economy is now beset by a number of the difficulties which we predicted in our evidence to the Committee in March. The key concerns are:

* Evidence of emerging supply constraints. Spare capacity in manufacturing industry is low, despite poor growth. In the labour market, the ratio of vacancies to unemployment is rising strongly, earnings increases show little sign of moderation and skill shortages abound.

* Investment expenditure has been weak relative to consumption and is forecast by the Treasury to remain so.

* The non-oil trade deficit is widening sharply at a time of dwindling oil surpluses.

* The trend rise in unit wage costs appears to be stuck at around 5% pa. Coupled with the turnaround in import prices and high profits growth, it implies an escalation in inflation from now on.

The Treasury forecast plays down these unhappy developments. Although it sees a larger non-oil trade deficit - £14bn in 1987 as compared with £10 1/2bn in 1985 - the overall current account deficit is contained by a remarkable increase in the projected invisibles surplus.

The officially estimated surplus on invisibles in the first nine months of this year is £5.8bn and includes the once-off benefit of the delayed rebate on UK contributions to the European Community's Budget worth nearly £1/2bn. The official projection on invisibles is now £600m a month indicating a figure for the full year of under £8bn. The Treasury forecasts £8 1/2bn this year rising to £9bn in 1987. This looks particularly optimistic on the basis of current estimates.

We have similar reservations about the export forecast. It is not unreasonable that non-oil export volumes should grow a little faster than world trade - though the Treasury have on previous occasions downplayed the importance of competitiveness changes. What is questionable is whether manufacturers have capacity of the right quantity and quality to take advantage of sterling's decline to the extent the Treasury now appears to assume. Overall, we expect a current account deficit in excess of £3bn next year, getting bigger.

The Treasury is similarly over-optimistic on inflation. Wage settlements are assumed to fall despite the pull of strong profits growth and tighter labour markets. It forecasts also a very sharp fall in unit labour costs in manufacturing industry. However, much of that fall is attributable to the cyclical pick up in output and, as a result, should not be a significant influence on manufacturers' pricing behaviour. We would expect to see a rising profit margin in relation to unit wage costs, not a fall in prices. Buoyant margins are being encouraged in any event by sterling weakness and robust demand. We expect inflation over 4 1/2% by end 1987.

Tough Budget required

In these circumstances, the Chancellor's policy settings implicit in the Autumn Statement are plainly wrong. Resources have to be redirected into improving the balance of payments and boosting investment but without re-igniting inflation. The first requirement is a reduction in real interest rates and a further fall in sterling. (Sterling has probably fallen by enough to compensate for the oil price drop but not for other factors which are undermining the current account.) However, at a time of near-full capacity, falling sterling has to be accompanied by a cut back in domestic expenditure. Falling sterling combined with surging domestic demand is simply a recipe for inflation. The second requirement, therefore, is a tough fiscal stance.

Table 4 gives the Committee some idea of how tough. It shows two model simulations producing, over three years, roughly equal improvements on the current account. The scale of that improvement - a cumulative £4bn - is probably not out of line with UK needs over the next few years. Indeed, it may understate them. In (A) sterling falls 10% each year - cumulating to over a 30% fall against the baseline level. That does the trick, but only at the cost of accelerating inflation - 4 1/2 points up by year 3.

Table 4 : How to right the current account

	Yr 1	Yr 2	Yr 3
(A) Large depreciation			
Current account (£bn)	Nil	1	3.25
GDP growth (% pts)	0.5	1	0.75
Inflation (% pts)	1	2.5	4.5
(B) Depreciation & tough Budget			
Current account £bn	0.5	0.5	3
GDP growth (% pts)	0.25	Nil	Nil
Inflation (% pts)	Nil	0.5	Nil

(A) Steady depreciation of 10% a year.

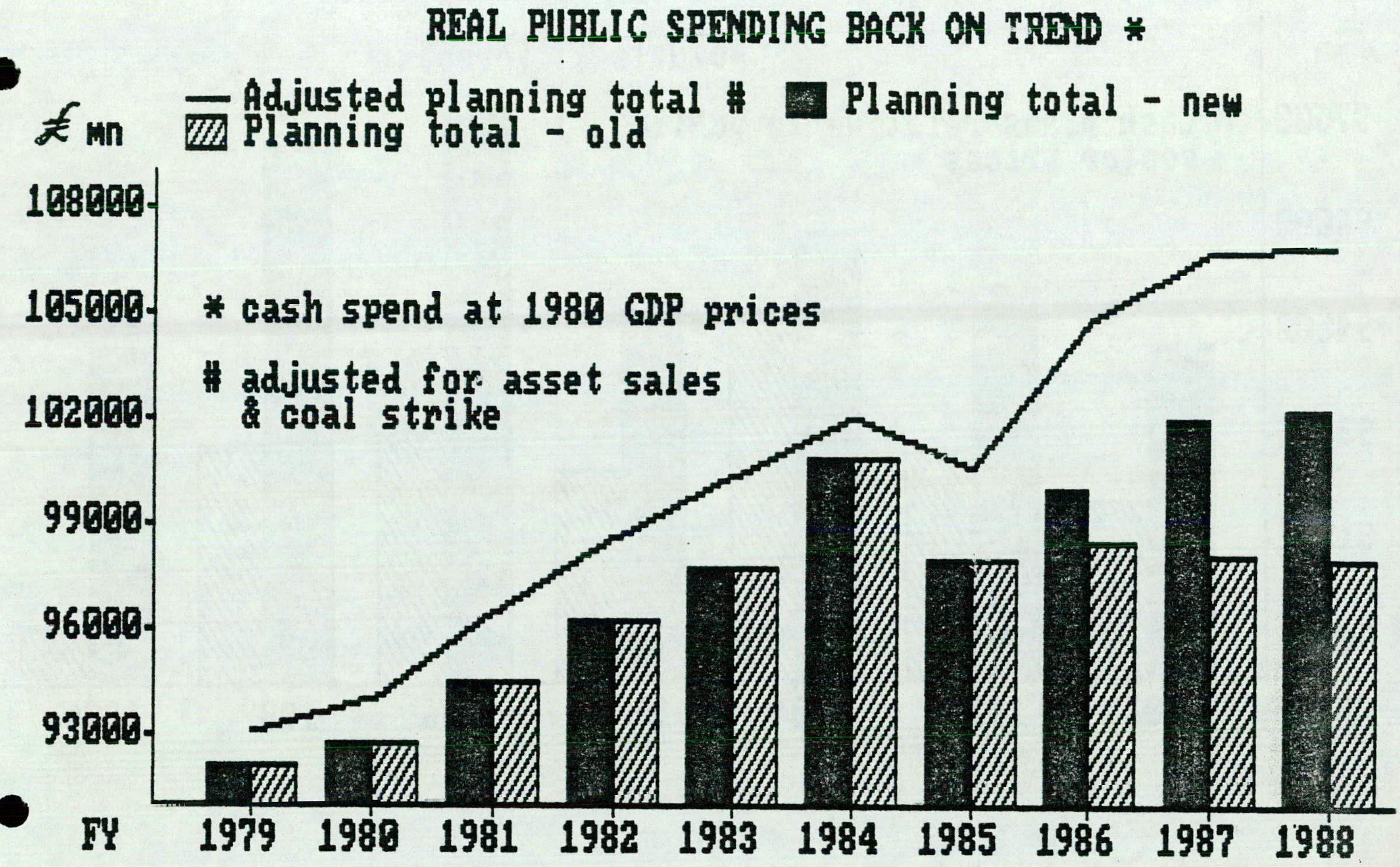
(B) Depreciation of 3% in years 1 and 2 only, plus tax increases.

Figures, rounded to nearest 0.25, show differences from a baseline forecast, eg in year 2, simulation (A) shows the current account is £1bn better than it would otherwise have been.

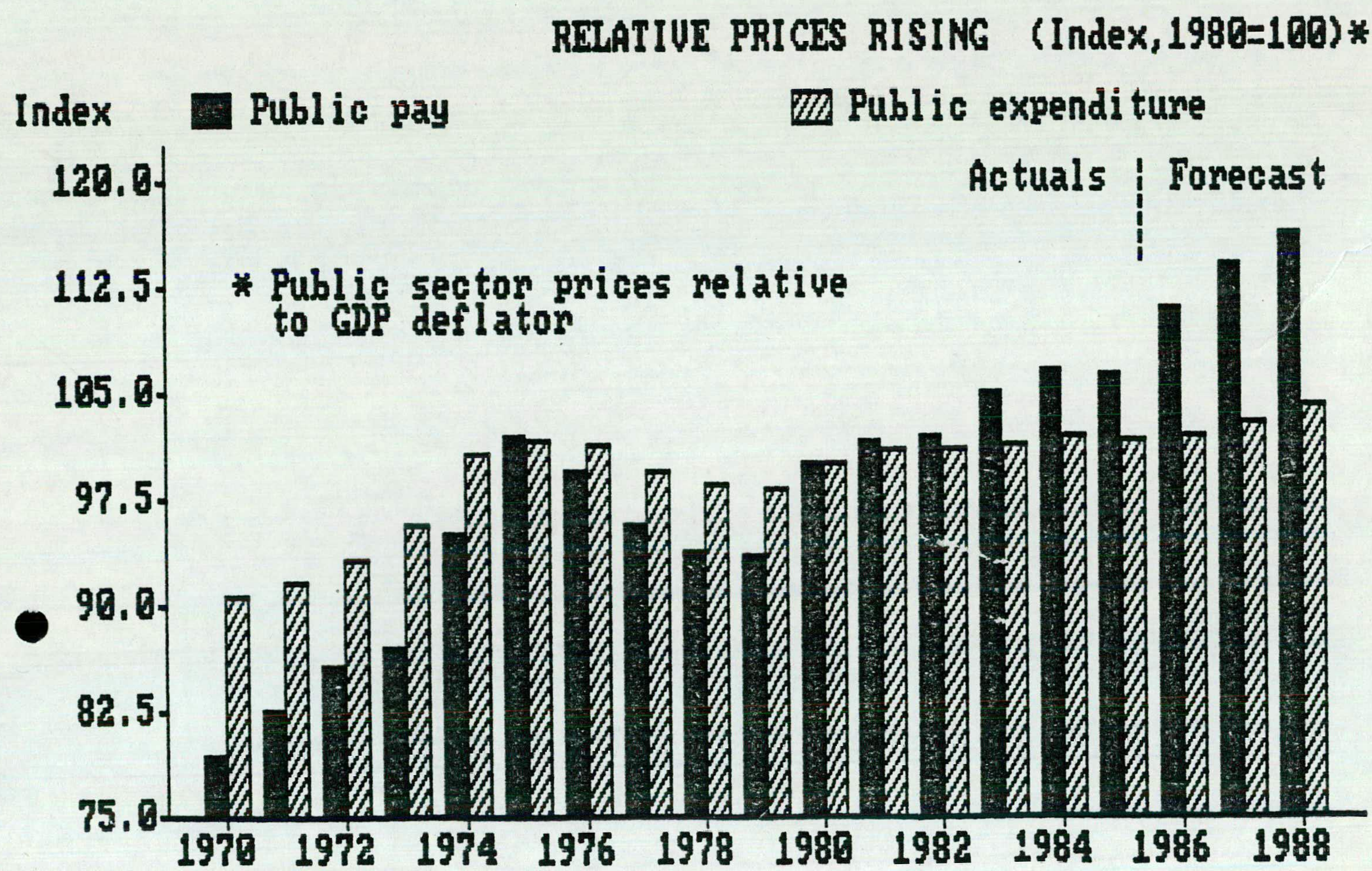
The simulations were conducted on Phillips & Drews macro-model of the economy by my colleague Mr. Chris Johns.

So in B, depreciation is combined with a tough budgetary stance involving (purely for the purposes of example) higher personal taxation. The reduction in consumption of itself helps to right the balance of payments, so the required cumulative fall in sterling is only 6% over 2 years. Inflation barely moves. And despite the tax increases output is not depressed - because of the rise in net exports. The bad news for the chancellor is that simulation (B) involves a cumulative rise in the standard rate of income tax of 7p in the pound!

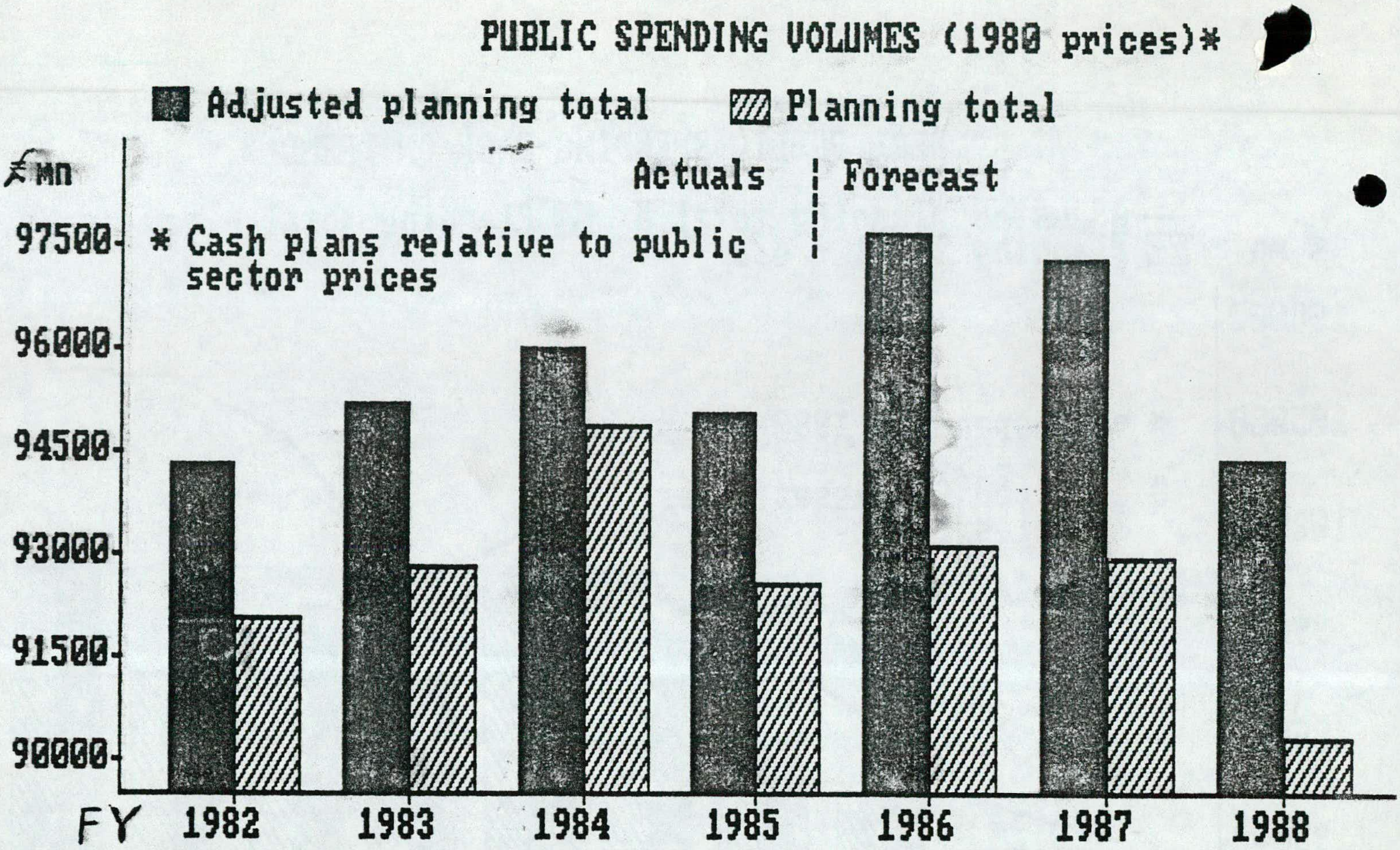
Political pressures could, conceivably, deflect the present Chancellor from adopting this route. <u>But tough budgets will come sooner or later in our view.</u> It would be far better that they came as a result of a cool appraisal of the true needs of the economy. Regrettably it is far more likely that the belt tightening will start after another massive flight from sterling. That's our final worry. It all seems a world away from the original vision of the MTFS.



REAL PUBLIC SPENDING BACK ON TREND *
— Adjusted planning total #
Planning total - new
Planning total - old
£ mn
108000
105000
102000
99000
96000
93000
* cash spend at 1980 GDP prices
# adjusted for asset sales & coal strike
FY
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988



RELATIVE PRICES RISING (Index,1980=100)*
Index
Public pay
Public expenditure
Actuals
Forecast
120.0
112.5
105.0
97.5
90.0
82.5
75.0
* Public sector prices relative to GDP deflator
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988


PUBLIC SPENDING VOLUMES (1980 prices)*
Adjusted planning total
Planning total
£mn
Actuals
Forecast
* Cash plans relative to public sector prices
97500
96000
94500
93000
91500
90000
FY
1982
1983
1984
1985
1986
1987
1988

Goldman Sachs

Not For Publication Before 00.01 Hours on Friday 14 November

Submission to the Treasury Committee

THE 1986 AUTUMN STATEMENT

Gavyn Davies
Chief UK Economist
Goldman Sachs

Ch

Reasonably helpful in the circs, (& given background).

AA

The attached memorandum is a recent submission to the Treasury Committee of the House of Commons, to which the author is an adviser. The Committee has kindly agreed to its publication.

THE 1986 AUTUMN STATEMENT

Memorandum by Gavyn Davies, Specialist Adviser to the Committee

Summary

The main points of this memorandum are as follows:

(i) The Autumn Statement involves something of a shift in strategy, with the displacement of tax cuts by extra public spending. Essentially, a £4bn increase in general government expenditure has, on plausible estimates of Treasury arithmetic, absorbed a £3bn increase in the underlying buoyancy of non-oil revenues, and half of the £2bn previously set aside for tax cuts. This may theoretically leave scope of £1bn for tax cuts in the 1987 Budget within a £7bn PSBR target.

(ii) If the level of public spending had been held to previous targets, the Chancellor could, on these estimates, have reduced tax by £5bn in the next Budget - enough to cut income tax to 25p in the £ - without increasing the MTFS estimates for borrowing.

(iii) The decision to substitute public spending for tax cuts does, however, seem sensible. There is no economic case for further fuelling consumer spending (and imports) at present. Public spending can have larger benefits to employment in the short-term, with a lower import content, than the spending generated by tax cuts. However, it is possible that the <u>composition</u> of spending proposed by the Chancellor has too large an element of public sector pay relative to help for the unemployed and capital spending.

Hmm!

(iv) The Chancellor has clearly stated an intention to hold next year's PSBR unchanged at £7bn, in which case the fiscal stance would be approximately neutral. In the absence of any monetary standard (such as EMS membership), and of any direct government action to control pay settlements, a neutral fiscal stance is sensible. Anything more stimulative would not appear justified, given the outlook for inflation, unit costs and money GDP. However, it is clear that the government is operating in a second best world. If pay pressures could be mitigated by direct government action, then a more expansionary fiscal stance could be safely undertaken.

1 3/4 %? GDP

(v) The Chancellor has also hinted that sterling has now fallen far enough to offset the balance of payments losses from lower oil prices. Again, this seems right for the moment, but a further sterling depreciation will eventually be needed if pay deals do not fall.

(vi) All this is based on the assumption that the Chancellor hits his PSBR targets. On this basis, the markets would accept the package with equanimity. But the markets are currently sceptical about the Chancellor's resolve. It seems quite likely that public spending will overshoot the newly-increased targets for 1987/88, taking the PSBR to £9-10bn. The actual fiscal stance would then be easier than the government targets imply. This would re-inforce the case for direct counter-inflation action.

(vii) Now that real public spending levels are planned to rise in the medium-term, there will be continuing conflicts between PSBR limits and tax cutting objectives. The underlying buoyancy of non-oil revenues will not continue after the unsustainable consumer boom ends. Specifically, a tax increase of some £3bn might be needed to hit a £7bn PSBR target in the years after 1987/88. Probably, the PSBR targets will be eased to avoid this.

12 November 1986

I. ECONOMIC STRATEGY

Same as last year

Increasingly, the Autumn Statement has been downgraded as an informative guide to economic strategy, and this year the Statement has contained little more than the bare details of the public expenditure plans for next year, along with the Treasury's economic forecast. This is a matter for regret. However, it is still possible to make some comments about the likely fiscal stance for next year, since the Chancellor has gone out of his way to reiterate the £7bn PSBR target built into the MTFS. Furthermore, there have been some wider hints about economic strategy, which make it possible to discern the government's latest thinking, in outline at least.

First, it is is useful to look at the fine print of the Treasury's documentation on financial conditions contained in its forecast summary, since this involves an important change of wording since last year. In publishing a forecast, it is necessary to make clear the monetary conditions assumed, and last year the November documents explicitly stated that:

> "The forecast assumes that monetary policy will continue to be directed towards sustaining downward pressure on the growth of money GDP and hence on inflation, as in the MTFS, and that short-term interest rates will be set so that the paths of the monetary aggregates and the exchange rate are consistent with this objective." (My emphasis.)

This year, the form of words on the monetary assumption is very different:

> "The forecast assumes that short-term interest rates will be set to maintain monetary conditions that are consistent with the counter-inflationary aims of the MTFS."

This is argument for repeating last years Doug unchanged silly.

Note that, in this year's formulation, there is no mention of "the paths of the monetary aggregates and the exchange rate" necessary to maintain downward pressure on inflation, nor is there any mention of money GDP. This seems to offer yet further evidence of a downgrading in monetary aggregates as a guide to medium-term policy - not even the Chancellor's favourite M0 is mentioned in this key paragraph about the government's monetary policy. This is bound to fuel speculation - which is already rife in the City - about the lack of a monetary standard at the heart of the government's policy.

Mr. Lawson has clearly attempted to neutralise these suspicions by emphasising two different strands in his thinking. First, he has been much more explicit than he was last November about his intention to stick to the PSBR targets built into the MTFS in the forthcoming financial year. In particular, in broadcasts subsequent to the Statement, he has emphasised that there will be "not a penny piece of additional borrowing" on top of the £7bn PSBR target. Last year, the assumption was made that the medium-term PSBR targets would be maintained, but this was presented more as a technical assumption, rather than as a firm commitment. Clearly, the Chancellor has gone out of his way to emphasise that the additional public spending incorporated in his plans has displaced the tax cuts which would otherwise have been available, rather than adding to PSBR limits.

The second strand which has received greater emphasis this year is the government's attitude towards the exchange rate. Again, this has been particularly notable in Mr. Lawson's broadcasts since the Statement itself, in which he has emphasised that he is willing to increase interest rates in order to prevent a further depreciation in the currency, and that he believes that sterling has now adjusted downwards sufficiently to offset the balance of payments losses from lower oil prices. In the Treasury forecast itself, the usual technical assumption of a stable exchange rate is made, but this year the Chancellor's oral statement specifically stated that ". . . the necessary adjustment of the exchange rate to the oil price collapse has now taken place". (My emphasis - note the past tense.) This suggests that the Treasury believes that the drop in the exchange rate this year has been sufficient to replace entirely the lost oil benefits to the current account and, for the time being, it seems that the Chancellor will seek to prevent a further depreciation in the currency.

The Strategy

The overall outline of the strategy now being pursued is therefore reasonably clear. Monetary targets have undergone yet another ratcheting downwards in their importance, leaving the government leaning more heavily than ever on fiscal targets and the exchange rate to exert financial discipline. This is obviously a complete reversal of the order of priorities in the original version of the MTFS, in which fiscal policy was supposed to be subordinate to monetary objectives. It also leads to the inevitable and familiar question about the EMS: if the Chancellor is relying on a stable exchange rate to exert counter-inflationary discipline, why stay out of the system which would make that discipline most effective?

Sterling

With this proviso, it seems to me that the Treasury has been sensible to accept that the necessary downward adjustment to sterling has been made for the time being. At a sterling effective rate of around 69, there has been a depreciation of 12% since the 1985 average, which means that UK competitiveness (after allowing for the more rapid rate of increase in unit costs in Britain than in other countries) may have improved by around 7-8%. Net oil exports are likely to deteriorate by around £4.5bn between 1985 and 1987, with about £2bn of the current account loss being offset by lower payments of interest, profit and dividends to foreign companies operating in the North Sea. A depreciation of 7-8% in the real exchange rate would, on most standard calculations, be capable of offsetting a current account loss of £2.5bn over a period of two or three years.[1] On this basis, the Chancellor is right to argue that the necessary downward adjustment to sterling has now been made. On the other hand, two offsetting arguments need to be considered. First, the non-oil current account has also deteriorated this year, suggesting that a somewhat larger reduction in the real exchange rate may be needed to offset the overall deterioration in the current account which seems to be taking place. Second, the UK is suffering an ongoing loss of competitiveness from the fact that its unit labour costs are rising 3-5% more rapidly than those in other countries, which means that a continuing depreciation in the nominal exchange rate would be needed to maintain this year's real competitiveness improvement. In consequence, it appears likely that some further downward move in the real exchange rate will be needed in the years ahead to prevent a current account deficit from emerging, while the nominal rate may need to move down rather more rapidly in order to offset the change in relative unit labour costs. But I am talking here about the medium-term. The speed at which these exchange rate adjustments should be made needs to be heavily circumscribed, since a downward shift in the currency always involves a major boost to inflationary pressures in Britain. Already, the depreciation which has occurred this year seems likely to cause more upward pressure on inflation than the Treasury expects in 1987 (see below); any further depreciation now would run severe risks of sending the underlying inflation rate well above 5% as we enter 1988. Since this is not acceptable, it seems that the Chancellor is right to attempt to put the brakes on the downward momentum in sterling for the time being. This will probably involve a continuation of the mixture of direct foreign exchange intervention, with judicious increases in interest rates if necessary, which the authorities have used to stabilise the

1. In recent Treasury simulations, a 5% change in the exchange rate is reported to produce a change of around £3bn in the current account after 3 years. (see C.L. Melliss, "H.M. Treasury Macroeconomic Model, 1986", Government Economic Service Working Paper No. 90.)

currency in recent weeks. (The threat of such action, now made clear by Mr. Lawson, may be sufficient in itself to provide extra support for the currency.) In the longer-term, however, some further downward move in sterling is almost certain to be needed, unless the government can introduce some alternative mechanism for getting a better grip on unit labour costs.

Fiscal Policy - Tax vs. Public Spending

Next, the overall fiscal stance and its composition. Here, much depends on whether the Chancellor succeeds in hitting his £7bn PSBR objective for next year. If he does, then the fiscal stance will be characterised by two main features. First, compared with previous versions of the MTFS, there will be a major substitution of additional public expenditure in place of tax reductions. In my view, this is wholly to be welcomed, especially in the current climate of explosive growth in consumer credit, and a deteriorating balance of payments. It is clear that the consumer needs no further stimulus at present, and some dampening action might actually be appropriate. In these circumstances, the substitution of public spending for tax cuts can only be beneficial. Furthermore, on virtually all calculations, public spending has a lower import content, and a higher jobs content, per unit of PSBR cost than tax cuts. It therefore seems much more accurately directed at the particular problems which confront Britain than another large reduction in income tax. Such a reduction may have beneficial supply-side advantages in the long term, and could help to dampen pay pressures, but these effects are far from certain. The substitution of public spending for tax cuts, while a very clear deviation from the government's previous objectives, is therefore to be welcomed.

The composition of the increase in public spending is not yet crystal clear, but seems to be rather less appropriate to the present needs of the economy. There must be a suspicion that a large proportion of the additional spending will leak into public sector pay, which has some of the same economic effects as a tax cut directed solely at the public sector and may have adverse knock-on effects on private sector pay. It would seem that rather more direct action on public expenditure which would directly benefit the unemployed might have been a preferable alternative. Furthermore, the new spending plans involve an increase of only around £1bn in capital expenditure, which seems rather meagre for a category which remains in urgent need of attention, after many years of cutbacks.

NO

The Overall Fiscal Stance

Turning to the overall fiscal stance, I mentioned in my post-Budget memorandum to the Committee that the Chancellor had missed an opportunity to set out a coherent "permanent income" framework for setting public borrowing targets as oil prices change. Instead, he then attempted to maintain the fiction that borrowing could be held at whatever number he first thought of, almost whatever happened to oil prices. (This was accomplished, of course, by allowing the PSFD to rise in response to lower oil revenues, disguising the PSBR consequences by increasing privatisation.) I argued, however, that (by chance?) the PSFD had been increased by almost exactly the right amount on permanent income grounds to compensate for the oil revenue losses. All of this still seems true, which suggests that on these long-term grounds the fiscal stance is roughly appropriate. But what about the shorter-term impact of the fiscal stance on aggregate demand? Table 1 shows my latest estimates of movements in the cyclically-adjusted PSBR and PSFD (the public sector financial deficit) over the past few years. These figures assume that the Treasury will hit its PSBR target of £7bn in 1987/88, which implies a PSFD of around £12bn. On this basis, the overall stance of fiscal policy looks likely to be approximately neutral next year, after an expansionary move in the cyclically-adjusted PSFD equivalent to 1.1% of GDP this year. (Within this broad neutrality, there may be some second-order benefits to aggregate demand from the substitution of public spending for income tax cuts, since the former have larger demand effects in the short-run. Also, there is the possibility that an overshoot in the PSBR - which is likely (see below) - will produce a more expansionary stance than is currently intended.) This approximately neutral stance on existing targets appears sensible, at least in the absence of any direct measures to reduce the level of pay settlements. The economy has just received a substantial boost from a depreciation in the exchange rate, while the activities of the deregulated financial markets are permitting a substantial credit injection, which is not being much dampened by high real interest rates. In consequence, economic growth looks likely to pick-up sharply in the next 12 months, after the slow-down phase in 1985/86, which was largely caused in my view by the tightening in fiscal stance last year (much of which was unintended). Meanwhile, inflation pressures are definitely rising. Money GDP looks set to rise by 7% in 1987/88, somewhat more than expected in the last Budget, while unit costs (my preferred target) will definitely accelerate in 1987. Overall, therefore, a sizeable fiscal boost would be inappropriate at present - unless accompanied by a new counter-inflation weapon.

Table 1: Changes in the Fiscal Stance

	Changes in Fiscal Policy (% of GDP)			
	Actual PSBR[1]	Actual PSFD[1]	Cyc. Adj. PSBR[1]	Cyc. Adj. PSFD[1]
Change in:				
1979/80	-0.5	-0.9	-0.1	-0.5
1980/81	0.5	1.0	-3.7	-3.2
1981/82	-2.1	-2.7	-4.4	-5.0
1982/83	-0.2	0.7	-0.5	0.4
1983/84	0.1	1.0	0.6	1.5
1984/85[2]	-0.9[2]	-0.4[2]	0.0[2]	0.5[2]
1985/86	-0.7	-1.5	-0.7	-1.6
1986/87[3]	0.3	1.1	0.3	1.1
1987/88[3]	-0.1	-0.1	0.0	0.0

[1]Negative figures indicate a discretionary tightening in fiscal stance. The cyclically-adjusted figures are the best guide to the policy stance, since they exclude the impact of variations in economic activity on government revenue and expenditure.
[2]Figures for 1984/85 (but not 1985/86) exclude the direct impact of the miners' strike on government borrowing (£2.8bn) and real GDP (1.3%).
[3]Figures for 1986/87 and 1987/88 are based on **intended** policy as outlined in the 1986 MTFS. If the 1987/88 PSBR and PSFD exceed targets, the policy stance would be more expansionary than shown here.

Summary

On economic strategy, I would therefore sum up as follows. In the absence of a monetary standard (such as EMS membership), and in the absence of any direct government action to control pay settlements (such as a tax on excessive deals, possibly with exceptions being made for profit-related pay increases), the overall strategy of substituting extra public spending for tax cuts within an unchanged PSBR target seems reasonable. Certainly, in present circumstances, it is important for the Chancellor to put the brakes on the sterling depreciation, and to avoid fuelling the consumer boom by being tempted into large tax cuts next year. But in my view it is very clear that the government is operating in a second best world. It seems to me that if pay pressures could

— eg by G Davies.

be mitigated by any of the new mechanisms recently proposed, then a more expansionary fiscal stance, concentrating in particular on a much larger boost to job creation, could be safely undertaken. This would be the first best policy which the government is currently ignoring.

II. THE FISCAL ARITHMETIC

This section looks at the details of what the Chancellor has announced about public spending and borrowing, and comments on the likelihood that the new targets can be achieved.

1986/87 and 1987/88

Table 2 gives a clear demonstration of what has happened in the Autumn Statement. Column 1 shows the latest estimates of expenditure and revenue for the current financial year (1986/87); column 2 shows the forecasts made for next year by the Treasury in the 1986 Budget; column 3 shows the Autumn Statement estimates for next year's spending, along with revenue figures implied by the latest Treasury economic forecasts; column 4 shows the latest Goldman Sachs forecast of the most likely actual outturn. The two columns on the right-hand side of the table show differences between the Treasury's Autumn and Budget arithmetic, and then between the Goldman Sachs forecasts and the Autumn Statement figures.

Table 2: The Fiscal Arithmetic

(£bn)	1986/87 Estimate (1)	1986 Budget F'cast (2)	1987/88 Autumn Statement F'cast (3)	Goldman Sachs F'cast (4)	Differences in 1987/88: Autumn Statement less Budget F'cast (3) - (2)	GS F'cast Less Autumn Statement (4) - (2)
Expenditure						
Departments	145.2	142.6	150.1	155.6	7.5	5.5
Contingency Reserve	0.0	6.1	3.5	0.0	-2.6	-3.5
Asset Sales	4.8	4.8	5.0	5.0	0.2	0.0
Planning Total	140.4	143.9	148.6	150.6	4.7	2.0
Other Adj.	24.0	25.6	25.1	25.0	-0.5	-0.1
Gen.Govt.Exp.	164.4	169.5	173.7	175.6	4.2	1.9
Revenue						
Oil Tax	4.5	4.0	3.5[1]	3.5	-0.5	0.0
Non-oil Tax	113.5	120.0	123.0[1]	122.6	3.0	-0.4
Nat. Ins.	26.5	28.0	28.5[1]	28.5	0.5	0.0
Other Adj.	12.0	12.0	12.0[1]	12.0	0.0	0.0
Gen.Govt. Receipts[2]	156.5	164.0	167.0[1]	166.6	3.0	-0.4
Tax Cuts	-	2	1[1]	1.7	-1	1
Gen.Govt.Borr.Req.	8	8	8[1]	10.7	0	3
Public Corp. Borr.	-1	-1	-1[1]	-1.0	0	0
PSBR	7	7	7[1]	9.7	0	3

[1]My calculations of figures implied by Treasury economic forecasts.
[2]Before tax cuts.
Note: Numbers are rounded in some cases.

Taking 1986/87 first, the Treasury has reiterated its previous belief that the PSBR will eventually end the current year close to its £7bn target. This is despite the fact that government expenditure is now expected to be £1.25bn higher than shown in the Budget plans, while oil revenues are down by £1.5bn. These short-falls are offset by the buoyancy of non-oil revenue and national insurance contributions, which are presently estimated to be running £2bn ahead of Budget plans. According to the Treasury, corporation tax and VAT are the main contributors to this excess. Provided that the buoyancy of VAT in particular is maintained (and there seems little reason why it should not be, given the continuing rapid growth in consumers' expenditure), then the £7bn PSBR target should be comfortably achieved this year.

Turning to 1987/88 we can see how Treasury plans have changed by comparing columns 2 and 3. Departmental spending plans have risen by a massive £7.5bn in the Autumn Statement, but this has been offset by higher asset sales and an allocation of the contingency reserve, leaving the planning total up by £4.6bn. General government spending is up by slightly less (£4bn). The revenue side of the accounts has not been published by the Treasury, but estimates of the relevant figures can be made by using the Treasury's economic forecasts to construct implied tax yields. On this basis, it seems likely that non-oil taxation will exceed the 1986 Budget plans by some £3.5bn next year, but that £0.5bn of this will be offset by a further drop in oil taxation. This would leave general government receipts around £3bn higher than was expected in this year's Budget. (Of this £3bn increase in revenue, £1bn is assumed to stem from the squeezing of the repayment of the debt injected into the British Gas balance sheet into 1987/88.) On these figures, the Treasury arithmetic seems to imply that there is theoretically very little scope for tax cuts - perhaps of only around £1bn - if the PSBR target is to be maintained at £7bn. Essentially the £4bn of extra public spending has absorbed the £3bn of unexpected buoyancy in non-oil tax, as well as half of the £2bn previously set aside for tax cuts next year.

If the Chancellor were to stick to the figures in column 3 of Table 1, then this should present the financial markets with relatively few long-term problems. The absence of large tax cuts, taken together with somewhat more honest public expenditure plans, and a PSBR target unchanged at £7bn, does not add up to any form of disaster for gilts or sterling. But the problem is that the market believes that there may be some further slippage in public expenditure, and that there is a reasonable chance of the Chancellor being tempted to announce tax reductions on top of the expenditure increases. Column 4 shows what might happen on these assumptions. On public spending, I assume that the most likely outcome for next year is that the Autumn Statement plans, though high in themselves, are exceeded by a further £2bn. This is justified on the following grounds. At the equivalent time last year, the Treasury allowed itself a £4.5bn Contingency Reserve for the forthcoming year, and still appears to have missed its target by at least £1.25bn. This suggests that a Reserve of around £6bn might be "par for the course" at the present stage of the planning process, rather than the £3.5bn actually incorporated into the Treasury's plans. Now, it can be argued that this low Reserve is a response to better prospects for control on local authority spending and social security spending this year than last year. But a central forecast must remain sceptical about this, especially since upward pressures on public sector pay appear to be much greater this year than last, and do not yet seem to have been fully incorporated into the Autumn Statement arithmetic (though it does include a £0.5bn allowance for the latest teachers' offer). On balance, the Treasury's plans therefore look a little tight, and the Goldman forecast (for example) shows an overrun of around £2bn in actual spending next year. This alone would take the PSBR outturn up from the Treasury's target of £7bn to around £9bn. On top of this, there must be a risk of some extra tax cuts being introduced in the Budget, even if these do not appear to be fully in line with fiscal prudence. In Table 2, I show the impact of assuming that £1.5-2bn of tax cuts are introduced; this takes the forecast outturn for the PSBR up to £9.7bn. At first sight, this might appear worrying, but it would still represent only 2.5% of nominal GDP; and the government would presumably try to steer the figure back down over the medium-term.

1988/89 and Thereafter

If the Treasury's fiscal plans for 1987/88 look tight, with the PSBR objectives quite likely to be exceeded, the medium-term plans published with the 1986 Budget for 1988/89 and thereafter look even more problematic. In the aftermath of the Autumn Statement, Mr. Lawson has reiterated two of his previous promises about medium-term fiscal developments. First, he has said that the additional public spending included in his new plans will not lead to any increase in the £7bn PSBR target over the medium-term. Second, he has repeated the long-term objective of achieving a 25p in the £ basic rate of income tax. However, on realistic medium-term arithmetic, these two objectives no longer appear compatible: one or the other will probably have to give.

The Treasury's new medium-term spending plans are based on the assumption of average annual growth in real spending of 1.25%, compared with zero in previous White Papers. Although this rate of growth remains below the assumed increase in real GDP, the Treasury will be hard-pressed on past performance to ensure that the medium-term rate of growth in public spending is consistent with the published objectives. Indeed, if the plans are exceeded by as much as they have been in the past, then the real level of spending would be likely to grow in line with the expected 2.5% rate of growth in real GDP. This demonstrates the full measure of the change of public spending strategy in the Autumn Statement: in previous years, the Treasury has at least intended to allow all of the proceeds of economic growth to go to tax cuts, with none going to improvements in public services. It now seems likely that the public spending horse has well and truly bolted, and that the Treasury will find it futile to close the stable door in 1988. The real level of spending will have been ratcheted permanently upwards. Furthermore, pressures on spending are anyway likely to emerge from an overshoot in inflation relative to the 3% Treasury objective. The forecasts shown in Table 3 assume that the public spending limits are slightly exceeded in real terms after 1987/88, and that the rate of inflation runs around 2% p.a. above the levels implied in the Treasury projection. This produces a substantial excess in public spending, even relative to the Autumn Statement arithmetic. Compared with the plans published in the 1986 Budget, the excess rises from around £6bn next year to about £16bn at the end of the decade. (This assumes that all of the additional inflation is passed into public spending in nominal terms, with none being squeezed out by the operation of cash limits.)

On the revenue side, higher inflation than is expected by the Treasury also boost receipts, but buoyancy in real government revenue will diminish as consumer spending slows, and as oil receipts decline. Hence, the overshoot in revenue shown in Table 3 is substantially less than the overshoot in expenditure, leading to a potentially very large excess in public borrowing towards the end of the decade. For all these reasons, control of the PSBR is likely to remain very problematic after 1987/88. Specifically, on the projections summarised in Table 3, tax increases of around £3bn would be needed in 1988/89 to bring the PSBR back to £7bn. Even for a newly-elected government, that seems a tall order - so public borrowing seems set to continue exceeding the MTFS targets. There consequently seems little or no chance of the MTFS borrowing limits being compatible with a 25p basic rate of income tax, at least for several more years. (If the government left tax rates unchanged in the final two financial years of this decade, the PSBR might run at an annual rate of £9-10bn.)

Table 3: Fiscal Policy - Summary Table

£bn	1986/87	1987/88	1988/89	1989/90
Gen. Govt. Expenditure				
1986 Budget	163	170	175	180
Likely Outturn	164 1/2	175 1/2	186	196
Gen. Govt. Receipts				
1986 Budget	156	164	174	182
Likely Outturn	156 1/2	166 1/2	178	189
Tax Cuts[1]				
1986 Budget	-	2	4	3
Likely Outturn	-	1 3/4	0	0
PSBR				
1986 Budget	7	7	7	7
Likely Outturn	7 1/4	9 3/4	10	9
PSFD[2]				
1986 Budget (Implied)	12	12	12	12
Likely Outturn	12	14 1/2	15	14

[1]New tax cuts to be announced each year. Cumulative totals can be derived by summing these figures. [2]Assumes privatisation receipts in line with Treasury target of £5bn a year.

<u>Summary</u>

On the fiscal arithmetic, I would conclude the following. It is probable that the unpublished Treasury arithmetic allows scope for around £1bn of tax reductions next year within a £7bn PSBR target. However, the public spending targets look a little tight, and an overrun of £2bn looks fairly likely. Assuming £1bn of tax cuts, this would the PSBR next year up to £9bn. If the Chancellor were tempted (misguidedly) to squeeze any additional tax cuts into a pre-election Budget, the PSBR outturn could easily rise to £10bn, implying a PSFD of £15bn. The financial markets would show concern if risks were taken with fiscal prudence in order to maximise tax cuts next year, not only because of the public borrowing consequences, but also for the more general economic reasons mentioned in Section I. After 1987/88, a large overshoot in public spending relative to 1986 Budget plans now seems almost inevitable. This is likely to exceed the buoyancy in non-oil revenues, making a £7bn PSBR target incompatible with tax reductions. On present forecasts, such a PSBR target might require £3bn of tax **increases** in 1988/89; alternatively, with no increase in taxation, the PSBR would rise to £10bn.

III. THE TREASURY'S ECONOMIC FORECAST

In general, the Treasury's economic forecast, which shows real GDP growth accelerating, inflation steady on an underlying basis, and only a relatively mild deterioration in the balance of payments, looks slightly optimistic, but not outlandishly so. The main problem concerns next year's inflation profile. The Treasury's relatively optimistic forecast of 3.75% inflation at the end of 1987 is based on several optimistic assumptions, including a stable exchange rate, a small reduction in pay settlements in the current round, a sharp acceleration in productivity growth, and constant profit margins. Most outside forecasters are not so optimistic about the exchange rate, or about unit labour costs, as the Treasury, and the consensus view is that inflation will be about 1% higher than the official forecast at the end of next year. Furthermore, there is a severe danger that the rate will still be rising at that time.

Because of this higher inflation, there may be a little less buoyancy in real GDP next year than the Treasury forecast suggests. It expects 3% real GDP growth, much of which is explained by a 4% increase in real consumption. With inflation running higher than the Treasury indicates, this consumption prediction looks a little optimistic, and domestic demand may run a little below the Treasury estimate. More important, the official prediction of a rise of only 4.5% in the imports of goods and services next year looks very low, given recent trends in import penetration. More rapid growth in import volume would not only depress GDP, but also lead to a current account deficit rather larger than the £1.5bn shown in the Treasury projection. It is not clear why the Treasury is more optimistic about imports, and the balance of payments, than most outside forecasters. It has been suggested that the Treasury forecasters have applied a large judgmental adjustment to the original projections produced by their econometric model in this area, and it would be interesting to discover whether this is in fact true.

XX

(This is copy of Terry's copy – his "XX"!)

Finally, the Treasury appears to have assumed that there will be no reduction in short-term interest rates over the forecast period. The increase of over 10% in the housing component of the RPI in the 12 months ended 1987Q4 suggests that mortgage rates are expected to remain at or above present levels, and this is confirmed by the fact that the Treasury states that the recent rise in mortgage rates will add about 0.5% to price inflation "for the next year". This certainly suggests that officials see no scope for the present very high level of interest rates to ease over the next 12 months.

12 November 1986

FROM: A Turnbull
DATE: 19 November 1986

CHANCELLOR OF THE EXCHEQUER

cc Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Scholar
Mr Sedgwick
Mr Gray
Miss O'Mara
Miss Evans

BRIEFING FOR TCSC

I attach briefing on the questions suggested by the TCSC Clerk and advisers. I also attach a note on Bill Martin's commentary, though many of the points he raises are covered in the briefing on the questions.

detached and put with Bill Martin section

VMBrown

A TURNBULL

2136/023

AUTUMN STATEMENT: TCSC QUESTIONNAIRE

Q1. Given that you have not stuck to the policy of keeping public expenditure constant in real terms, does this imply that the Government has changed its view of the importance of reducing public expenditure as a proportion of GDP as fast as possible to help the overall economy? Are you simply recognising that you are unable to control public expenditure as effectively as you would like?

A. Government's fundamental objective has been and remains to reduce public spending as share of GDP. Share will not come down as fast as would have done if spending held constant in real terms but present plans still imply a further 2 per cent fall. Do not disguise difficulty of restraining public expenditure, but progressively we are bringing rate of growth down.

TURNBULL BRIEFING

Q2. You have said that the ratio of GGE to GDP has fallen this year as for the past four years but real departmental spending is up this year by 3.4 per cent and similarly total expenditure including gross debt interest payments is up by 2.7 per cent. Both measures are above GDP growth this year. Would you not prefer to see an across-the-board decline as a proportion of GDP as opposed to selecting one measure?

A. The figure for the real growth in th eplanning total and GGE in 1986-87

	Incl PP	Excl PP
Planning total	2.2	3.5
GGE	0.8	2.0
GDP real	2.5	
deflator	3.0	

GGE, which includes debt interest, increased more slowly than GDP. [The questioner's 2.7 per cent is a hybrid adding gross debt interest to the planning total ie excluding reductions in PCMOB and national accounts adjustments.]

2(a). What about coal strike? If reduce the £1¼ billion which the Committee were given as the effect in 1985-86, the growth in 1986-87 is even higher? (Raised by Mr Townsend with at hearing officials)

A. Have not sought to go back and re-estimate what effect of coal strike actually turned out to be in 1985-86, though rapid improvement in British Coal's finances indicates the figure may have been somewhat less than our original estimate. But simplest test is to strip out the two coal strike years and compare 1986-87 with 1983-84. Over that time we estimate GGE as a proportion of GDP will fall (excluding privatisation proceeds) from 46¾ per cent to 44½ per cent. Average real growth over that period was 1¾ per cent, well below average for GDP of 2.9 per cent.

In looking at real growth between any pair of years there is a more general point. Plans are made in advance in cash terms. What the real terms change turns out to be depends on what in the event happens to the GDP deflator. In 1986-87, deflator will go up about ¾ per cent less than we anticipated in FSBR, so real growth recorded is correspondingly higher. But this is the mirror image of 1985-86 when deflator rose about 1 per cent more than expected. Need to judge expenditure trends over a number of years.

Note. Last December Committee were told the effect of the coal strike on the planning total was about £2½ billion in 1984-85 and nearly £1¼ billion in 1985-86. We would now estiamte the 1985-86 figure at £¾ billion but we have no wish to go on putting out revised estimates.

Q3. The estimated real increases in planned expenditure next year are calculated by deflating the cash plans by the GDP deflator. There may be a substantial relative price effect against the public sector which would produce a volume squeeze. Will this not add to the difficulty of achieving your plans particularly given the expectation of improvement in service provision?

A. Across the whole range of programmes there is likely, in the event, to be a wide spread of relative price movements. Some may be adverse, but others may be favourable. Once budgets have been set in cash terms - and this is how they are determined - budget managers are expected to maximise outputs and performance from those resources. Relative price effects may have been accommodated in the days of volume planning. Now they are not. Managers are expected, and have every incentive, to minimise and offset them. In some cases this may mean having to find savings and efficiency improvements in one area to offset higher than average cost increases in another.

Q4. Public expenditure in 1987-88 is planned to be 2 per cent higher in real terms than the outturn for 1986-87. But since the last Budget, the plans for 1987-88 have increased by 4 per cent. Is this not a sign of the continuing battle to keep the lid on expenditure?

A. Controlling public spending is certainly difficult, but share of GDP and rate of growth are steadily being reduced.

Note. When 1987-88 was year 3 in 1985 White Paper the planning total was set out at £141.5 billion. This was raised to £143.9 billion in the March 1985 Budget and to £148.6 billion in the Autumn Statement, a rise of 5.0 per cent.

Answer is rather thin - but point to emphasise is that we are still planning for a reduction in the GGE/GDP ratio, albeit smaller than that implied by earlier, vaunted plans.

Q5. In your Oral Statement you said that the average real increase in expenditure over the planning period would be 1¼ per cent a year. But this covers a lumpy profile, growth of 2 per cent in real terms in 1987-88, ¼ per cent in 1988-89, 1 per cent in 1989-90. This looks exactly like the pattern of previous plans, ie expenditure slippage in the short term with restraint in the longer term. Is it reasonable for the Committee to be sceptical about this?

A. Are two aspects to this question. First, the implied real terms profile of the cash plans over the Survey period does vary considerably from one year to another. The low figure of ¼ per cent in 1988-89 is followed by another larger figure of 1¾ per cent in 1989-90. This is no more erratic than has occurred in recent years, eg a big real drop in 1985-86 (even adjusting for the miners' strike) followed by a rise in 1986-87. Too much significant should not be attached to the particular annual real terms increase which shows a net effect of bringing together the plans for all departments which have been drawn up in cash and then deflating them by the forecast GDP deflator.

Secondly, the actual figure in 1988-89 is, however, particularly affected by the erratic annual profile of the latest cstiamtes of net contributions to the European Communities. The very low figure of £440 million in 1988-89 reflects the assumption that the UK will benefit from a large correction to its 1987 abatement during 1988. [NB. If the 1988-89 figure was on trend at about £1 billion, it would add about 1/3 per cent to the overall 1988-89 growth figure and reduce the 1989-90 figure correspondingly.]

Q6. What is your view of the 1987-88 Reserve?

A. It is larger, both absolutely and as a proportion of planning total, than in any previous plans except those published last year, when the expecially large reserves reflected the treatment of local authority current expenditure, ie virtually no increase in 1986-87 on 1985-86 outturn and constant cash thereafter.

Changes in the Reserves

£ billion
(percentages in brackets)

	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90
1983 PEWP	1.5 (1.3)	3.0 (2.4)	3.0 (2.3)				
1984 PEWP		2.75 (2.2)	3.75 (2.8)	4.75 (3.5)			
1985 PEWP			3.0 (1.9)	4.0 (2.9)	5.0 (3.5)		
1985 Budget			5.0	6.0	7.0		
1986 PEWP				4.5 (3.2)	6.25 (4.3)	8.0 (5.4)	
1986 Autumn Statement					3.5 (2.4)	5.5 (3.6)	7.5 (4.6)

Q7. The forecast 1¼ per cent a year average real increase in expenditure growth is below the average for the last few years. Why should the Committee not be sceptical of the likelihood of success in getting below the trend of several previous years?

A. A number of factors

(i) no real terms growth in defence budget;

(ii) prospects for unemployment now better than for many years.

Both of these added substantially to growth in the past but are unlikely to do so over period of plans.

(iii) Reserves rise in larger steps in any previous plans.

TRSC

PMG

Supplementary briefing on PM's interview in FT

UK economy "not strong enough" to join EMS

That was FT headline. But inside story shows that PM's main points were the ones we've always made:

- Petrocurrency.
- Internationally held and traded to a degree only matched by the DM among EMS currencies.

- Not a soft option.

The Prime Minister said "We are getting stronger and one day we will go in".

Do not want interest rates higher?

2. The Prime Minister made it perfectly clear that interest rates would continue to be set at whatever level was necessary to keep downward pressure on inflation [FT quote "I have to put them up in order to keep a limit on inflation"].

Won't support exchange rate?

3. The Prime Minister said "I think it has gone low enough". She went on to point out what is clearly true: that market forces in the foreign exchange market are very strong, with capital movements more important than trade flows. We will continue to take great account of exchange rate movements in interest rate decisions, as we have done hitherto.

FINANCIAL TIMES

2

Thatcher rules out EMS entry until economy is stronger

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BY PETER RIDDELL, POLITICAL EDITOR

MRS THATCHER has firmly ruled out full UK membership of the European Monetary System until the economy is "stronger." She says she would expect to reconsider the issue after the next general election.

The Prime Minister's comments were made during an hour-long interview with the Financial Times at 10 Downing Street. She was at her most confident, looking forward to at least another term in office and "geting rid of socialism as a second force."

Among a wide range of points, Mrs Thatcher expressed her support for the privatisation of the electricity industry after the election, for concentrating tax cuts at the lower end of the range, and for building more nuclear power stations — she hopes to read the long-awaited report on Sizewell over Christmas.

The Prime Minister gave the most explicit statement of her doubts on EMS membership which contrast with the support for entry expressed by the Treasury, the Foreign Office and the Bank of England.

She said the economy was not "quite strong enough yet" for EMS. "We are getting stronger and one day we will go in," she added, saying she would expect to reconsider the issue after the election.

Mrs Thatcher stressed throughout the interview that she wanted to go into EMS from strength.

"I want to be absolutely certain that there can be no repetition of what happened before, when we came out of the snake," (the linking of European Community currencies which sterling left in 1972 after a couple of months). "When we go in, we will go in strong and stay in." She said repeatedly that entry would not be an easy or soft option.

Mrs Thatcher also argued that other EEC countries should reconsider the rules, particularly the retention of exchange control in most cases.

She also expressed concern about "hitching our wagon to a Deutsche Mark standard and all the problems we used to have with devaluation if it comes." She thought the pound would be tested and that would mean "swinging up interest rates very sharply" since "there is no way you can intervene to any great extent."

Mrs Thatcher thought the pound had gone low enough against the D-Mark. She underlined her dislike of increasing interest rates and market intervention. "We may believe it (thet pound) has gone enough but it is what the market believes and you know what the market is: 95 per cent of the movement is speculation and the other 5 per cent is trade."

On other economic issues Mrs Thatcher expressed caution about the scale of any tax cuts. She argued the public spending planned for next year—higher than "we wished"—must be "honestly financed" as in 1981. She underlined the public borrowing target for next year of 1¾ per cent of gross domestic product.

The Prime Minister said tax reform was still on the agenda. "At the moment the most urgent thing is people at the bottom, because I think they pay far too much." She said the feeling of the country was that further cuts in the higher marginal rates were not the top priority but, referring especially to scientists, "I do have to watch and see that people are not leaving the country."

She expressed great confidence in Mr Graham Day, chairman of Rover Group, and said the Government would probably be reaching decisions on his corporate plan after Christmas. She stressed that Rover Group could not carry on indefinitely alone as a volume car producer without having an arrangement with someone else.

Mrs Thatcher said that on her forward agenda were the the need to re-examine the cities, with the increased use of urban development corporations, the need to reexamine the structure of local authority finance and the extension of denationalisation and share ownership.

The Thatcher interview, Page 24

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Wednesday, 19 November 1986
FINANCIAL TIMES

6

An interview with the Prime Minister

Two more terms to eliminate socialism

By Geoffrey Owen and Malcolm Rutherford

24

MRS Margaret Thatcher hopes to "get rid of socialism as a second force" in British politics in the course of one or perhaps two more terms of Conservative government.

The Prime Minister told the Financial Times in an interview on Monday that the main themes for the Tory manifesto at the next election will include reforms in education, more initiatives to renovate the inner cities, investment in nuclear power and more—much more—privatisation.

She remains committed to cutting taxes, especially at the bottom end of the income scale, but warned that if public expenditure looks like getting out of hand, the Government is prepared "to do another 1981"—when taxes went up.

Mrs Thatcher said that she was "quite pleased" with the economic growth prospects at the moment — 3 per cent next year on the Treasury forecasts — and "quite pleased with the steadily improving performance of manufacturing industry." But: "We are not quite the same as West Germany yet. I wish we were."

In a central part of the interview she argued that the economy will have to become stronger before she is ready to commit Britain to full membership of the European Monetary System, and that time will come almost certainly after the general election. Although "one does not rule out anything at the moment, that is when I would expect to have to reconsider it," she said.

The Prime Minister's main arguments against full membership at present were as follows.

First, she thinks EMS members ought to observe the same rules. "For example, some of them have exchange control . . . That obviously gives them a control mechanism, which we do not have."

Secondly, while Germany does not have exchange controls, it also does not have the petro-currency problem. "When the price of oil goes down it is 100 per cent benefit to Germany and only 50-50 to us."

"Thirdly, people think of going into the EMS believing . . . that somehow you go in and everything in the garden will be lovely without you having to make so much effort. That is just not true."

If Britain went in along those lines, Mrs Thatcher said: "The speculators will come in." To resist them, "you have to do one of two things—you have got interest rates or intervention. There is no way in which you can intervene to any great extent." Support operations from other central banks, she added, amounted only to other people lending you money.

Asked whether full membership might not lock in a low inflation rate, the Prime Minister replied: "Ah, but that means then that I have to swing up interest rates very high regardless. They might fluctuate much more because we would be tested . . . I do not want interest rates any higher. I have to put them up in order to keep a limit on inflation."

Mrs Thatcher no longer refers very much to the sterling/dollar rate. "What we are talking about," she said, "is a D-mark standard, and then you have all the problems that we used to have with devaluation, if it comes. We are getting stronger and one day we will go in."

She then gave a further reason for her reluctance to go in now. "You know, we came out of the snake" (a forerunner of the present European monetary system). "It is etched on my mind. We went in and we came out. When we go in (to the EMS) we will go in strong and stay in."

To a question about the current sterling D-mark rate, the Prime Minister said: "I think it has gone low enough." However, she refrained from making any pledge that the rate will be supported. "We may believe it has gone enough," she went on, "but it is what the market believes and you know what the market is: 95 per cent of the movement is speculation and the other 5 per cent is trade. That is why I said to you earlier that if we had confidence that we will have a clear run—you will have alternative governments to this one, but if they were not socialist governments—then I do think that the prospects for this country would be transformed."

Mrs Thatcher was harking back to what she said at the start of the interview about the need for a third term: "If people could be sure that we would never have another socialist government, increasing control of state, increasing control of ownership . . . then I think the prospects for this country would be really bright . . . and if only we could get rid of socialism as a second force and have two (parties which) fundamentally believed that political freedom had to be backed by economic freedom and that you get the best out of a people when you delegate power down — it is not really ours to delegate; the history of democracy is the history of increasing liberty from the power of the state."

She is undecided on whether to accept the terms of the teachers' agreement reached last weekend, mainly on the grounds that the best may not be sufficiently rewarded. "Differentials matter, what your top teachers are paid matters and it matters to your mathematicians and physicists that they have a chance, if they are good teachers, that they get a reasonable salary in a reasonable time, so the pay structure is absolutely critical."

Whatever the decision here, education is part of what the Prime Minister called "very much a forward movement" for the next manifesto. Inner cities will feature prominently there will be more Urban Development Corporations, with powers over the heads of the local authorities.

Nuclear power is another priority, though what kind of reactors and whether any are commissioned before the election depends on the Sizewell Report which Mrs Thatcher may have to use as her Christmas reading. (Two Christmases ago, it was the report on the fourth London airport.)

On the basic principle she is adamant: "You cannot do without nuclear power and more nuclear power . . . oil is at a low price at the moment. It is only a question of time as to when it goes up. Some people say five years, some would say 10, but it takes about 10 years to build and commission nuclear power stations."

Much of the rest is privatisation, and the only question is the order and the form. "The longer I am in government," the Prime Minister said, "the more I know that governments ought not to have to make some of the decisions that they do on nationalised industries. If you look to see why an industry is nationalised, the only reason that I can really work out is so that government can interfere."

She was asked to be more specific. That, she replied, was not possible at present. "You look and see which are the best ones to take first and also how best to do it, because sometimes you do it piecemeal, sometimes you will take a whole industry. Sometimes you will do it with 50 per cent and then . . ." In various ways, the electricity, coal and steel industries are all possibilities.

The coal industry, she said, "really is getting into a much healthier state than it has ever been and I find myself saying in some speeches: 'Do you realise that under a Conservative Government even the nationalised industries run better?'"

It was, she said, a question of delegating power and responsibility and of spreading both ownership and management. Mrs Thatcher went to the Nissan plant in the North Eeast

CONT...

2/2

Cont....

the other day. What struck her was "the attitude of the people there; because of the way in which they had been treated by management, every single person knew that his job was significant."

One of them told her: "We do not have to call in the unions very much, because if we have a problem it is sorted out there and then on the shop floor between whoever is responsible and the next management up."

She made a speech saying that within a few years our standards and quality would be every bit as good as the Japanese and the workers interrupted and said: "No, ours will be better."

The Prime Minister also scattered praise on some British companies, and not only Jaguar: Carrington Viyella, for instance. "Manufacturing raw materials, like polyester cotton," she said, "is now done so much by big machines that there is no earthly reason why we cannot repatriate it here from the Far East." Mr Peter Black who makes goods for Marks and Spencer and Sir Ralph Halpern of the Burton Group received further plaudits. What they have in common is that they are "all companies which were at one with their people."

Jaguar apart, she sees the British car industry as a problem expressing her disappointment at the successful opposition to the deals involving General Motors and Ford earlier this year.

"Ford," she said, "has done a lot for this country. Ford actually contributes to the revenue of this country. . . . It contributes to the money that we have been paying to British Leyland. . . . What was terribly difficult to get over to people was that BL was no longer a big volume car manufacturer . . . whereas we had 4 per cent of the cars of the European market, the others had 11-13 per cent . . . there is no way in which you can spread your overheads over 4 per cent, no way in which you can do your new models."

Mrs Thatcher thought that she might have handled the matter better if she had been in power longer. "We came across—sometimes you get it in politics—a political feeling which you just cannot, at that moment, overcome, and then you have to say: 'All right, we will just have to put it on one side at the moment'." With the assistance of Mr Graham Day, she will try again in the New Year.

The Prime Minister seemed rather less happy about tax and public expenditure than the public persona at the time of the autumn statement two weeks ago. "We have got higher public expenditure than we would have wished," she said. "Insofar as money has been spent, it is not available for tax relief. . . . When we get that higher expenditure, as we have, then the only thing that I can do is as we did in 1981: insist that it is soundly financed."

On tax cuts, she went on: "The most urgent thing at the moment is the people at the bottom." However, she is also giving consideration to cutting the top rate of income tax from 60 to 50 per cent, if only because lower tax rates and higher salaries in the US could induce a further brain drain from Britain. She added: "I cannot promise that that would be top priority," though she said she was concerned about the position of scientists.

"The fact that the American top rate is coming down so much," she claimed, "will affect some of our top people and that does give me cause for concern because to our top scientists they can offer both a fantastic laboratory facility as well as fantastic salaries and most people do work for their family, and that is not a bad thing.

"So we will have to watch that, particularly the science and technology side because so much industry is science-based and so much of the future is going to be science-based."

Mrs Thatcher also referred to—as is the habit of Chancellor Nigel Lawson—the problem of high unit labour costs in Britain.

Asked what could be done about it, she said only: "I can only point out . . . look, if you lose business, people must be intended to presume the consequences of their own action."

The political sting in the interview came at the end when she returned to the need to eliminate socialism as the alternative government. "I think you could get another realignment in British politics," she said. After another Tory victory? "After two more victories," she concluded.

2/3.

18/3066

CONFIDENTIAL

FROM: DAVID PERETZ
19 November 1986

MR SCHOLAR

cc Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Sedgwick
Mr Turnbull
Mr Culpin
Miss O'Mara
Mr Kelly
Mr Allan

Ch
David said a further worry was that a statement might be taken as further signal of PM/Ch rift by the markets.
AA

OPENING STATEMENT BY THE CHANCELLOR TO THE TCSC ON 20 NOVEMBER

I recognise that the Chancellor may want to say something about the exchange rate tomorrow, and to draw attention to his remarks in the BBC interview a few days ago. But my advice would be strongly against, and particularly against doing so in the course of a prepared opening statement. (I do not need to go into the problems inherent in stating too clearly that we have a "floor" for the exchange rate. It is a recipe for securing a rise in market interest rates whenever the exchange rate flickers down (as it looked as if it was beginning to do earlier today), in a way that could be hard to resist - while one can envisage circumstances in which it would be right to resist.)

2. There are two reasons for leaving this area out of the opening statement. First, it has nothing to do with the Autumn Statement. Fair enough to answer any questions the Committee ask: but we do not want to give the impression that we think it has anything to do with the Autumn Statement.

But was much discussed @ officials' hearing.

3. Second, the text of the opening statement as I understand it would be passed to reporters. It has all the appearance of words carefully prepared: and that adds to the weight the market would be likely to give to every nuance. It would be better, particularly if the Chancellor wants to go some way towards repeating what he said on BBC, for it to have the appearance of an off-the-cuff remark.

4. If it is dropped you would need to change paragraph 2; and might change the second sentence on page 2 to read: "The Autumn

Statement contains no restatement of monetary policy - and I would be happy to answer questions on that if you like. In any event no restatement of policy is needed because ....".

5. The attached suggested redraft of the passage on monetary policy and the exchange rate might then be used by the Chancellor in answer to questions later on. The last sentence is as far as I would advise going towards repeating the BBC remarks.

DLCP

D L C PERETZ

17/3066

I understand there was some interest in the exchange rate and monetary policy on the part of members of the Committee during your session on Monday with Treasury officials.

I have nothing new to say on this. Short term interest rates were raised by 1% on 14 October because I judged that rise was necessary, looking at the evidence available, to keep financial policy on track. I explained the reasons in my speech at the Mansion House on 16 October. The particular triggers to action on that occasion were the acceleration there has been since the summer in the rate of growth of MO - even though it remains within its target range; and the exchange rate.

We have a clear policy on the exchange rate. There is no target: public or secret. But I take it into account along with other indicators in assessing monetary conditions and taking decisions on interest rates.

Following the collapse in the oil price earlier this year some fall in the exchange rate was inevitable and necessary. I made it clear as long ago as 1984, in a lecture I gave in Cambridge, that following a fall in North Sea oil revenues some corrective fall in the exchange rate would be needed. It is part of the way the economy adapts to the change. But there are clearly limits to the fall that was desirable. I have always rejected the view that we should follow a policy of exchange rate depreciation to accommodate excessive cost pressures in this country relative to our competitors abroad. I believe that we need an exchange rate, and indeed monetary conditions more generally, that have a bracing impact on domestic costs. .

If there were any evidence of a losening in monetary conditions in future, as judged by the available evidence including the exchange rate, then of course short term interest rates would have to be raised again.

CONFIDENTIAL

PMP

Ch
Peter's comments
especially on XR
AA

FROM: M C SCHOLAR
DATE: 19 NOVEMBER 1986

CHANCELLOR OF THE EXCHEQUER

cc Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr Cassell
Mr Peretz
Mr Sedgwick
Mr Turnbull
Mr Culpin
Miss O'Mara
Mr Kelly
Mr Allan

Stronger than that.

I think I prefer the Cassell version on the exchange rate - but have suggested some changes to this.

In the light of Peter's comments, I have changed the XR section altogether, & will leave this to questions & answers. I have also shortened the statement in other ways, & made a few amendments.

YOUR OPENING STATEMENT TO THE TCSC TOMORROW

Mr Allan asked me to draft, after consulting Sir Terence Burns (who, I understand, had discussed with you), a possible opening statement for your session with the TCSC tomorrow.

... 2. A draft is attached (flag A). It has not been possible to clear this today with Sir Peter Middleton.

3. Mr Cassell and Mr Peretz both strongly advise you not to say anything on the lines of the section on the exchange rate, particularly if it is to be part of your opening statement. If - as seems virtually certain - you are questioned on this topic they would prefer you to speak on the lines of the draft at flag B. Their reasons for preferring you to omit this section from your opening statement are that

(i) the exchange rate has nothing to do with the Autumn Statement; and

(ii) because this section has every appearance of words carefully prepared the markets are more likely to give weight to every nuance.

4. Sir Terence Burns, on the other hand, sees no objection to your including a passage as in the draft at flag A.

MCS

M C SCHOLAR

CONFIDENTIAL

1461

FROM: M C SCHOLAR
DATE: 19 NOVEMBER 1986

PMP

CHANCELLOR OF THE EXCHEQUER

cc Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr Cassell
Mr Peretz
Mr Sedgwick
Mr Turnbull
Mr Culpin
Miss O'Mara
Mr Kelly
Mr Allan

Ch
(1) I imagine you will want to use the exchange rate passage.
(2) This is too long - 1450 words, or over 10 mins. I have suggested some pruning.
AA

YOUR OPENING STATEMENT TO THE TCSC TOMORROW

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(i) the exchange rate has nothing to do with the Autumn Statement; and

See David Peretz's note below.

(ii) because this section has every appearance of words carefully prepared the markets are more likely to give weight to every nuance.

4. Sir Terence Burns, on the other hand, sees no objection to your including a passage as in the draft at flag A.

MCS

M C SCHOLAR

Flag A

DRAFT

OPENING STATEMENT BY THE CHANCELLOR TO THE TCSC ON 20 NOVEMBER

Yes, Mr Chairman, I think it would be useful if I made one or two points at the outset of today's proceedings.

I would like to say something about four subjects: the continuity of the government's approach to public spending the matters which arise in the Autumn Statement and in discussion of it; public sector borrowing next year; the exchange rate; and the prospects for economic growth. On some of these matters I would like to amplify what has already been said, either in the Autumn Statement or subsequently; on others I think I should counter some misconceptions which appear to have arisen.

As the Committee knows, the Autumn Statement is not the occasion on which the government reassesses the Medium Term Financial Strategy, or when it announces new monetary targets or new conclusions on fiscal policy. Those are matters for the Budget. It is, rather, a collection of separate announcements which it is convenient to make at this time of year, on the government's revised public expenditure plans, and on national insurance contributions, and on the costs of illustrative tax changes, together with the Industry Act forecast for the economic prospect to the end of the following year.

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This year's Autumn Statement, like its predecessors, is firmly set in the framework of the policy stance in the Budget Red Book, which itself, of course, followed closely earlier versions of the MTFS in the Red Books of preceding years. As usual the Autumn Statement contains no restatement of monetary policy because none is needed. There has been no change in the operation of monetary policy, as I explained in my Mansion House Speech recently -and as elaborated upon subsequently by the Governor of the Bank of England in his Loughborough lecture.

This wasn't really about the operation of monetary policy.

On public expenditure, this year's Autumn Statement marks a further stage in the government's progress in rolling back the relative size of the public sector. We have reduced the proportion of national income taken by public spending every year since 1982, and the plans set out in the Autumn Statement carry that process on a further three years. By the end of the current planning period, in 1989-90, the ratio of public spending to national output will be back to the level of the early 1970s.

Some commentators have professed to see a discontinuity in all of this. There has been, it is true, a discontinuity. But that was back in 1982-83 when general government expenditure as a proportion of GDP stopped rising - as it had been doing continously once the immediate aftermath of the IMF crisis in 1976 was over, and went on doing until the legacy of the Labour Government worked its way through the system. Since then this ratio has declined, just as the rate of growth of public spending in real terms, even excluding privatisation proceeds, has declined, from about 3 per cent a year in the decade up to 1979 to about $2\frac{1}{4}$ per cent a year during our first Parliament, and about $1\frac{3}{4}$ per cent a year in the present Parliament so far. The planned increase envisaged in the Autumn Statement over the next three years is at the still slower rate of 1 per cent a year.

The same continuity of policy may be seen in our policy for the public sector borrowing we have undertaken. In successive versions of the MTFS we have mapped out a course for the PSBR in which it is would gradually reduced diminish as a proportion of GDP over the medium-term. Throughout my time as Chancellor I have stuck firmly to this path, and in successive Budgets I have set the PSBR at or below the level given in the previous year's MTFS. Apart from 1984-85, when I allowed public borrowing to expand to finance the expenditure needed in resisting the coal strike, the outturn on the PSBR has been broadly in line with that envisaged at the time of the Budget.

For this financial year, the figures published on Tuesday of this week confirm that the PSBR is so far well on track. For next year I have thought it right to go a little further than is usual at this time of year, and to dispel from the start any worry there might be that the increased planning totals might imply a relaxation on public borrowing. I have therefore reaffirmed the

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government's commitment to the fiscal stance set out in the 1986 MTFS, and made it clear that the PSBR next year will be held to $1\frac{3}{4}$ per cent of GDP. So there is continuity on public borrowing just as on public spending, on monetary policy, and indeed on all the elements of economic-policy.

I turn now to the exchange rate, where there was some interest on the part of members of the Committee, in your session on Monday with Treasury officials, in remarks I made on this topic in a BBC interview a week or so ago.

What I said then was no more and no less than what I have said on many occasions in the past. We have a very clear policy on the exchange rate: we take it into account, along with the other indicators, in making our assessments of monetary conditions, and in deciding what action, if any, needs to be taken with the key instruments of monetary policy - short-term interest rates. And we will continue to keep short rates at whatever level is necessary to secure monetary conditions which bear down on inflation.

We do not have an exchange rate target. Indeed, I do not believe it is possible to have a target outside a fixed exchange rate mechanism such as EMS. But I have always rejected the view that we should follow a policy of exchange rate depreciation, in order to accommodate excessive cost pressures in this country relative to those in our competitors abroad. I have always believed, rather, that the exchange rate should have a relatively bracing effect on domestic costs. But I made it clear, as long ago as 1984, in a lecture I gave in Cambridge, that following a fall in oil revenues there would necessarily be a corrective fall in the real sterling exchange rate. After the collapse in the oil price early this year, that adjustment has now taken place; and that is why I would not wish to see sterling any lower than it is at present, because I wholly reject the misconceived policies, and the vicious downward spiral of those who advocate continued devaluation.

Finally, Mr Chairman, I turn to the prospects for growth over the coming year.

The past five years have seen a remarkable stability in the growth performance of the economy. Growth has averaged almost 3 per cent a year over the whole of this period, and the Industry Act forecast predicts that it is set to continue at this rate in 1987. This expected growth is not, as some critics have asserted, the result solely of a fragile and very rapid growth of consumer spending. The forecast is for more balanced growth next year, with a somewhat slower rise in consumer spending, faster growth of exports - something which has already begun in the second half of the current year - and continuing growth in investment from its record level this year.

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The Committee will know that there has been criticism of the Autumn Statement from some quarters for showing what is represented as an excessive growth of demand and activity. This criticism is misconceived: that the Industry Act forecast shows that the growth of money GDP for the economy as a whole in the current financial year seems likely to undershoot the figure I gave at Budget time - at 5½ per cent rather than 6¾ per cent. Only a few months ago, when there were signs that output was very sluggish, some of these same critics argued that policy was too tight and that the halving of the oil price would spell the end of the upswing unless I took action vigorously to expand the economy. I rejected their view then, as I reject it now, and instead took the view that the pause in growth was no more than a pause. Subsequent events have proved that view right, and it has since become clear that this slowdown in growth was something which we were experiencing in common with the rest of the developed world. In recent months there have been more and more signs worldwide that this pause is over - a most welcome development, and not least for the UK.

You could leave this paragraph out in the interests of keeping the opening short.

Mr Chairman, I hope that these opening remarks will provide a helpful framework for the Committee's questions, which I will now endeavour to answer to the best of my ability.

HM

17/3066

Flag B

I understand there was some interest in the exchange rate and monetary policy on the part of members of the Committee during your session on Monday with Treasury officials.

I have nothing new to say on this. Short term interest rates were raised by 1% on 14 October because I judged that rise was necessary, looking at the evidence available, to keep financial policy on track. I explained the reasons in my speech at the Mansion House on 16 October. The particular triggers to action on that occasion were the acceleration there has been since the summer in the rate of growth of MO - even though it remains within its target range; and the exchange rate.

We have a clear policy on the exchange rate. There is no target: public or secret. But I take it into account along with other indicators in assessing monetary conditions and taking decisions on interest rates.

Following the collapse in the oil price earlier this year some fall in the exchange rate was inevitable and necessary. I made it clear as long ago as 1984, in a lecture I gave in Cambridge, that following a fall in North Sea oil revenues some corrective fall in the exchange rate would be needed. It is part of the way the economy adapts to the change. But there are clearly limits to the fall that was desirable. I have always rejected the view that we should follow a policy of exchange rate depreciation to accommodate excessive cost pressures in this country relative to our competitors abroad. I believe that we need an exchange rate, and indeed monetary conditions more generally, that have a bracing impact on domestic costs.

If there were any evidence of a losening in monetary conditions in future, as judged by the available evidence including the exchange rate, then of course short term interest rates would have to be raised again.

RA7.69

pwp

TCSC

GENERAL GOVERNMENT CONSUMPTION: NOTE BY HM TREASURY

Table 1.15 of the Autumn Statement gives a forecast of general government consumption in volume terms at constant 1980 prices. This forecast is fully consistent with the path of public expenditure set out in Chapter 2 of the Autumn Statement.

2. General government consumption is current expenditure on goods and services, accounting for about [50] per cent of total general government expenditure. It excludes such items as capital expenditure and transfer payments (eg social security benefits).

3. There are well-known difficulties about converting cash plans into volume figures. It is not easy to find appropriate price indices for each category of general government consumption, and the provisional data in particular is subject to revision. There are additional complications over linking together the CSO's ~~published~~ provisional data for the first half of the calendar year, and the ~~latest estimates~~ forecast ~~of~~ spending over the financial year as a whole. It is therefore not advisable to put too much weight on the precise ~~quarterly or~~ half-yearly profiles.

4. In these circumstances the forecast claims to be no more than a guide to broad movements from one year to another. The year-on-year changes in table 1.15 show fairly steady growth.

5. Since the figures in table 1.15 are volume forecasts, they are not affected by changes in teachers' pay.

early published estimates

TCSC: QUESTIONS FOR THE CHANCELLOR ON 20 NOVEMBER

MONETARY POLICY

1. Given the overshoot in the growth of £M3, do you intend to set a new £M3 target? If £M3 is an unreliable indicator do you propose to substitute an alternative measure such as PSL2?
2. Do you share the concern of the Governor of the Bank of England about the build-up of liquidity in the economy?
3. Paragraph 61 in Chapter 1 of the Autumn Statement says that for the past six years high rates of growth of broad money have been consistent with appropriately tight monetary conditions and thus a substantial fall in inflation. Is the Government saying that whatever the growth in £M3 it is consistent with low inflation?
4. What can be done to control the growth of credit given that interest rates are already very high?
5. Recent statements suggest that you think that sterling is at about the right level and that any further decline would be resisted by a tightening of policy. Does that mean both higher interest rates and a tighter fiscal policy? If the exchange rate were to fall further it would seem erratic to try to tighten fiscal policy given the apparent loosening in the Autumn Statement. What is your view on this?
6. Do you think that interest rates will need to increase over the next year to maintain sterling? Is there any prospect of interest rates being allowed to fall without undermining sterling?

FISCAL STANCE

1. Sir Terence Burns said that the reason for restating the PSBR figure for 1987-88 in the Autumn Statement was to reassure people that fiscal policy had not changed since the Budget. Given that the outlook for the economy is quite different from the beginning of the year, do you think that a different PSBR would now be more valid?
2. Given your statement that the same £ cannot be used twice, presumably there is now little scope for tax cuts in the next Budget?
3. There are some grounds for scepticism that the Reserve for 1987-88 will be adequate. If expenditure overruns and there is a risk that the PSBR target will not be met, what will be the Government's response?
4. Some commentators are suggesting that the balance between inflation and growth would be better served by a tighter fiscal policy and a looser monetary policy. What is your view on this?

PUBLIC EXPENDITURE

1. Given that you have not stuck to the policy of keeping public expenditure constant in real terms, does this imply that the Government has changed its view of the importance of reducing public expenditure as a proportion of GDP as fast as possible to help the overall economy? Are you simply recognising that you are unable to control public expenditure as effectively as you would like?
2. You have said that the ratio of GGE to GDP has fallen this year as for the past four years but real departmental spending is up this year by 3.4 per cent and similarly total expenditure including gross debt interest payments is up by 2.7 per cent. Both measures are above GDP growth this year. Would you not prefer to see an across-the-board decline as a proportion of GDP as opposed to selecting one measure?
3. The estimated real increases in planned expenditure next year are calculated by deflating the cash plans by the GDP deflator. There may be a substantial relative price effect against the public sector which would produce a volume squeeze. Will this not add to the difficulty of achieving your plans particularly given the expectation of improvement in service provision?
4. Public expenditure in 1987-88 is planned to be 2 per cent higher in real terms than the outturn for 1986-87. But since the last Budget, the plans for 1987-88 have increased by 4 per cent. Is this not a sign of the continuing battle to keep the lid on expenditure?
5. In your oral statement you said that the average real increase in expenditure over the planning period would be 1¼ per cent a year. But this covers a lumpy profile, growth of 2 per cent in real terms in 1987-88, ¾ per cent in 1988-89, 1 per cent in 1989-90. This looks exactly like the pattern of previous plans ie expenditure slippage in the short term with restraint in the longer term. Is it reasonable for the Committee to be sceptical about this?
6. What is your view of the 1987-88 Reserve?
7. The forecast 1¼ per cent a year average real increase in expenditure growth is below the average for the last few years. Why should the Committee not be sceptical of the likelihood of success in getting below the trend of several previous years?

WAGES AND MANPOWER

1. What can the Government do to avoid a knock-on effect from teachers' pay to other public sector pay? Is there not a serious risk that a high proportion of the agreed increases in departmental plans will be absorbed by pay without any improvements in output?

CE7

FROM: MISS C EVANS
DATE: 13 NOVEMBER 1986

MR SCHOLAR

cc Chancellor of the Exchequer 12/2
Chief Secretary
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr Cassell
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Turnbull
Mr S Davies
Mr Gray
Mr Mathews
Mr Mowl
Miss O'Mara

TCSC: OFFICIALS' HEARING ON MONDAY 17 NOVEMBER

I have received the attached questions by phone from the Clerk. These relate only to monetary policy, the exchange rate and balance of payments. The Committee has still not formulated its questions on other aspects of the forecast and Chapters 2-4: he will telephone with these tomorrow morning.

C Evans

MISS C EVANS

MONETARY POLICY AND THE EXCHANGE RATE

Wait for Budget.

1. Is the Treasury going to stop setting targets for £M3? Why not target another indicator like PSL2?

See Lombard speech.

2. Does the monetary policy stance in the forecast amount to an exchange rate target?
3. Does the Treasury share the concern of the Governor of the Bank of England about the build up of liquidity in the economy? Loaded. see Mansion House speech.
4. If you believe credit growth is too high what can be done to control it given real interest rates are already very high? Can't have argument both ways!
5. Is the recent increase in base rates sufficient to protect sterling? Entirely appropriate in circs
6. What is the basis for the assumption in the forecast that the effective exchange rate will remain at present level? Is this realistic - if the pound falls in effective terms what is the effect on the forecast for inflation and exports? Has fallen far enough to offset oil price fall.
7. Is the deterioration in UK relative unit costs likely to continue? Big improvement.
8. The Japanese, Americans and Germans are attempting to stabilise cross rates with each other, the EMS is another element of stability. Does this not leave sterling out in the cold?

BALANCE OF PAYMENTS

1. The forecast expects non oil export growth to be higher than world trade growth - is this consistent with the view that exports are not very responsive to changes in competitiveness? Yes.

surpluses?

2. For 1986-87 and 1987-88 the forecast predicts substantial balances on invisible trade: on what basis? — idiotic question.
3. The forecast expects import growth to level off from the second half of 1986 - is this optimistic - what is thought to underlie this trend?

Improved competitiveness

Slower growth in consumers expenditure.

TRANSCRIPT: For instructions on its use, see below. Ev.2

HOUSE OF COMMONS

MINUTES OF EVIDENCE

TAKEN BEFORE

THE TREASURY AND CIVIL SERVICE COMMITTEE

THURSDAY 20 NOVEMBER 1986

THE RT HON NIGEL LAWSON, MP, SIR PETER MIDDLETON, KCB,

SIR TERENCE BURNS and MR A TURNBULL

Evidence heard in Public | Questions 82 - 156

USE OF THE TRANSCRIPT

1. Members and prospective witnesses to whom the transcript is sent in strict confidence, under the authority of Mr Speaker and the Committee, are asked to note that the text is unpublished and that its use should be governed by the guidelines in the following paragraphs.

2. Members receive copies for the purpose of correcting questions addressed by them to witnesses, and are asked to send any corrections to the Committee Clerk as soon as possible.

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FROM: SIR T BURNS

DATE: 20 November 1986

CHANCELLOR

cc Sir P Middleton
Mr Sedgwick
Mr Bottrill
Mr S Davies

TREASURY AND CIVIL SERVICE COMMITTEE

Last Monday I was questioned by Mr Wainwright (and later by Mr Mitchell) about possible inconsistencies in our statements on the effects of competitiveness on exports.

2. In the 1985 Autumn Statement we said "The experience of the past five years suggests that export volumes have not been very responsive to price and cost changes". (Para 1.20, Flag A).

3. In this year's Autumn Statement we said "This, together with the lagged benefits from this year's gain in competitiveness, suggests that exports should continue to grow steadily". (Para 1.25, Flag B).

4. I argued there was no inconsistency in these statements and that we have not changed the size of the impact of changes in competitiveness on exports. The transcript of my exchanges with Mr Wainwright and Mr Mitchell is at Flag C.

5. You will recall we were questioned on this last year. I attach (Flag D) the Committee's report last year. It includes a useful quote from you "It is not that exports are not responsive to price and cost changes; the point is that they are not very responsive". The transcript from our joint evidence last year is attached at Flag E and of my earlier evidence with Treasury officials at Flag F.

6. I suggest that you stick to the line taken last year. This year's Statement is entirely consistent with it.

T BURNS

ENCS

A

FLAG A.

AUTUMN STATEMENT 1985

year export prices are expected to rise at much the same rate as import prices. The terms of trade in goods (other than fuel) may therefore remain close to the current level, which is some 4 per cent better than the 1983 and 1984 average. The terms of trade in services may follow broadly the same pattern.

Trade volumes (goods other than oil and erratics)

1.20 Export volumes rose strongly in the second half of 1984 at a time when world trade was also rising strongly. Since then, during a period of slower growth in world trade, they have fallen back somewhat but in the three months to September were 7½ per cent higher than a year earlier. Next year, exports are expected to rise gently. World trade is expected to continue expanding. The worsening of price and cost competitiveness this year may restrain exports next year, but experience of the past five years suggests that export volumes have not been very responsive to price and cost changes. Exports of goods are forecast to rise by some 2–3 per cent in volume terms in 1986, after a rise of 7½ per cent in 1985.

1.21 Although domestic demand for manufactures has probably been growing more slowly this year, the level of imports has risen less than expected. The deficit on trade in manufactures in 1985 is now expected to be much the same as in 1984. There may be a fairly sharp rise in imports in 1986 due to further increases in domestic demand, and to rising import penetration in manufactures—the main factor in which is the continuation of a longstanding trend in most of the developed economies. Imports of goods are projected to increase in 1986 by 5–6 per cent in volume terms, compared with 4 per cent in 1985.

Trade in oil

1.22 Domestic demand for oil was boosted temporarily in 1984 and in the early months of 1985 by the coal strike. In underlying terms demand for oil has been broadly flat, despite rising GDP, as the economy continues to adjust to the large rises in oil prices in the seventies. This decline in oil demand, relative to GDP, may continue next year. UK oil production may be at much the same level this year as in 1984 and there may be little change next year. Net oil export volume is expected to be higher in 1986. But with sterling oil prices currently below the average so far in 1985, and futures markets pointing to some further decline, the balance of trade in oil at current prices may fall a little (see Table 1.2).

Invisibles

1.23 The balance on services has been improving since 1982. Travel and tourism earnings, strong this year, are particularly sensitive to price changes. Some improvement in the services terms of trade is expected to be broadly offset by a deterioration in the services balance at constant prices. The profile of the transfers balance depends largely on the timing and size of government transactions with the EC.

1.24 The surplus on interest, profits and dividends (IPD) increased in 1984 but fell back in the first half of 1985. The data for both 1984 and 1985 are however liable to substantial revision. In particular, the implied rate of return on direct investment overseas looks low and it has been assumed that the provisional data for the first half of 1985 will be revised upwards. The IPD balance in 1985 may be similar to 1984. A rise in UK interest rates relative to those overseas, and an increase in North Sea debits, are offset by a higher level, for 1985 as a whole, of net overseas assets. With a further rise in net overseas assets and little change in relative returns, the IPD balance should increase in 1986.

Current account

Table 1.2 Current account—balance of payments basis

£ billion

	Manufactures	Oil	Other goods	Invisibles	Total
1984	−4	7	−7	5	1
1985	−3½ −3	8½ 8	−7 −7½	5 5½	3 3½
1986	−4½ −5½	8 4	−5½ −7	6 8½	4 0

AUTUMN STATEMENT 1986 FLAG B

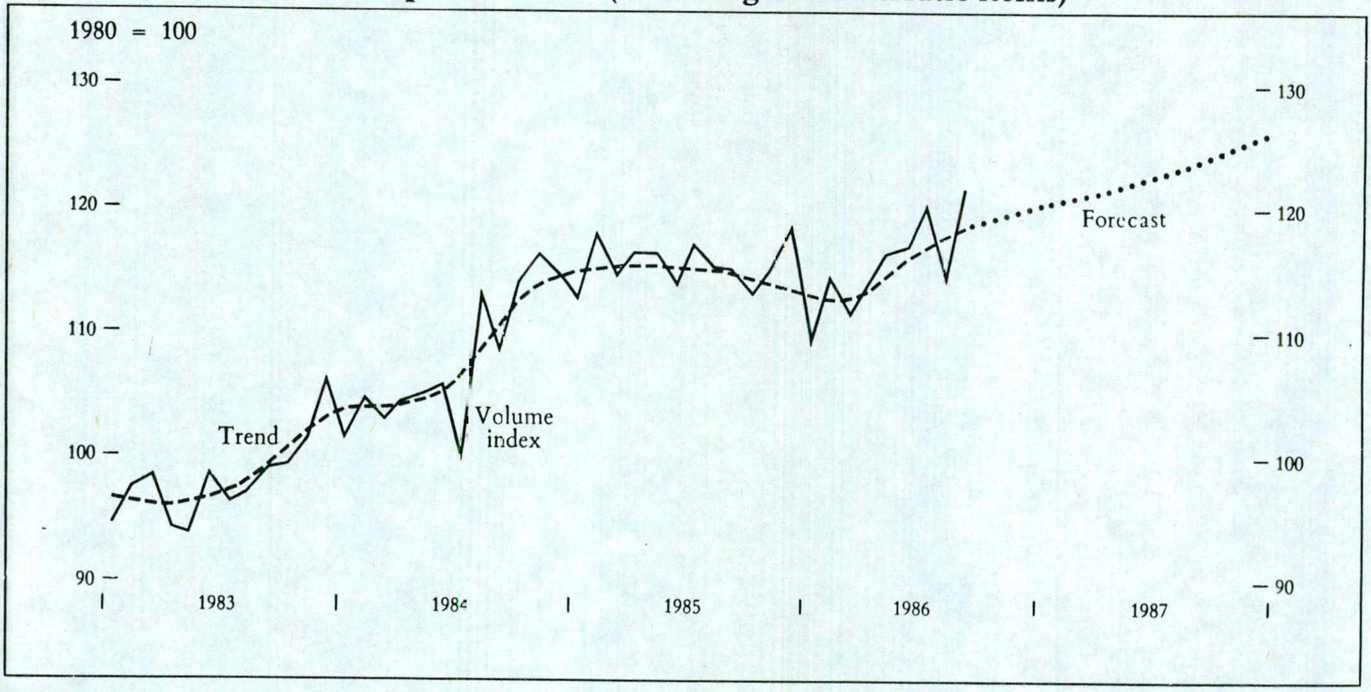
B

were weak until very recently since lower world prices for many commodities offset the effects of sterling's depreciation. The non-oil terms of trade, therefore, have remained relatively steady. They may worsen slightly over the next year as a result of rises in some commodity prices and the recent depreciation of sterling.

Trade volumes (goods other than oil and erratics)

1.25 As Chart 1.5 shows, the share of UK manufactured exports in the volume of world trade has been broadly steady since 1980—following the decline of earlier years. Non-oil export volumes fell in the early months of 1986 when world trade growth was sluggish but have risen again in recent months. In the third quarter of 1986 exports of manufactures were some 3 per cent higher than in the first half of this year. World markets for UK manufactures are expected to grow more rapidly in 1987. This, together with the lagged benefits from this year's gain in competitiveness, suggests that exports should continue to grow steadily. As can be seen from Chart 1.4, a rising trend in UK non-oil exports has been evident since the second quarter of 1986 when world trade began to recover from its slowdown during the winter. The forecast is that a continuation of this trend will bring growth of $5\frac{1}{2}$ per cent between 1986 and 1987—a sharp rise over the 1 per cent growth between 1985 and 1986.

Chart 1.4 Export volumes (excluding oil and erratic items)



1.26 Non-oil imports grew relatively slowly in the first half of this year, but have tended to rise more rapidly in recent months. The volume of imports has risen rather more rapidly than domestic demand, although the increase in import penetration has been less rapid than during some previous periods with similar growth of domestic demand. Manufactured imports rose particularly fast: some $8\frac{1}{2}$ per cent up in the third quarter over the first half of the year. Imports of food have also been unusually high this year as a

Evidence by Treasury Officials Monday 17 November 1986 Flag C

C

36. Those very powerful factors being as you describe, are you not really very optimistic in your 1987 forecast of the total balance of payments outcome of a deficit of only 1½ billion, in view of the trends which you have just been elaborating?

(Sir Terence Burns) Again there have been some sharp movements recently and if you examine the balance of payments forecasts which have been made by the various people who engage in this business, obviously there have been some quite sharp revisions in recent months, largely reflecting the actual outcome in the last three to four months. I think it is still early days to be sure to just what extent those pressures will continue. After quite a period when imports grew relatively slowly compared to the growth of domestic demand or final demand, we have suddenly seen quite a sharp increase in the summer months; a lot of the forecasts of the current account have changed as a result of that. We think this is not necessarily an optimistic forecast, although I would stress and fully accept that the standard error around balance of payments forecasts is huge. The other thing I could point out in defence is by and large we have not had a record of being excessively optimistic about the balance of payments. It is true that that is the way it has turned out in 1986, but if you go back and look at the record over the last five or six years, I think you will find by and large the errors have been in the other direction. I never like to be forced into the position of saying, "Absolutely, this forecast is the only one there could possibly be", just as I do not want to resist any suggestion from your side of the table that we are inevitably unduly pessimistic or optimistic on any item. I accept with all the humility that all forecasters should express that forecasts can turn out to be wrong.

37. While acknowledging the Treasury's successes in forecasts in past years, in saying a lot of things have changed in this year's

Autumn Statement, it occurs to us the forecasting system may be one of them.

(Sir Terence Burns) That is an incorrect assumption; there has been no change to the forecasting system. There may have been change in some of the people engaged in the forecasting system, as I said earlier, but there has been no change in the forecasting system.

38. In trying to explain your forecast for 1987 exports, in paragraph 1.25 of the Autumn Statement you speak about world markets expecting to grow more rapidly, and then, "This, together with the lagged benefits from this year's gain in competitiveness, suggests that exports should continue to grow steadily." However, in the Autumn Statement of last year, 1985, you said, and again I quote, "The experience of the past five years suggests that export volumes have not been very responsive to price and cost changes."

(Sir Terence Burns) There is no inconsistency in those statements. The statement last year was a relative statement, it was suggesting how responsive it was compared to some other views which had been expressed. It did not say exports were totally unresponsive, and if you recall we had an exchange about this particular subject, and indeed we had a further exchange when I came with the Chancellor, and again you expressed some dismay at my statement, if I remember - or certainly Mr Mitchell expressed those thoughts.

39. It was both of us.

(Sir Terence Burns) We have not changed our view about that, and indeed in the forecasting system which has been operated it is exactly the same impact of changes in competitiveness on imports as last year. There has been a significant change in competitiveness over the past year and even with the relatively small impact of those changes upon exports you would expect to see this shown up in our export performance. I repeat, I do not regard those statements as inconsistent. I never said at any stage there was no impact of changes of competitiveness upon exports, what I said was, we had over the course of the 1980s revised down the size of that impact, but nevertheless it still left a significant effect, and that is what is essential here to produce this slightly faster growth of UK exports than world trade.

40. The words which were actually used were those I quoted from last year's Autumn Statement.

(<u>Sir Terence Burns</u>) But they are not inconsistent with what I have just said, I am sure.

41. We can pursue this on Thursday, but I would like to move to invisibles, because here again I would like to ask why you are able to produce a relatively optimistic forecast for the future of the balance of invisibles and put it for this current year, 1986, to 8½ billion whereas in the Budget it was only 5 billion? That is a very steep increase after only 8 months. I would like to put these figures to you: the official estimated surplus of invisibles for the first nine months of this present year is stated to be 5.8 billion, and that includes nearly half a billion of the delayed rebate from the EEC. The Department of Trade and Industry in its customary press notice about the balance of payments puts in the invisible balance for the final three months of this year, following the nine months I have just mentioned, an invisible balance surplus of 600 million a month. These figures together do not add up to what in the Statement is the optimistic total outcome of 8½ billion for invisibles.

(<u>Sir Terence Burns</u>) Could I check an earlier statement you made? Did you say our Budget forecast had the invisible surplus at 5½ billion, because according to the document I have here it is 8?

tax rates would generate the sort of revenues which people have talked about in the United States as following from those lower taxes.

47. Do you think it would in the future?

(Sir Terence Burns) I think that that is very much a question which you should put to the Chancellor. So far the overall fiscal stance has been a matter of considerable importance to this Government and they have been prepared to increase tax, as they did in 1981, if it was necessary, in order to maintain a credible fiscal stance. I do not see any signs of that overall approach changing.

Mr Mitchell

48. Can I just express my joy that our exchanges on the exchange rate had such a marvellous effective effect on Treasury thinking?

(Sir Terence Burns) I am sorry to disappoint you Mr Mitchell.

49. It does seem a very substantial change from last year.

(Sir Terence Burns) What is the substantial change?

50. You are making the best of a bad job. The exchange rate has gone down, therefore you have to find virtue in that process: what you said would not happen last year will happen because exports will have to increase. You need them to fill the figures in and therefore they will because of depreciation.

(Sir Terence Burns) I appreciate your desire to debate this subject, I really do not think that is fair. The Chancellor made quite clear in his speech some years ago at Cambridge in the face of sharply changing oil revenue there would have to be some real exchange rate change as part of the correcting mechanism. He has continued during the course of the last few months to accept that what we have seen in the way of exchange rate change has been that behaviour in practice. I repeat we have not changed our views about the impact of exchange rate changes or of changes in cost competitiveness upon exports, maybe we should but we have not and in time you will see what the scale of the effect will be.

Mr Mitchell: Not to continue on rhetorical questions: in 1981 when the pound was at its height we were told it was not really all that bad for industry after all and it was making them leaner and fitter and last year we were told competitiveness was not all that important and this year because there is a gap to be filled we are told that depreciation will give certain advantage to which you will allow exports to increase to fill it. Can I move on because I do want to turn on to ---

Chairman

51. A process of mutual education.

(Sir Terence Burns) Chairman, I enjoy this experience where one is fighting for the final word but, out of deference to Mr Mitchell, I will cease to question him.

Mr Mitchell

52. To move on to something there is agreement on: the fact that industry and the economy are being crucified on the cross of high interest rates which are higher than our competitors which means putting up the cost of living higher than it should be and yet you seem to be assuming, as I read the statement, they will continue at this daft level. Is that correct, are you assuming interest rates will continue at this level, maybe even increase?

D

Flag D

TCSC REPORT ON 1985 AUTUMN STATEMENT

We hope that the Treasury's judgments will be borne out by events, but we feel it right to point out that a high number of favourable assumptions carries a commensurate risk of error.

30. The Treasury's forecast of 3 per cent growth in 1986 compares with a range of 1.9 per cent to 2.3 per cent from our independent forecasters.[1] The major contribution to the Treasury's growth forecast is consumption growth of 4 per cent, higher than other forecasts.[2] During questioning, Treasury officials told us that any tax cuts assumed in the forecast would have limited effect on the consumption forecast.[3] Another source calculated that a 2p cut in the standard rate could account for ½ per cent increase in consumer expenditure in a full year.[4] We take the Treasury's point of view that any tax cuts will affect demand for only part of the year.

31. The Treasury's investment forecast of 3½ per cent is above most other forecasts.[5] Their view is that profits which have been accumulating over the last year or two will sustain investment growth (Autumn Statement para 1.30). However, the combination of reduced capital allowances and continued high interest rates makes it difficult to see why the Treasury have become more optimistic since the Budget.

32. The balance of payments current account is forecast to improve by £1 billion. Improved terms of trade are expected to make a substantial contribution to this improvement. However, this situation may be considered as temporary and the current account may appear far less robust when the terms of trade eventually decline. Nor does this estimate take adequate account of the increasingly competitive conditions British exports are likely to find if the dollar comes down and competition grows in other markets. Then British exports will be competing with a whole range of countries, but particularly West Germany and Japan whose labour costs have risen more slowly than ours, whose productivity has grown faster and which has invested more heavily over the last six years. Meanwhile our traders will be carrying the burden of higher interest rates and a pound which is high in real terms, particularly against the deutschmark.

33. The Autumn Statement's discussion of the prospects for manufacturing exports says, *inter alia*, that,

> "The worsening of price and cost competitiveness this year may restrain exports next year, but experience of the past five years suggests that export volumes have not been very responsive to price and cost changes." (para 1.20)

We questioned the Chancellor on this reduction in emphasis on cost competitiveness as an influence on our export performance. In reply he said that,

> "It is important to read the sentence as it is written there. It is not that exports are not responsive to price and cost changes; the point is that they are not *very* responsive. That can be shown simply by comparing what has

[1] Annex, Table 1.
[2] Annex, Table 1.
[3] Q. 15.
[4] Appendix 6, para 2.4.
[5] Annex Table 1.

happened to export volumes with what has been happening to price and cost changes. There is not as close a correlation as perhaps Treasury economists used to think was the case. We always learn by experience and that experience goes into the judgements that produce the forecast".[1]

Sir Terence Burns told us,

"This is one of the issues which are frequently debated amongst people who undertake statistical analyses. We try to analyse what the correlation has been in the past between changes in cost price competitiveness and export volume. From time to time, people change their views. Our analysis of the information led us to the conclusion that looking over recent years, it may be that changes in competitiveness cannot be so closely related to exports as we once thought."[2]

The Chancellor reaffirmed his view that containing costs is important to the economy as a whole. Even so there appears to have been a quite significant change in the Treasury's view of the way in which changes in domestic costs affect UK trade performance. We have not, so far, been given convincing evidence in support of the Treasury's new view.

34. An important aspect of the forecast concerns the sustainability of the economy's performance on growth and inflation. Real earnings growth of 3–4 per cent is expected on the back of productivity growth of 2–2½ per cent. This reverses the position of the last three years in which the economy's underlying productivity growth has averaged over 3 per cent per annum and real earnings have advanced by 2½ per cent per annum. A reversal of the improvement in the terms of trade, slower productivity growth and expectations of continuing increases in earnings growth could put the economy under pressure beyond 1986.

The Planning Totals

35. The Autumn Statement contains a significant innovation. A new series of Tables, Table 2.2–2.2D, provide details of the estimated outturns for 1985–86 for both the planning total and individual spending departments. The same tables also contain projections of departmental spending for the next three financial years.

(i) The Plans for 1985–86

36. Para 2.02 of the Autumn Statement makes the claim that, "the estimated outturn for 1985–86 is £134.2 billion—as in the FSBR". This means that the Reserve of £5 billion, £2 billion of which was added in the Budget, is expected to be fully utilised. Tables 2.2A, 2.2B and 2.2C in the Statement indicate that £3 billion of the Reserve has been allocated to central government; £1.05 billion to local authorities; and £900 million to the Nationalised Industries, mainly to meet further costs associated with the Miners Strike, the total cost of which is now estimated to stand at £3.75 billion.[3] Central government programmes which are expected to spend above plan include Social Security (+ £1.2 billion), IBAP and other CAP expenditure (+ £450 millions), Housing (+ £400 millions), and the Exports Credits Guarantee Department (+ £210 millions).

[1] Q. 146.
[2] Q. 31.
[3] Q. 49.

E

Flag E

[Mr Wainwright *Contd.*]

our exports forecast. Could you tell the Committee what you consider to be the main causes, or what will be the main causes, of this forecast slowing down of growth?

(Mr Lawson.) The real thing to focus on is the increase this year, 1985—the 7 per cent real increase, which really is very remarkable. What did we forecast a year ago for the increase? Nothing like 7 per cent, was it?

(Sir Terence Burns.) No.

(Mr Lawson.) This is a very high rate of growth and it would be unwise to expect to see anything like that continuing. The odd figure is the very high rate of export growth this year.

145. Well, can I direct your attention, Chancellor, to a statement in part explaining this in paragraph 1.20 of your Autumn Statement. I will quote, if I may: "The worsening of price and cost competitiveness this year may restrain exports next year, but experience of the past five years suggests that export volumes have not been very responsive to price and cost changes." Now what are the sources of this experience leading to what many businessmen, especially exporters and many in the commercial sector, will think is a shattering suggestion?

(Mr Lawson.) I do not think many people in the real world will think this is a shattering suggestion. The CBI certainly know full well that there are two other factors that are very important as well as price and cost changes. The rate of growth of markets overseas, which obviously has a considerable bearing, and what is generally known as non-price competitiveness which is also an important factor. I do not think people in the real world who read this will be all that shattered.

146. That is not the sentence I have just quoted. Of course, it is well understood in business. naturally, the buoyancy or otherwise of world markets and quality and aptness of British goods available are important factors. You say here: ". . . experience of the past five years suggests that export volumes have not been very responsive to price and cost changes." If you stand by that what is the meaning of all the admirable exortations to become more competitive with our goods for export, to keep our costs down, to keep the exchange rate at a level where our prices are also competitive? What happens to all that if you stand by your second part of that sentence?

(Mr Lawson.) It is important to read the sentence as it is written there. It is not that exports are not responsive to price and cost changes; the point is that they are not *very* responsive. That can be shown simply by comparing what has happened to export volumes with what has been happening to price and cost changes. There is not as close a correlation as perhaps Treasury economists used to think was the case. We always learn by experience and that experience goes into the judgments that produce the forecast. May I say, too, that it is not the case that keeping costs down is important only in terms of overseas trade. Keeping costs down is important full stop. It is important in relation to the efficiency of the economy and, therefore, the rate of growth. Even in a closed economy it would be important to try and produce the maximum added value by keeping costs low. Wage costs are particularly important if one wants to see, as I do, more people in work. So this is not a factor which is confined to overseas trade. It has a bearing on overseas trade, it is true, but it is something which would be important even in a closed economy.

147. How do you square this astonishing reference to exports not being very responsive to price and cost changes with the appalling experience of exporters in 1981–82 when it is a matter of history that largely due to inflated foreign exchange sterling a large number of well-managed competent businessmen simply had to put up the shutters because on price grounds they were excluded from markets where they had been trading for decades?

(Mr Lawson.) I do not accept the premise of your question, nor the highly coloured way in which you have described what happened then. The Autumn Statement is not saying that there is no relationship between exports and price and cost changes; it is saying precisely what it does say here, that experience suggests that export volumes have not been very responsive to price and cost changes. The precise degree of responsiveness of exports to price and cost changes, is not absolutely central to the Government's strategy, but it is important if we are trying to give you and the House our best guess of the short-term development of the economy based on the lessons of recent experience. Again, if you want to pursue these questions further Sir Terence Burns will, I am sure, be able to tell you what the mathematical equation is in the model which describes this correlation.

[Mr Wainwright *Contd.*]

148. Are you denying it is central to your whole, in effect, appeal to industry to keep its costs and prices down? Was it not central to that appeal hitherto, until this sentence burst on the world, that it was a reduction in prices which would contribute not alone, but very greatly, to enhancing successes in export markets especially in view of the oil surplus gradually diminishing?

(Mr Lawson.) Clearly that is particularly important. But it is important to keep control of our costs for general reasons, not just for overseas trade. It is also important in the overseas trade context because other factors which have a bearing on exports such as the growth of world markets are not under our control at all, whereas industry's costs are a matter within the control of industry itself.

(Sir Terence Burns.) Could I make one extra point? To the extent that price and cost competitiveness does affect exports in the Treasury model it does so with a considerably long lag. Therefore, changes in competitiveness from one year to another, particularly if they are simply reversing the movement that has taken place in the previous year or the previous six months, have very little effect. You also have to bear that in mind when you read the sentence because it is referring to a worsening of price and cost competitiveness this year. It points out that if you simply look at short-term movements of price and cost competitiveness you cannot observe a very clear relationship between them and the short-term movement of exports, providing you also take into account movement of the world trade which has a considerable impact on our export performance.

149. You are saying volumes of our exports do not appear to respond quickly to falls in price and cost competitiveness but that is not what is actually said in the Statement.

(Sir Terence Burns.) If you look at the sentence I think you will see that is part of what is being referred to. It is also the case, even if you look at the cumulative effects over three or four years, that we now estimate the longer-term effects to be less than we did some years ago.

150. You have just told us, Chancellor, at any rate whatever the Statement says about exports—I still find it an unexplained Statement—that prices and costs are very important on other fronts and for other reasons. What is your reaction, therefore, to the statement you made very early in you first page of the Statement that substanti: increases, further increases, in real wage are to be expected in 1986? If that happen and that is your assessment is this not goin to be a blow to cost competitiveness?

(Mr Lawson.) It is not a blow that ha: not been taken into account in the forecast; it is in the forecast.

151. In actuality?

(Mr Lawson.) If the increase in wage settlements is less than we envisage then I think there will be a better outcome all round. The pattern will be different with probably more investment and slightly less growth in consumer expenditure in the short run and probably, in the longer term, more employment. I think this would be a better outturn. But what we are trying to do is give you our best guess, not to give you something seen through rose-tinted spectacles.

152. But your best guess astonishes us, especially those of us who have been on this Committee for a number of years, because both your predecessor and yourself used to come here saying the gradual success of your anti-inflation policy would greatly reduce inflationary expectations and, therefore, without resort to an incomes policy would greatly reduce wage increases.

(Mr Lawson.) Well, it is a fact, of course, that without resort to an incomes policy wage increases have been greatly reduced from what they used to be not so long ago. Some of you may have watched the television programme, "The Writing on the Wall"; in the instalment last Sunday we had Sid Weighell reminiscing about how they turned down 27 per cent. Things have changed, and changed for the better. There are still further changes required, I absolutely agree with you, Mr Wainwright, and in particular the management needs to take a firmer grip of its costs in general and wage costs in particular.

Mr Beaumont-Dark

153. Chancellor, in 1982 our interest rates were 2½ per cent on average lower on the medium rate than in the United States. Our same rates today are 3½ per cent higher than in the United States, that is about a 6 per cent differential. Bearing in mind the hapless policy which America is following, which lacks all guts and reason, because of their unwillingness to tackle their own

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Flag F

[Mr Freeman *Contd.*]

are concerned, a reasonable assumption; a reasonable judgment to take, in the light of the available evidence of the various factors that we expect to influence the exchange rate. It is more in the nature of an assumption or forecast than a target or plan.

29. We talked about the forward market, the forward market for the oil prices. Would it not be sensible to extend that to exchange rates. In other words, at least your forecast would consistently follow the practice you adopt for commodity prices? Have you adopted forward exchange rates?

(Sir Terence Burns.) No, it is one of the factors we take into account, when we make a judgment about exchange rate profiles. By and large, we find it quite useful to ask ourselves, what is being suggested in the market? I think it would be wrong to follow this precisely through to the exchange rate, because the exchange rate is part of a collection of events which are rather nearer home in terms of monetary policy and fiscal policy.

30. Could I move on to the balance of payments and look at exports, to begin with? We are looking at the fairly sharp reduction in the percentage change. This is on page 20 of the Autumn Statement. Exports of goods and services are forecast in 1986 to rise by 2 per cent in real terms, down from a rate of 7 per cent in 1985 and the previous year. What is the main reason for the reduction in the rate of growth of exports in real terms?

(Sir Terence Burns.) There are a collection of factors affecting the behaviour of exports. As far as 1984 and 1985 is concerned, exports have probably done rather better than we would have guessed from the relationships given what has happened to the level of world trade. So there is a significant part of the growth of exports in 1985 which is not explained by our relationships. We have therefore taken a cautious view about 1986. We could have said "1985 has turned out better than we expect, so let us add something into the forecast of 1986". But we have followed a rather cautious approach with regard to exports. Obviously, there are a number of other factors; competitiveness is a bit worse but it only accounts for about 1 per cent or so of the slower growth. Our view, as mentioned in the document, is that it is quite difficult to identify large effects on exports from changes in competitiveness if you look at the data for recent years, taking into account the pattern of world trade. You will see we are following our customary cautious approach.

31. Could you comment on a sentence on page eight, paragraph 1.20 of the Autumn Statement. The penultimate sentence reads: "experience of the past five years suggests that export volumes have not been very responsive to price and cost changes"?

(Sir Terence Burns.) This is the point I have just referred to. This is one of the issues which are frequently debated amongst people who undertake statistical analyses. We try to analyse what the correlation has been in the past between changes in cost price competitiveness, and export volume. From time to time, people change their views. Our analysis of the information led us to the conclusion that looking over recent years, it may be that changes in competitiveness cannot be so closely related to exports as we once thought.

32. It is important to look at the underlying longer term trends?

(Sir Terence Burns.) Yes. And other non-price issues, such as changes in world trade and changing pressures from capacity utilisation. There is also the category of "unexplained movement" and some of the 1985 growth falls into that category. It may signify that exports have been performing rather better over the last year or two, than has been the case in previous years. We will have to see whether it is a sustained change or whether it is simply short-term wobbles. World trade may have been more buoyant than we measured it. That is another possibility. At this stage we are basing our judgments upon estimates of what is happening in the rest of the world. It will only be as time unfolds that we will be able to see what is happening to other countries exports. Then it will be easier to make a judgment about the factors lying behind our own good export performance over the past two years.

33. Could you comment about the import forecast that imports in real terms will rise fractionally next year? What are the main reasons? Is that principally a currency factor?

(Sir Terence Burns.) The main reason, not only in the UK but in a lot of other industrial countries, is that there has been an upward trend of imports in expenditure which has, indeed, gone on for a long time.

2134/001

FROM: A Turnbull
DATE: 20 November 1986

CHANCELLOR OF THE EXCHEQUER

cc PS/CST
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Odling-Smee
Mr Scholar
Mr Gray

UPWARD REVISION OF EXPENDITURE PLANS

You asked how the upward revision of the plans for 1987-88 could be defended.

2. On the attached table A I have marked in the latest plans. This shows that the plans for 1987-88 were originally published at £141.5 billion. They were revised in the Budget and subsequent White Paper to £143.9 billion by 1.7 per cent, and again in these plans by 3.3 per cent to £148.6 billion. In moving 1988-89 forward from year 3 to year 2 it has been increased by 3.7 per cent.

3. These revisions, which of course may not yet have come to an end, are already larger than the average overruns since cash planning was introduced. Table B attached shows that the average overrun on plans made one year earlier has been 0.8 per cent (including the coal strike); on plans made two years earlier 1½ per cent; and on plans made three years earlier 1¾ per cent. It is clear, therefore, that this average will increase as 1987-88 and 1988-89 become actuals.

4. An alternative line of argument is to compare the growth of the economy foreseen in the Long Term Green Paper, with that which has occurred. The Green Paper assumed growth of 2¼ per cent a year between 1983-84 and 1988-89. In fact growth has been 2.9 per cent and a further 3¼ per cent is foreseen next year. While it is better to set expenditure plans low and then revise them upwards if growth is better than expected, in contrast to practice in the 1970s, the weakness is that by 1987-88 real GDP may be only 2.7 per cent higher than assumed in 1984 but

public spending has been revised up by more; GGE in real terms in 1987-88 may be 6-7 per cent higher than envisaged in the 1984 FSBR.

AT

A TURNBULL

 TABLE A

Main changes in the plans

60 Table 1.9 gives figures for developments in the aggregate planning totals between successive sets of plans. It shows, for each year since 1980-81, how the latest planning totals and outturns compare with the plans when they were first set.

Table 1.9 Public expenditure[1] plans and outturns

£billion

plans

outturns and estimated outturns

	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89	
March 1980 White Paper (Cmnd 7841)[2]	91.2	101.0	106.3	112.4						
March 1981 White Paper (Cmnd 8175)[2,3]	92.8	104.4	109.9	113.6						
March 1982 White Paper (Cmnd 8494)[3]	93.0	105.7	114.6	120.7	127.7					
Feb 1983 White Paper (Cmnd 8789)	92.7	104.7	113.0	119.6	126.5	132.3				
Feb 1984 White Paper (Cmnd 9143)	92.7	104.7	113.4	120.4	126.5	132.1	136.7			
Jan 1985 White Paper (Cmnd 9428)	92.7	104.6	113.4	120.3	128.2	132.1	136.7	141.5		
March 1985 Budget (FSBR)	92.7	104.6	113.4	120.3	129.7	134.2	139.1	143.9		
This White Paper	92.6	104.0	113.3	120.3	129.6	134.2	139.1	143.9	148.7	
Autumn Statement 1986	92.6	103.9	113.4	120.3	129.8	133.6	140.4	148.6	154.2	161.5

[1] *Public expenditure planning total as defined in this White Paper.*

[2] *Converted into cash as explained on page 103 of Cmnd 8191 Vol. 2.*

[3] *Including changes announced in the March Budget Statement.*

61 Chart 1.10 shows the main changes for departmental provision (including local authorities and public corporations) in 1986-87 compared with the last White Paper.* Estimated proceeds from privatisation have increased and there have been transfers to departments from the higher Reserves provided for in the 1985 FSBR. The main increases are for social security, employment, health and personal social services, education and science, and housing. Provision for roads has been increased, within a small overall net reduction for transport reflecting reduced finance for the railways.

**Figures for the Department of Energy are not included in the chart. In the run-up to privatisation, figures for the financing of the British Gas Corporation have been treated differently in this White Paper from Cmnd 9428 and this substantially distorts any comparison for the total Department of Energy figures.*

TABLE B.

AVERAGE OVERRUN ON PLANNING TOTAL

	One year ahead		Two years ahead		Three years ahead	
1982 PEWP	114.6					
1982-83	113.4	-1.0%				
1983 PEWP	119.6		120.7			
1983-84	120.3	+0.6%	120.3	-0.3%		
1984 PEWP	126.5		126.5		127.7	
1984-85	129.8	+2.6%	129.8	+2.6%	129.8	+1.6
1985 PEWP	132.1		132.1		132.3	
1985-86	133.6	+1.1%	133.6	+1.1%	133.6	+1.0
1986 PEWP	139.1		136.7		136.7	
1986-87	140.4	+0.9%	140.4	+2.7%	140.4	+2.7
Average		0.84%		1.53%		1.77
Excl coal strike		0.44%		1.02%		1.12

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HOUSE OF COMMONS

MINUTES OF EVIDENCE

TAKEN BEFORE

THE TREASURY AND CIVIL SERVICE COMMITTEE

THURSDAY 20 NOVEMBER 1986

THE RT HON NIGEL LAWSON, MP, SIR PETER MIDDLETON, KCB,

SIR TERENCE BURNS and MR A TURNBULL

Evidence heard in Public Questions 82 - 156

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THURSDAY 20 NOVEMBER 1986

Members present:

Mr Terence L Higgins, in the Chair
Mr Anthony Beaumont-Dark
Mr John Browne
Mr Nicholas Budgen
Mr Ralph Howell
Mr Austin Mitchell
Mr John Townend
Mr Richard Wainwright
Mr John Watts

THE RT HON NIGEL LAWSON, a Member of the House, Chancellor of the Exchequer, examined.

SIR PETER MIDDLETON, KCB, Permanent Secretary, HM Treasury, called in and examined.

SIR TERENCE BURNS, Chief Economic Adviser, and MR ANDREW TURNBULL, Under Secretary, General Expenditure Policy Group, HM Treasury, called in and further examined.

Chairman

82. Mr Chancellor, may I welcome you on behalf of the Committee to what has now become a traditional annual event, namely, your evidence on the Autumn Statement in preparation for the report which we hope to prepare for the Floor of the House of Commons. You are indeed most welcome. You will have noticed that, although the view from your present seat has not greatly changed from the previous one, there are a considerably greater number of people sitting behind you. I hope this is advantageous from your point of view, but it does, however, create a bigger problem as far as the acoustics are concerned, because obviously it is difficult for those at the back to hear. That being said, we are glad you are able to come. Perhaps I might first ask you, in very traditional form, to introduce your officials for the benefit of the shorthand writers, and also ask whether there are any preliminary remarks you care to make.

(Mr Lawson) Thank you very much indeed, Mr Chairman, for your words of welcome. As you know, I am always happy to appear before your Committee. ~~(I hope those behind me can hear what I am saying.)~~ On my right is Sir Peter Middleton, Permanent Secretary to the Treasury; on my left is Sir Terence Burns, Chief Economic Adviser; and on the far right is Andrew Turnbull, Under Secretary in charge of the General Expenditure Policy Group. You kindly invited me to say a few words and, if I may, I will say a few words about three subjects: first, the continuity of the Government's approach to public spending; secondly, public sector borrowing next year; and, thirdly, the prospects for economic growth. On public expenditure, I have announced an increase in the planning totals for 1987-88 and 1988-89 within the overall constraint of ensuring that total public expenditure continues to decline as a proportion of GDP. Even excluding privatisation proceeds, we have reduced the proportion of national income taken by public spending every year since 1982, and the plans set out in the Autumn Statement carry that process on a further three years. By the end of the current planning period, in 1989-90, the ratio of public spending to national output will be back to the level of the early seventies. Some commentators have professed to see a discontinuity in all of this. There has been, it is true, a discontinuity, but that was back in 1982-83 when general government expenditure as a proportion of GDP stopped rising, as it had been doing continuously once the immediate aftermath of the IMF crisis in 1976 was over, and went on doing until the legacy of the Labour Government had worked its way through the system. Since then this ratio has declined, just as the rate of growth of public spending in real terms has declined, even excluding privatisation proceeds, from about 3% a year in the decade up to 1979 to about 2¼% a year during our first Parliament, and about 1¾% a year in the present Parliament so far. The increase envisaged in the Autumn Statement over the next three years is at the still lower rate of 1% a year. The same continuity of policy may be seen in public sector borrowing. In successive versions of the MTFS my predecessor and I have mapped out a course for the PSBR in which it would gradually diminish as a proportion of GDP. Throughout my time as Chancellor I have stuck firmly to this. In successive budgets I have set the PSBR at or a little below the level given in the previous year's MTFS. And apart from 1984-85, when I allowed public borrowing to expand to finance the expenditure needed in resisting the coal strike, the outturn on the PSBR has been broadly in line with that envisaged at the time of the Budget. For this financial year, the figures published on Tuesday of this week confirm that the PSBR remains on track. For next year I have, exceptionally, gone further than is usual at this time of year so as to dispel from the start any worry there might be that the increased planning totals imply a relaxation on public borrowing. I have therefore explicitly reaffirmed the Government's commitment to the fiscal stance set out in the 1986 MTFS, and made it clear that the PSBR next year will be held to 1¾% of GDP. Finally, Chairman, I turn briefly to the prospects for growth over the coming year. The past five years since the world recession of 1980-81 have seen a remarkable stability in the growth performance of the economy. Growth has averaged almost 3% a year over the whole of this period, without very much variation from year to year. There has been a relatively brief pause earlier this year, but that has now passed, as I predicted it would, and the Industry Act forecast suggests that it is set to continue at this rate in 1987. This expected growth is not, as some critics have asserted, the result solely of a fragile and very rapid growth of consumer spending. The forecast is for a somewhat slower rise in consumer spending next year, much faster growth of non-oil exports - something which has already begun in the second half of the current year - and continuing growth in non-oil business investment from its record level this year, broadly in line with the growth of the economy as a whole; in other words, balanced growth.

83. Mr Chancellor, thank you for introducing your officials. Perhaps I might take this opportunity of expressing our appreciation to Sir Terence Burns and his colleagues who gave evidence on Monday; it was very helpful. I turn immediately to the point you made in your opening remarks regarding the continuity of government policy. I ask you to turn your mind back to early 1980 when you were Financial Secretary, a post much older than that of Chancellor of the Exchequer.

(Mr Lawson) Is it?

84. Yes, indeed. I ask you whether it was the case at that time that the Government's intention was to reduce public expenditure progressively in volume terms?

(Mr Lawson) That aspiration has never been achieved, as you see by looking at the figures, and therefore it was a long time ago that we ceased to talk in those terms. I cannot remember when that was, but it always seems sensible to me that the description should correspond with reality.

The reality is that, in addition to saying what you have referred to ~~that~~ in 1980, we ~~also~~ said in the 1979 Manifesto, and I think we also said it in the document "The Right Approach to the Economy", which was a quasi ~~stated~~ economic manifesto published before the 1979 Manifesto proper, that we thought that public expenditure was taking an excessive share of GDP and we wished to see it progressively decline. That theme has been there continuously ~~continued~~ and it is that which accurately describes ~~describe~~ what has happened since 1982/83. It is that which also characterises the public expenditure plans which are published in the Autumn Statement. As I say, this is a remarkable change from the historical trend, which has been towards a steady increase in public expenditure as a share of GDP. It was slightly curious during the Labour Government, when you had an astonishing rise of something like 12 per cent, in real terms in the first two years ~~and then~~ followed by the great disaster, the ~~collapse of~~ bailing out by the IMF in 1976 and so on; ~~and~~ then you had an almost equally sharp fall, as capital expenditure was cut drastically. So you had during that period an inverted 'V'. But the long-term trend has been public expenditure rising faster than the growth of the economy as a whole and that is what we have sought to reverse and that is, indeed, what we <u>have</u> reversed. ~~and~~ The plans continue that trend.

85. But if we then look at what happened between 1980 and, say, 1984, the policy then seemed to be to keep the level of public expenditure broadly stable in cost terms, is that correct?

<u>(Mr Lawson)</u> As I say, if you look at what has actually happened there has been a continued growth in real terms of public expenditure, but the growth ever since 1982 ~~was~~ has been less than the growth of the economy as a whole. So the ~~rate of growth~~ share of GDP has been declining; and the rate of growth of public expenditure has been declining, as I say, within that period. ~~We have improved the rate of growth.~~

The rate of growth of public expenditure in real terms during this Parliament has been less than the rate of growth in real terms during the last Parliament, despite the fact that in a sense it is easier to make reductions at the beginning of a period of office, simply because you make the easy changes first and it then gets progressively more difficult. Nevertheless, despite that we have improved our performance if you accept the overall objective. As I say, I think the presentation I used in this Autumn Statement accurately represents the reality not merely of what is planned but also what has been happening since 1982/83.

86. Nonetheless, in terms of the continuity of policy, the objective in 1980 was to reduce public expenditure in real terms, by 1983 it was to hold it constant in real terms and we are now in a situation where it is the growth which has to be reduced rather than the absolute level and it has to be reduced as a percentage of GDP? That is a fair assessment of the way in which the policy has developed, is it not?

(Mr Lawson) I would say it is the way in which the presentation has developed rather than the policy. I think the policy has been consistent throughout and you can see a practically straight line on the graph showing what we have done ~~thought~~. As I say, in so far as there has been any change it has been an improvement. The rate of growth in real terms of public expenditure has slowed down. I think it is the presentation which has changed slightly. I would not want to make too much of it. If you think of the extraordinary cataclysmic changes there have been in previous governments with the policy turning round 180° and all you can find here is a minor change in presentation, I think that is quite remarkable.

Chairman: No doubt we will wish to study carefully what you have just said. Can we turn now to the question of manpower, and you will not be surprised that I am going to call on Mr Ralph Howell!

Mr Howell

87. Chancellor, may I congratulate you on the way in which you have presented your Autumn Statement, so that you please practically all your supporters and confound almost all your opponents. I would also like to say how pleased I am that you are maintaining your course of reducing public expenditure as a percentage of GDP. There are two points which I am sure concern us all and one is the fact that local government is not properly under control, having spent 9 per cent. more than was intended, and also that the manpower watch figures show that we are employing more people in local government than we were a year ago and there has been a rise since 1982. What can be done to counter this?

(Mr Lawson) I have no doubt whatever that you have identified a major problem. You will know what we have done already to try and influence local government spending through the way in which the rate support grant operates and through the introduction of rate-capping in the cases of the worst ~~overspending~~ overspenders. We have no control at all over local government manpower, none whatever, and the position is not satisfactory. I have before this Committee previously said that in my opinion the constitutional position we have in this country between local and central government is very unsatisfactory. We have a typically British compromise ~~but this~~ which arguably gives us the worst of both worlds. We neither have the out-and-out centralisation ~~that~~ of a unitary state carried to its logical conclusion, as they have in France, nor do we have a federal constitution as they have in Germany. So there is just a mix and a muddle and nobody knows who is responsible for what, which enables local authorities, if they are so minded - and a number are - to act in a wholly irresponsible manner. This was kept in check in the past by a kind of concordat. It was one of the conventions of the constitution that local government, even though it was not obliged statutorily to do so, nevertheless conformed to the overall economic policy of the government of the day, whatever government it happened to be. But that progressively has broken down and certainly now, with a large number of local authorities under Labour control, many of them, ~~but~~ though not all, have not the slightest intention of co-operating with the economic policy of the government of the day. As I say, that convention of ~~getting the show on the road~~ co-operation has gone, so we have to think of changes. There are two ways in which this is being approached now. One is the proposals we have made for changes in the method of local government finance, which ~~is~~ are designed to bring a much greater degree of local accountability, accountability by local authorities to their electors. ~~Obviously~~ Pretty well everyone will pay the community charge whereas only a relatively small number of people pay rates. ~~so it is to get that local authority accountability that we are going to try and get a change that way.~~ We are seeing another change, too - and I do not know where it will lead at the end of the day - in the situation which has arisen over the pay of teachers. When you think that education is easily the biggest single item in local authority expenditure and ~~the fact~~ that teachers' pay is a very large part of that, the fact that we have now decided to scrap the Burnham machinery altogether and make a major change in this field is an indication of another way in which this problem can be addressed. Meanwhile, we are going to have this problem over local authority spending and it is something we ~~are going to~~ have to live with.

88. The other major subject is the problem of DHSS spending and the open-ended nature of the social security package. Have you any plans for limiting some of the huge amounts of money which are being paid, often to people who are not really, in many cases, in need?

(Mr Lawson) We are certainly taking various steps to try and ensure that money is not paid to people who are not entitled to it, ~~and~~ to strengthen the administrative side of the DHSS in this respect, and also to reinforce ~~reinstate~~ which fell ~~it has fallen~~ into disuse ~~perhaps~~ through a false economy which we took on the staff side in the early years - the Availability For Work test for Unemployment Benefit and Supplementary Benefit. But there are no plans to deprive people of what they are actually entitled to.

89. But surely something must be done in the case which has recently come to light of a family costing £2,000 a week. Another example was where somebody had got in trouble in his business and had taken out a very large mortgage on his house and was costing the State £1,200 a month. Surely there must be some urgency to put a top limit on such payments so that such examples could never happen again.

Mr Mitchell: Is this the City of London or the DHSS?

Mr Howell

90. I am talking about payments which are being made.

(Mr Lawson) I am not sufficiently familiar with the case you mentioned to know the precise circumstances ~~of~~ and whether the family concerned ~~is~~ was entitled to that amount of money or not. If they were not, then clearly steps need to be taken to see that that does not happen. I think that it is clearly something which has to be kept under review, and we did have a major review of social security, as you know, quite recently under the Secretary of State. ~~and~~ Various changes are to come into operation - I think most of them in April 1988 - as a result of the outcome of that review.

91. Could I turn to the question of wages rising faster than you would like. Do you agree that as long as we have fully indexed benefits, tax-free, that will cause an upward pressure on lower wages, which will ricochet all the way up the scale?

(<u>Mr Lawson</u>) Most of ~~the~~ benefit~~s~~ expenditure is ~~are~~ not now tax-free. Child Benefit is tax-free, but most of the ~~other benefits have~~ rest has either always been tax~~ed~~able, like ~~the~~ pension~~s~~, or ~~are~~ is on benefits which we brought into tax, like Unemployment Benefit. But ~~I think~~ certainly a case can be made for saying that the level of benefits does cause the level of unemployment to be higher than it otherwise would be. I cannot quantify how much higher, but ~~I think there have been various academic studies,~~ I know that academic studies done by economists ~~in~~ about the Thirties suggested that what happened was that ~~when~~ you had prices and wages actually falling but benefits staying the same in cash terms, so that they were actually going up in real terms, that was a major contributory cause of the high level of unemployment. But as I say, we have no plans to make any changes other than the plans which have already been announced in the light of the ~~Fowler~~ Secretary of State's Review.

92. My last question is while everybody is concerned at the level of unemployment and wish to do everything possible to reduce it, are you equally concerned at the labour shortages which are developing in many parts of the country? Even in my constituency, where we have above average unemployment, employers are having great difficulty in recruiting in many instances. I feel this is going to cause considerable trouble as the economy tries to expand.

(<u>Mr Lawson</u>) There are some shortages of particular skills, although I must say that my sympathy for employers is slightly tempered by the lack of investment they make in training. The ~~major~~ main answer to a lack of skilled people, if the labour market is working that way, is to train people. ~~and indeed, people have many skills now.~~ Partly because of ~~the~~ developments in technology you can train people far, far quicker to do these jobs than through the old methods, when you had a long apprenticeship; ~~but certainly~~ with modern machinery people can be taught much more quickly. I think it is a great weakness in this country that British industry and British employers spend so little money on training, and I think this is something which is being increasingly recognised. You may recall I mentioned this in my Budget Speech. It is a weakness, and the time was when profitability in industry was so low that it was understandable; ~~they thought they~~ businessmen could not afford ~~it~~ to spend money on training. That is no longer the case. There has been a very welcome recovery in profitability, and I would like to see more money spent on training, which is, I think, the answer to ~~that~~ the problem of skill shortages.

Mr Townend

93. I was intrigued listening to your reply to the Chairman when you said the changes in public expenditure policy in the White Paper were presentational. Can I remind you that as recently as the Budget you did say in real terms the planning total is expected to remain broadly constant over the period 1988-89. Most people would consider that is a significant change in policy.

(Mr Lawson) As I said in my opening remarks, we have increased the planning total. If you look at the previous planning totals, the "broadly constant" was a description of a gently rising trend in real terms but by a very small proportion; ~~and~~ it was a very small percentage amount; and it marked a big improvement on the trend previously. That proved in the event to be over-ambitious, and therefore the planning totals have had to be increased slightly, although the growth projected is still ~~is~~ less than the growth has been in real terms in the past, throughout the whole of the period we have been in office. ~~a slower rate of real growth than projected.~~

94. Can I turn to this financial year, where despite a very large reserve, we have overrun on expenditure. Would you agree that if you take account of the unwinding of the effect of the coal strike and delete asset sales, in actual fact the underlying increase in expenditure is something like £6 bn over the previous year, which is an increase of some 4.3 to 5 per cent., which is actually greater than the increase in GDP?

(Mr Lawson) I do not. I think that the figures that you take for the effects of the coal strike are figures which we would no longer agree with. We have revised, in the light of greater knowledge, our estimate of the effect of the coal strike in 1985-86, so the growth would not be, on the coal strike adjusted basis, as great as that.

95. What would that be?

(Mr Lawson) I do not know whether Mr Turnbull has the figure in his head; I do not.

Chairman

96. Has it been published?

(Mr Lawson) No, it has not been published.

Mr Townend

97. We were given a figure last year of £1.25 bn.

(Mr Lawson) In the light of greater knowledge, we have revised that downwards. I do not know what the latest estimate is, but it is lower than that. You also have to recall that in 1985-86 public expenditure was exceptionally low. I think that really it is better to look at the two years from 1984-85 to 1986-87 together. There was a marked dip in 1985-86, as is clear if you look at the graph, which ~~I suppose~~ was partly due to inflation being higher in 1985-86 than we expected. In the same way, of course, inflation has been lower in 1986-87 than expected. If you are on a cash planning system, which we are, then - although I do not think this is the only reason - you tend to have fluctuations in real terms of that kind. Indeed, to some extent it ~~inhibits~~ is inherent in the system of cash planning ~~as well~~.

98. Having accepted that, even if the figure for the coal strike were half the figure of £1.25 bn, the increase would still be in percentage terms higher than GDP. Perhaps I can go on to another question.

(Mr Lawson) The plain fact is that the figures are here. The figures in the Autumn Statement would show that even if you exclude privatisation proceeds, then as I say, each year, including 1986-87, on our latest estimates - of course, the year is not over yet - there is a reduction in public spending as a percentage of GDP. If you take a run of three years: 1984-85, excluding privatisation proceeds, 46.25 per cent.; 1985-86, sharp fall to 44.75 per cent.; 1986-87, small further fall to 44.5 per cent.

99. That is not allowing for any unwinding at all of the coal strike.

(Mr Lawson) That is what has actually happened.

Chairman

100. Perhaps we might have a note which would clarify what the figure now is for the coal strike.

(Mr Lawson) I do not know whether Mr Turnbull can help.

Chairman: I think we should move on. Let us have the figure later and we can analyse it.

Mr Townend

101. On Table 1.15 under "General Government Consumption", which is fairly static in the first and second half of 1985 and the first half of 1986, it suddenly jumps sharply in the second half of 1986 and then levels off again. Can you explain why that has happened?

(<u>Mr Lawson</u>) Let me just get the Table.

102. It is page 24 of Table 1.15, "General Government Consumption." Three ~~quarters~~ halves: the first and second ~~quarter~~ half of 1985 and the first ~~quarter~~ half of 1986 it is fairly stable. Then you get a big jump in the second ~~quarter~~ half of 1986, and then it becomes stable again. Can you explain that big jump in those two half-years?

(<u>Mr Lawson</u>) There may be other factors, but I will ask Mr Turnbull, because it is on the public expenditure side. Perhaps I should not speculate, but public expenditure does have these patterns.

(<u>Mr Turnbull</u>) One possible factor here is the pattern of teachers' pay. During the year 1985-86 there was effectively no increase. If there was a settlement reached in the middle of March 1986, that ~~would~~ could account for some part of this.*

Chairman

103. How much?

(<u>Mr Turnbull</u>) I could not give you a figure for that.

Mr Townend: It must be more than teachers' pay with a jump as sharp as that.

Chairman

104. What are the other factors?

(<u>Mr Turnbull</u>) We will have to go into the detailed figures to see what the various increases are.

Footnote:
* The Treasury note confirms that, unlike real terms changes in the planning total and general government expenditure, the volume terms figures shown in the forecast would not be affected by a rise in teachers' pay.

(Mr Lawson) I will be happy to let you have a note on that. There is nothing to hide at all. Quite what the incidence is of various factors I do not know. Teachers' pay ~~could~~ ~~will undoubtedly~~ might possibly be one of the factors.

Mr Townend

105. Turning to the reserves, in the current year we have over-run expenditure in spite of reserves; in the coming year the reserves are 20% less. You have said you are confident that that figure will be adequate, but presumably it must depend on public sector pay increases keeping within or perhaps just above inflation. Is that correct?

(Mr Lawson) The reserves are what I consider to be adequate taking into account everything, including departmental running costs. ~~and what might happen~~. All the contingencies are covered. ~~there~~. The reserves are, with the exception of last year, the highest we have ever had both in absolute terms and as a proportion of the planning total. Last year, in ~~In~~ the first year's plans there was a very, very tight figure given for increases in local authority spending. In the subsequent years there was no further increase at all; the same cash figure was rolled on, and it was explained that this was purely ~~the~~ a convention. We did not expect ~~it~~ that to happen, but we had not at that time been able to ~~come~~ agree to what the figure should be, so we put in a big reserve. This year there is a much bigger increase in local authority current expenditure, ~~which~~ what we believe to be a realistic estimate - and so on for the subsequent years - and therefore reserves on the scale of last year are not required. And this year's reserves are ~~It is~~ bigger than in any of the previous years, other than last year. I was interested in reading the various scribblings just before the Autumn Statement where there was a general consensus that reserves of this size - £3bn-£3½bn - would be necessary, and I was criticised in advance for an alleged desire to bring the reserves down to £2bn. In fact the reserves have been set at a figure which I consider adequate and which before the event the scribblers would have considered adequate as well.

106. Obviously, if public sector wages go up along the line of the recent firemen's settlement of 7% the situation could be different.

(Mr Lawson) I do not think you should draw any conclusions from that.

107. It would seem to me, looking at the figures, that if you were able to stick to the planning totals which were put out in last year's Autumn Statement, at the next Budget it would be well within the realm of possibility for you to be able to achieve your aim of bringing the standard rate down to 25p. Do you agree that by having increased spending in 1987-88 by over £4bn that aim will have to be deferred?

(Mr Lawson) Certainly I would agree with that. As I said in the House in the questioning that followed the Autumn Statement, a pound used in additional public expenditure is a pound which is not available for reductions in taxation, unless you are prepared to ~~extend~~ expand the borrowing requirement, and I have made it clear and explicit that that I will not do.

Chairman

108. Chancellor, I think we want to move on to the fiscal stance about which Mr Wainwright has some questions, but may I say we would appreciate a note about the point made on Table 1.15. We were under the impression that these were figures given in volume terms and therefore they excluded teachers' pay.

(Mr Lawson) I am not sure. ~~they would include teachers' pay if they were in volume terms.~~

Mr Wainwright

109. It would be helpful in compiling our report if you could describe what are the main instruments of your counter-inflation policy.

(Mr Lawson) The main instrument of counter-inflation policy is, and always has been, monetary policy, and the essential instrument of monetary policy is the interest rate.

110. Moving on to the public sector borrowing requirement, your Autumn Statement very rightly stresses the immense number of uncertainties to which the British economy is unavoidably subject; it is out of British control. In those circumstances, how unconditional is your PSBR target of £7bn?

(Mr Lawson) It is a firm commitment which I have given. I was not obliged to give it but I chose to do so.

111. But apart from extraneous uncertainties, it is a notoriously difficult subject because, as you rightly said in your 1985 Autumn Statement, "the average errors in PSBR forecasts at this time of year [autumn] have been ¾% of GDP, equivalent to £2½bn." That being so, how do you reconcile your statement that the PSBR will not be a penny piece more than £7bn?

(Mr Lawson) I ~~understood~~ thought it was quite clear, and I am sorry that some people do not understand it. What I was talking about was the PSBR which I ~~was~~ will be setting in the Budget in the normal way, which I do every year in the Budget and ~~which~~ previous Chancellors have done likewise. I cannot guarantee that at the end of the year the PSBR will in fact turn out to be what I have said at the time of the Budget. But, as I said earlier, with the exception of the coal strike year, which was quite exceptional and explicitly so, where there was a sudden shock which I decided it would be right to ~~tack~~ take on ~~to~~, the borrowing requirement, the outturn has been pretty close to what I said at the time of the Budget; sometimes a little above and sometimes a little below. Last year's outturn was below it and this year so far it seems to be on track. I did touch on this ~~shock~~ in my Lombard Association speech. Dealing with fiscal policy, I said that one of the guidelines of fiscal policy is to set the PSBR at a level which not merely can be comfortably financed in a non-inflationary way but which has a margin, so if there is a shock of the kind we had because of the coal strike you can still finance it in a non-inflationary way, which is what we did. However, I am not anticipating or expecting a coal strike in 1987-88.

112. Without anticipating a coal strike - God forbid! - you are yourself on record as saying, very rightly, that the PSBR figure, which is the residue of two enormous totals, is subject to errors which average £2½bn. If there were to be an overshoot of that order, would you finance it by increasing the PSBR or raising taxes?

(Mr Lawson) That is a purely hypothetical question, and the important thing which I think the Committee should focus on is that they have been told that the PSBR will be set at 1¾% of GDP; and that is a genuine figure which, within a margin of error, will be the outcome.

Mr Budgen

113. You know that you are widely and rightly admired ---

(Mr Lawson) I did not know that!

114. --- for the medium-term financial strategy and for your Zurich speech as evidence of your implacable determination to eliminate inflation and to make that elimination more important than any other objectives of either economic or political policy. Therefore, we have all been very interested to read your recent statements about monetary policy. The position is at present that you find the monetary aggregates are no longer a satisfactory guide to future inflation?

(Mr Lawson) This is a very important subject and a very complex one and that is why I thought it right - and when I last met this Committee (it was just before then) ~~and~~ I told the Committee I was going to make the speech - to set out how we operate monetary policy and why, very clearly and very lucidly. It is not perhaps ideal bedside reading but ~~that is why there~~ in it I have set out – more fully than in most countries – how we operate monetary policy. It is all there in my Lombard Association speech. Certainly it is true, if you take broad money, particularly the best-known broad money aggregate, ~~one~~ £M3, – though ~~but~~ it is true for the other broad money aggregates as well – there is not a clear relationship between their growth ~~of that~~ and the growth of money GDP, which is what the core of the policy is. ~~and,~~ Therefore, one needs to interpret it carefully. This is not new, incidentally. I think it is becoming increasingly difficult but it happened right from the beginning, from 1980, as I recall, and we have increasingly had to put weight on MO ~~broad money~~ - and I introduced this as soon as ~~since~~ I became Chancellor and it is a useful guide - and on the exchange rate. As I say, the policy and the way it is practised and implemented is set out very fully in my Lombard Association speech. Other countries, too, are experiencing similar difficulties at the moment. Germany started targeting central bank money, as they call it, a composite aggregate~~s~~, in 1975 and they have hit the target every year since 1978. But ~~and, indeed,~~ this year they are well above it ~~now and~~ yet I do not think there is much fear of a great resurgence of inflation in Germany.

115. Can I use an old-style expression, "overheating", and can we look through the indicators in the economy and ask you whether they might indicate overheating. For instance, could you remind us by how much on average London house prices have increased in the last year?

(Mr Lawson) I do not have the figure offhand.

116. Can I suggest about 20 per cent. Might that not be an indication of overheating and loose credit?

(Mr Lawson) I think that if one is trying to assess whether there is what you call overheating - and by that I understand you to mean that the economy is running up against a supply constraint, that it cannot meet the demand that there is in the economy - you have to look at all the evidence. ~~and~~ I must say, looking at all the evidence all over the country, I do not believe there is overheating, nor does it really emerge out of the CBI surveys.

117. But you keep referring to "all the evidence". Let me go through a few of the pieces of evidence and you tell me which of the pieces of evidence I have left out.

(Mr Lawson) A change in relative prices, which is what you are talking about, is not evidence of overheating.

118. Might not house and property prices be one piece of evidence in the mosaic?

(Mr Lawson) Yes, they might.

119. Might share prices be one piece of evidence?

(Mr Lawson) Not of overheating in a direct sense.

x Certainly share prices might be an indication of financial ~~deficiency~~ laxity.

120. Do you agree with the Governor of the Bank of England that liquidity in the company sector may be an indication of easy credit?

(Mr Lawson) No, I would not say that liquidity in the company sector is evidence of excessive ~~easy~~ credit.

121. Did not the Governor say that there were dangers from the present level of liquidity in his Loughborough speech?

(Mr Lawson) There are two issues here. There is the question of whether the growth of credit is presaging increased inflation, and those who watch it very carefully ~~certainly~~ have to form a judgment about that based on all the other financial indicators and what is happening in the economy. Then there is the quite separate question of whether there are prudential risks in the extension of credit in particular cases.

122. But dangers to the banking system as opposed to dangers to future policy?

(Mr Lawson) That is right.

123. Let us go through a few of these guidelines. For instance, might not wage increases running at between 7 and 8 per cent. - and I am talking about average manual workers not the more favoured sector in the City - be an indication that credit has become fairly lax?

(Mr Lawson) I do not think so. We do have a problem, as I have said on a number of occasions, of an excessive growth of unit labour costs as a result of excessive growth of wages in the economy. But this is something which is not new, and if you are going to say that is a sign of overheating, of inflationary pressure, then you have to say that that has been the case for some years now, ~~and~~ yet what we have seen is inflation coming down to the lowest level for something like 20 years. The pay problem ~~It~~ is much more closely connected with the level of unemployment - a point I have made on previous occasions.

124. For instance, yesterday Sir Peter Hordern drew attention to the level of new hire purchase credit - I am sure your advisers have it, it is paragraph 610 - and he said, and I expect he got it right, that the level of hire purchase new credit in 1981 was £7.8 bn, by 1985 it had risen to £13.5 bn and in the first six months of this year it rose 50 per cent. He went on to say that the same sort of figures were to be seen for bank lending. I expect you were present and heard those remarks?

(Mr Lawson) Yes, I was present.

125. If those figures are true, is that not an indication that the economy is enjoying a dangerously fast consumer boom?

(Mr Lawson) First of all, as I say, over the past five years the economy overall has been growing at a pretty steady rate of around 2½-3 per cent a year or thereabouts and there has been no great change in that. The upswing ~~steadiness~~ is quite remarkable, both in its steadiness and its duration, which contrasts quite markedly with previous upswings. Then if you look beyond the overall pattern of what has been happening to the economy and look within it, ~~as you are doing in various aspects of it~~ to see whether you think there is overheating, you point to some factors. One could point to other factors. One could point to the level of unemployment, which is still high, although I am glad to say it now appears to be coming down; one could point to the amount of overtime working, which is lower than a year ago ~~relatively low~~; the fact that the most recent CBI surveys say that what is most likely to limit output is lack of demand rather than capacity constraints. If you look at the level of unskilled vacancies, which is rising all the time, it is still not historically high. The same is true of skilled vacancies. Despite the shortages, the level of skilled vacancies is not anything like as high as it was when we had overheating in the economy in the past. If you look at land prices throughout the country, there is no sign of overheating there.

126. Chancellor, that is not so.

(Mr Lawson) Yes, it is so. If you look at MO, which is a very useful indicator, ~~there is no rising there~~ it is edging up a little bit, and this is one of the reasons why I decided the interest rate should go up by one per cent last month. But MO is still within ~~the~~ its target range. Outside London house prices are not rising at anything like the rate at which you indicated they are in Central London - I take your word for it - and, indeed, there are some signs ~~of a rapid~~ that the rate of increase in house prices outside London may be falling off a bit. One has to make an assessment based on all of the evidence and not on a part of it.

127. Just taking up two of the points you made, could you please tell us of any occasion when the CBI has complained that demand has been excessive?

(Mr Lawson) There ~~are~~ have, certainly, been such occasions, in CBI surveys.

(Sir Terence Burns) Two of the CBI ~~points~~ indicators, the Chancellor mentioned - skilled vacancies and firms constrained by capacity shortages - ~~a number of those and his Budget of 1972/73~~ showed very high figures in 1972-73. What you have to do is look at these figures relative to the historical average. And if ~~they are~~ you do compare the position today relative to the historical average ~~when you look at these~~ you will find there are not the signs of pressure.

128. It is true, of course, as far as agricultural land is concerned, but there is an indication that forces in agricultural land think that eventually the Common Agricultural Policy will come unstuck, is there not?

(Mr Lawson) Maybe Central London is a similar special factor.

129. As far as development land is concerned?

(Mr Lawson) ~~Central London houses~~ I really do not think that a change in relative prices, as I said earlier, is a sign of overheating. ~~you will always find something,~~

130. Just a final point: on development land it is not a question of change in relative prices, development land has gone up very fast throughout the whole of the country, is that not a particular indication of loose credit just as it was in the period 1972 to 1974?

(Mr Lawson) The conditions between 1972 to 1974 and now are as different as chalk and cheese. If you look at MO; if you look at what was happening to public spending and house prices then; if you look at the PSBR as a share of GDP then; if you look at what was happening to money GDP and, perhaps most strikingly, if you look at interest rates, where real interest rates then were, if anything, ~~they were~~ negative, whereas now they are historically high and positive, the differences are quite dramatic.

Chairman

131. I think we should move on. I did not quite hear the date of the comparison which Sir Terence Burns made?

(Sir Terence Burns) I was speaking about the same period Mr Budgen was mentioning which was 1972/73.

Mr Browne

132. I believe you are on record as saying you do not wish to see sterling fall further, can you tell us against which benchmark you are looking, is it against the US dollar, the deutschemark or the trade weighted index? Could you tell us if there is a psychological floor in your book for sterling and is there also a psychological ceiling?

(Mr Lawson) I suppose the thing I look at most is the index. You are quite right. ~~I do think~~ As far as the exchange rate is concerned, the view which I have expressed to this Committee before, I think last year, is that ~~I believe that~~ the exchange rate should always be exercising a financial discipline on the economy; I do not believe in a weak exchange rate. We are pursuing ~~I think you will be seeing~~ an anti-inflationary policy and it is desirable to have an exchange rate which is reinforcing ~~exercising~~ it. What we had to do earlier this year was to allow the exchange rate to fall because of the sharp collapse of the oil price. There clearly had to be a step change in the exchange rate and that duly occurred. ~~and~~ This is something that I pointed out as far back as 1984 when I gave a talk in Cambridge entitled "What will happen when the oil runs out". ~~I pointed out~~. There had to be an exchange rate adjustment, though ~~judgment~~, I was then envisaging it ~~the thing~~ happening more gradually than has in fact happened. Again, ~~perhaps, and~~ I said the same thing when I gave evidence to the Aldington Committee in the other place. This adjustment has duly happened, but it has now come to an end and the ~~that~~ step~~ping~~ change has occurred. So ~~and~~ we are back to the policy of having an exchange rate which is exercising a financial discipline and that means that I do not wish to see it fall further. I do not know whether you call that psychological or not: it is operational ~~apperently~~.

133. If we could now turn to the subject of the European Monetary System. Would you agree for a currency such as sterling, whether or not it is actually perceived as a petrol currency, that going into EMS is not an easy policy and would not be automatic, we would have to negotiate entry and we would effectively link ourselves with the deutschemark block in a mechanism which would reduce our options for the Government and whilst the United Kingdom economy is much more competitive purely from a marketing mix point of view instead of purely from a price point of view it is still not competitive enough vis a vis Western Germany? Therefore, if we were to join United Kingdom interest rates

would become potentially much more volatile and subject to strong upward pressure and our counter-inflationary policy you have outlined in a question previous would be out of our determined, democratic hands and subject to the vagaries of the marketplace.

(Mr Lawson) First of all, of course, the EMS is not solely composed of Germany but also contains France, Belgium, Holland, Italy, Denmark ~~and~~, Luxembourg and Ireland. I think that is the lot.

134. It is effectively a deutschemark block.

(Mr Lawson) They are all ~~parties~~ members and I think one has to bear that in mind rather than thinking of it solely as Germany although certainly the deutschemark is far and away the most important currency within the ERM. That is ~~the right~~ a necessary qualification to the way in which you were expressing it. Secondly, there has to be financial discipline. If you are going to keep on top of inflation ~~I do not think~~ You ~~can~~ cannot run the economy successfully without financial discipline any more than you are can run a company successfuly without financial discipline. There has to be financial discipline and no form of financial discipline is a soft option. One has to make a judgment as to whether this particular form of financial discipline on balance is more desirable, or more helpful, or more useful than the forms of financial discipline which one can, and does, apply outside the ERM. I notice this Committee ~~did report~~ itself reported on this matter a little while back and came to the conclusion it was not desirable to join the ERM. I notice your Chairman in his interesting speech yesterday said he had changed his mind.

Chairman: With respect, the Committee's report did not say that and what I pointed out was the relevant exchange rates have changed since.

135. Could I turn you to page 18 of the Autumn Statement, Table 1.7, to look at the figure on the fourth quarter under housing, $10\frac{1}{4}$ per cent. Could you give us some idea of your underlying assumption as to the interest rate used for that?

(Mr Lawson) No. We do not forecast interest rates.

Mr Browne: Thank you.

Mr Mitchell

136. I was interested in what you said to Mr Wainwright, interest rates are a central weapon against inflation, echoed now by what you have said to Mr Browne when you said the exchange rate is a financial discipline. That means there has been a basic change in Government attitudes towards the exchange rate, does it not, because in 1980 you were telling us you had no policy for the exchange rate. It was a kind of residual. Now, clearly the strategy seems to be to keep it up by high interest rates, interest rates heavier and higher than our competitors and to stop the tendency for market forces to bring it down in order to fight inflation by presumably making imports cheaper.

(Mr Lawson) I do find that this continual harking back to 1980 when - as you reminded the Committee - I was Financial Secretary to the Treasury, has a nostalgic charm which appeals to me greatly. I am happy to talk about that for some time. What happened in 1980 was interesting. There were a combination of factors: you had a totally discredited Labour Government replaced by a Conservative Government in which there was great worldwide confidence at a time when we were in the latter period of the Carter regime in the United States which had lost all international confidence completely. Coinciding with those factors you had this sudden rather belated discovery by the markets that Britain was a substantial oil producer, likely to be so for some time, at a time when ~~this~~ that was a rather desirable thing to be. So that led to the market pushing up sterling very substantially indeed; greater - I readily conceded - ~~far more~~ than we had expected at the time, certainly far more than I had expected. There was very little, ~~because of the power then,~~ we could sensibly do about it without really undermining ~~the~~ our monetary policy ~~very considerably~~ and ~~the~~ financial policy very considerably. We also recognised very quickly, and indeed this was said a number of times, that the pressure from the exchange rate was one of the reasons why we could take a relatively relaxed view ~~with~~ of the fact that sterling M3 was overshooting by quite a wide margin. the target range, ~~shall we say, and~~ We said that we would still get - as a result of the overall balance of financial discipline as such - inflation down. ~~and~~ Indeed that proved to be the case. I have no doubt whatever that the high exchange rate at that time, looking back, was a very important instrument in getting inflation and inflationary expectations down.

137. Just that it was not avowed. Thank you for the fascinating history lesson. Is the exchange rate being kept now at a level higher than market forces would have it, at higher interest rates than our competitors, in order to fight inflation?

(Mr Lawson) Certainly ~~the~~ interest rates are set at the rate needed to fight inflation, that is absolutely right. The level of the exchange rate, what is happening to the exchange rate is an important determinant of that; that ~~we have made clear on a number of occasions and~~ I have made clear on a number of occasions.

138. Two questions arise from that: you mentioned the step change produced by the fall in oil prices, why should there not be a decline in interest rates by the fact our labour costs are going up faster than our competitors? Surely that too would require the pound to come down?

(Mr Lawson) If you wish simply to surrender to the potential ~~inflation~~ inflationary forces in the economy, that is indeed what you would do and you would have steadily increasing inflation. The whole essence of the battle against inflation can be summed up in one hyphenated word, and that is "non-accommodation". That is what it is all about. What you are advocating, and what I resist, is ~~an operation~~ a policy of accommodation.

139. I am advocating not going back to the mistakes of 1980 and 1981 when the over-valued exchange rate was ruinous for industry and destroyed our manufacturing by 78 per cent of our manufacturing capacity. What is the logic of hitting industry with high interest rates to punish it for the increase in labour costs? First of all, this hits manufacturing rather than services; secondly, manufacturing cannot control its labour costs and Government cannot either because all it does is preach sermons; thirdly it penalises investment; fourthly it puts up RPI by higher mortgage rates and fifthly it means we have to carry a double burden, high interest rates and over-valued exchange rates; what is the virtue to industry of that?

(Mr Lawson) The virtue to industry of that is that it benefits from low inflation instead of high inflation which there would be under the policies which you are advocating. It is perfectly true, and I search for common ground always with you Mr Mitchell ---

140. Might be rather muddy!

(Mr Lawson) ~~I will tread it~~ I am intrepid. It is absolutely true that if industry were to get a better grip of its costs, in particular its pay costs, then I do not think that it would be necessary, as part of the anti-inflationary strategy, to have interest rates as high as they are today.

141. It is a form of salvation through suicide: inflicting damage on the economy which we need to survive as oil falls away.

(Mr Lawson) It is a curious form of suicide when industry is growing steadily and is more profitable than it has been for decades - not years, more profitable than it has been for decades. Indeed, I notice - quite astonishingly really because I do not think they normally do take sides in the party political battle at all - that at their recent conference, the CBI came out in unequivocal support of the Government's economic policy, which I do not think they would be doing if it was actually a policy of industrial suicide because they are not stupid. If you look at what is happening to the economy, in terms not merely of inflation but the steady growth, the steady improvement in profitability, the fact that ~~you say this policy is inimical but this policy~~ investment is at all time record levels, then I think it is quite impossible to sustain the thesis which you are putting forward.

142. The Government too, of course, engaged us in some element of double talk on this issue. It is not only my thesis. In 1980 the Government was saying that the over-valuation of 1980 and 1981 would inflict no great harm on industry and would bring effects in the form of discipline. Now you are saying in the projections in the Financial Statement, there are going to be effects on the fall and rise of the value of the pound, exports will increase next year and imports will be restrained

next year. Why should not those processes, those benefits, go further by allowing the pound to come down to counteract the increases in labour costs?

(Mr Lawson) I have explained why this would be a complete surrender to inflationary pressures and it would also remove all financial discipline which is necessary if industry is going to become more competitive and the country is going to prosper in the long run. ~~This~~ Yours is an essentially short-term approach which we have seen all too often in the past. ~~because it has been forecast in the pas~~t. It has produced not merely high inflation but a weakened and debilitated industry in contrast to the more vigorous and healthy industry we have today.

143. In terms of projections, particularly on balance of payments which do seem rather optimistic, are we at risk of a very tight balance of payments constraint which will produce a sterling crisis in its wake, you are surely more vulnerable? In other words, the financial statement and, indeed, the Chancellor's act is rather like a highwire act on the wire of high interest rates, I think, keeping a rickety show on the road.

(Mr Lawson) Nothing rickety about it.

144. What is in many respects a rickety show on the road is like the marvellous Buster Keaton thing of "pretending all is well 'til ...", keeping everything apropos before the deluge.

(Mr Lawson) There will never be a deluge if this Government is returned.

145. It does not matter which shower is in, Chancellor, there will be consequences from the fact that things have been allowed to let slide to keep the mood happy until the election.

(Mr Lawson) You seem to have done an extraordinary U-turn. A moment ago you were accusing me of having everything far too tight and crucifying industry and now you are saying

x that everything is being loosened up for the election. I wish you would make up your mind.

146. It is being kept going for the election, this somewhat rickety show, and the only way to regenerate it is to bring down interest rates and stimulate investment in manufacturing, particularly in the exporting industry and make the economy competitive again.

(Mr Lawson) I will bring down interest rates when

x it is prudent and safe to do so and not before then. ~~I was emphasising~~

x ~~this idea and~~ I would have thought your own strictures about the high level of interest rates, ~~I would have thought this~~ should dispose of any idea somehow that what we are engaged in is some great relaxation because we think that will be helpful in the context of the election. There has been no change in the policy stance at all, as I indicated in my opening remarks~~;~~ and this is the policy stance that we will be continuing after we have won the next election, whenever that may be.

147. That is just in terms of this relaxation. Can we take it, therefore, if the PSBR overshoots, I am talking about the whole stance across ~~1977/78~~ 1987/88, can we take it that success will be clawed back in principle in 1988/89 thus maintaining your commitment to the seven billion PSBR?

(Mr Lawson) That is a purely hypothetical question, ~~as~~ and ~~which~~ I will have to decide what action is right in the light of the circumstances at the time as I have done each year since I have been ~~the~~ Chancellor of the Exchequer.

Mr Watts

148. I would like to pursue your answer to Mr Wainwright about the interest rate being the essential instrument of monetary policy. In your view is the main role of the interest rate to reduce the demand for borrowing by making it more expensive, or is the major way it exercises an influence by maintaining sterling at a level which keeps up the pressure?

(Mr Lawson) The role is to keep financial ~~commitments~~ conditions sufficiently stringent to ensure that inflation remains low and ultimately to eliminate inflation altogether and have stable prices. There are various indicators of ~~the~~ financial conditions of which narrow money and the exchange rate are particularly important. ~~It~~ The interest rate clearly does have an effect ultimately on the amount of credit in the economy, but the relationship there is far more complex, far less clear and is difficult to ~~[illegible]~~ establish.

Also, ~~you have to~~, when you are thinking of broad money, the question on ~~the~~ which one has to make a judgment is the extent to which ~~the~~ holders of broad money are willing holders of broad money. ~~and~~ Where there has been a ~~simple~~ shift in the propensity to hold broad money that, itself, does not pose any inflationary dangers. If, on the other hand, you judge that they are unwilling holders - and it was the Governor of the Bank of England at some stage before this Committee who had a colourful expression about an "avalanche" --- a glacier -

Chairman

149. Frozen glacier.

(Mr Lawson) Then, of course, you have to take rapid ~~repeat~~ action because otherwise there will be very real inflationary dangers, but I see no sign of the glacier being about to melt.

Mr Watts

150. As the monetary aggregates are no longer considered to be such a reliable indication.

(Mr Lawson) It is ~~the~~ broad money which is a particular problem in this country. Monetary aggregates are being difficult in most countries. Not only the Germans but the Americans are exceeding their targets both for ~~in~~ M1 and M2 and the French are exceeding theirs. It is pretty much a worldwide disease. In so far as the difficulty ~~it~~ is linked with financial liberalisation and innovation, I think it is fair to say there is no country in the world which has gone further along the path of financial liberalisation and innovation than the United Kingdom.

151. In view of that, and the emphasis you were giving to the importance of the exchange rate as one of the indicators of monetary conditions, have you given consideration to setting the exchange rate target range in the same way we had a target

range for ~~sterling~~ £M3, both to give an indication of where you intend that exchange rate discipline to be exercised and to remove uncertainty?

(Mr Lawson) The reality of foreign exchange markets, and this does not apply to monetary ~~which makes it very different from~~ targets, ~~the reality of the foreign exchange market~~ would make that in my opinion an unwise course of action. I think there is a case clearly ~~Mr Browne has left the room~~ for being part of an explicit regional fixed exchange rate system. Alternatively, you can have the sort of policy which we have at the present time. I do not actually think there is a viable halfway house.

152. You reasserted earlier today in your oral statement you did not wish to see sterling fall further.

(Mr Lawson) That is right.

153. I believe when you made the statement the basket was 69½ and I believe today it is 67½. I understand that when you say "not fall any further", you do not want to stay exactly on that spot for the whole of the year. When there is such a variation over a relatively short period of time, I think that adds to uncertainty as to precisely what is intended in the period.

(Mr Lawson) The question of uncertainty is a very difficult one. I can quite understand that good people with all the best motives would like greater certainty as to at what point one would act in order to affect the exchange rate. On the other hand, that degree of certainty would also be playing into the hands of the short-term operators. In practical market management, I do not think it is sensible to be any more explicit than I have been.

Mr Watts: Thank you.

Chairman

154. Thank you very much Chancellor, I wonder if I might take up one or two of the points which have been raised already? I think you are aware there are some colleagues who have to be elsewhere in the House which is why we are slightly like an Agatha Christie thriller where the characters keep disappearing. This is in no sense my colleagues being discourteous to you.

Could I ask you a couple of points which came up in the earlier discussion: in Paragraph 61 of the Autumn Statement it says: "for the past six years, high rates of growth of broad money ..... have been consistent with appropriately tight monetary conditions and thus a substantial fall in inflation."

(Mr Lawson) Yes.

155. Are you now saying that regardless of what is happening to M3 that might be consistent with low inflation or continuing to battle against inflation?

(Mr Lawson) Yes, that is what is implied here, certainly. I do not have the figures in my head but the change in the velocity of ~~sterling~~ £M3 as between, say, the 1970s and 1980s, ~~I am not sure where the turning point was but it~~ is quite remarkable. ~~and~~ I quoted the figures ~~to you~~ for, one five year period and another five year period, in ~~the~~ my Lombard Speech, ~~saying~~ showing that the ratio between ~~what we have in~~ the growth of money GDP and the growth of ~~sterling~~ £M3 in one period and the ratio in another ~~is~~ was quite different. This overrunning of the ~~sterling~~ £M3 targets has been pretty well a feature of the period we have been in office, except for a short period when it was kept down by very heavy overfunding. I think this Committee was among those who queried whether that was achieving anything and I think it was partly this Committee's views on that which led us to abandon overfunding as a way of life. There has been this general tendency ~~in~~ for broad money to grow ~~money~~ very rapidly and yet, and this is the important thing, inflation has come down and come down very markedly and that is the proof of the pudding.

(Sir Peter Middleton) It is also true of Europe as a whole, or OECD as a whole.

156. You began by speaking of continuity of policy, the views you express now are radically different to those expressed at the beginning of the Government's period of office.

(<u>Mr Lawson</u>) I think that it is perfectly true to say that right at the beginning we did not expect to see such a sharp change in the velocity of ~~sterling~~ £M3, but it actually happened very ~~quickly~~ early on and we very quickly realised that things were changing. ~~and~~ Indeed, in ~~the~~ My Zurich speech to which Mr Budgen referred I alluded there to the fact that ~~sterling~~ £M3 was giving a false reading. Although it is perfectly true we did not expect to see this sharp change when we first took office in 1979 it is something that became apparent very quickly thereafter: ~~and~~ you will remember the abolition of the corset and the growth which continued in ~~sterling~~ £M3 after it. This is not in any sense a new development, although it has become more pronounced so far as broad money generally is concerned as financial liberalisation and financial innovation have developed much further.

(<u>Sir Peter Middleton</u>) One might say that inflation has come down.

Chairman: Yes, we understand that. Chancellor, we have, as you have noticed, gone back quite a bit to the situation in the earlier years of the present Government because it seemed to us perhaps there could be some lessons to be learnt as I think you indicated perhaps some of them have been learnt. Obviously we will need to consider very carefully the various points you have made before producing our report for the House. We would appreciate the couple of notes we mentioned earlier on in order to help us in reaching our conclusions. Having said that, can I express my thanks to you and your colleagues for coming this afternoon. Thank you.

CONFIDENTIAL

PWP

FROM: A C S Allan
DATE: 20 November 1986

MR SCHOLAR

cc Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Peretz
Mr Sedgwick
Mr Turnbull
Mr Culpin
Miss O'Mara
Mr Kelly

OPENING STATEMENT TO THE TCSC

The Chancellor was most grateful to you for preparing a draft of his opening statement to the TCSC. In the light of Sir P Middleton's comments, supporting those of Mr Cassell and Mr Peretz, the Chancellor decided to eliminate the section on the exchange rate altogether. He also shortened your draft somewhat. I attach a copy of the final version.

ACSA

A C S ALLAN

OPENING STATEMENT BY THE CHANCELLOR TO THE TCSC ON 20 NOVEMBER

I would like to say a few words about three subjects: the continuity of the government's approach to public spending; public sector borrowing next year; and the prospects for economic growth.

On public expenditure, I have announced an increase in the planning totals for 1987-88 and 1988-89 within the overall constraint of ensuring that total public expenditure continues to decline as a proportion of GDP. Even excluding privatisation proceeds, we have reduced the proportion of national income taken by public spending every year since 1982, and the plans set out in the Autumn Statement carry that process on a further three years. By the end of the current planning period, in 1989-90, the ratio of public spending to national output will be back to the level of the early 1970s.

Some commentators have professed to see a discontinuity in all of this. There has been, it is true, a discontinuity. But that was back in 1982-83 when general government expenditure as a proportion of GDP stopped rising - as it had been doing continously once the immediate aftermath of the IMF crisis in 1976 was over, and went on doing until the legacy of the Labour Government had worked its way through the system. Since then this ratio has declined, just as the rate of growth of public spending in real terms has declined, even excluding privatisation proceeds, from about 3 per cent a year in the decade up to 1979 to about 2¼ per cent a year during our first Parliament, and about 1¾ per cent a year in the present Parliament so far. The increase envisaged in the Autumn Statement over the next three years is at the still lower rate of 1 per cent a year.

The same continuity of policy may be seen in public sector borrowing. In successive versions of the MTFS my predecessor and I have mapped out a course for the PSBR in which it would gradually diminish as a proportion of GDP. Throughout my time as Chancellor

I have stuck firmly to this. In successive Budgets I have set the PSBR at or a little below the level given in the previous year's MTFS.

And apart from 1984-85, when I allowed public borrowing to expand to finance the expenditure needed in resisting the coal strike, the outturn on the PSBR has been broadly in line with that envisaged at the time of the Budget.

For this financial year, the figures published on Tuesday of this week confirm that the PSBR remains on track. For next year I have, exceptionally, gone further than is usual at this time of year, so as to dispel from the start any worry there might be that the increased planning totals imply a relaxation on public borrowing. I have therefore explicitly reaffirmed the government's commitment to the fiscal stance set out in the 1986 MTFS, and made it clear that the PSBR next year will be held to $1\frac{3}{4}$ per cent of GDP.

Finally, Mr Chairman, I turn briefly to the prospects for growth over the coming year.

The past five years since the world recession of 1980-81 have seen a remarkable stability in the growth performance of the economy. Growth has averaged almost 3 per cent a year over the whole of this period, without very much variation from year to year. There has been a relatively brief pause earlier this year, but that has now passed, as I predicted it would, and the Industry Act forecast suggests that it is set to continue at this rate in 1987. This expected growth is not, as some critics have asserted, the result solely of a fragile and very rapid growth of consumer spending. The forecast is for a somewhat slower rise in consumer spending next year, much faster growth of non-oil exports - something which has already begun in the second half of the current year - and continuing growth in non-oil business investment from its record level this year, broadly in line with the growth of the economy as a whole. In other words, balanced growth.

4-20a

~~Flag A~~

pmp

~~DRAFT~~

OPENING STATEMENT BY THE CHANCELLOR TO THE TCSC ON 20 NOVEMBER

~~Yes, Mr Chairman, I think it would be useful if I made one or two points at the outset of today's proceedings.~~

I would like to say ~~something~~ a few words about ~~four~~ three subjects: the continuity of the government's approach to ~~the matters which arise in the Autumn Statement and in discussion of it;~~ public spending; public sector borrowing next year; ~~the exchange rate;~~ and the prospects for economic growth. On some of these matters I would like to amplify what has already been said, either in the Autumn Statement or subsequently; on others I think I should counter some misconceptions which appear to have arisen.

As the Committee knows, the Autumn Statement is not the occasion on which the government reassesses the Medium Term Financial Strategy, or when it announces new monetary targets or new conclusions on fiscal policy. Those are matters for the Budget. It is, rather, a ~~collection~~ set of ~~separate~~ announcements which it is convenient to make at this time of year, on the government's revised public expenditure plans, on national insurance contributions, and on the costs of illustrative tax changes, together with the Industry Act forecast for the economic prospect to the end of the following year.

This year's Autumn Statement, like its predecessors, is ~~firm~~ly set in the MTFS framework ~~of the~~ policy described ~~stance~~ in the Budget Red Book. ~~which itself, of course, followed closely earlier versions of the MTFS in the Red Books of preceding years. As usual the Autumn Statement~~ however ~~contains~~ a ~~no restatement of monetary policy~~. ~~because none is needed. There has been no change in the operation of monetary policy, as explained in my Mansion House Speech and~~ as ~~elaborated upon subsequently by the Governor of the Bank of England in his Loughborough lecture.~~

dangerous : not made to parliament

On public expenditure, totals I have announced an increase in the planning totals for 1987-88 and 1988-89 within the overall constraint of ensuring that public expenditure continues to decline as a proportion of GDP. Even ~~without~~ excluding privatisation proceeds, we have ~~this year's Autumn Statement marks a further stage in the government's progress in rolling back the relative size of the public sector. We have~~ reduced the proportion of national income taken by public spending every year since 1982, and the plans set out in the Autumn Statement carry that process on a further three years. By the end of the current planning period, in 1989-90, the ratio of public spending to national output will be back to the level of the early 1970s.

decline

Some commentators have professed to see a discontinuity in all of this. There has been, it is true, a discontinuity. But that was back in 1982-83 when general government expenditure as a proportion of GDP stopped rising - as it had been doing continously once the immediate aftermath of the IMF crisis in 1976 was over, and went on doing until the legacy of the Labour Government has worked its way through the system. Since then this ratio has declined, just as the rate of growth of public spending in real terms, has declined, even excluding privatisation proceeds, ~~has declined,~~ from about 3 per cent a year in the decade up to 1979 to about 2¼ per cent a year during our first Parliament, and about 1¾ per cent a year in the present Parliament so far. The increase envisaged in the Autumn Statement over the next three years is at the still slower rate of 1 per cent a year.

The same continuity of policy may be seen in ~~the~~ public sector borrowing. ~~we have undertaken.~~ In successive versions of the MTFS ~~we~~ my predecessor and I have mapped out a course for the PSBR in which it would ~~gradually~~ gradually diminish as a proportion of GDP. ~~over the medium-term.~~ Throughout my time as Chancellor I have stuck firmly to this ~~path~~, ~~and~~ In successive Budgets I have set the PSBR at or a little below the level given in the previous year's MTFS. And Apart from 1984-85, when I allowed public borrowing to expand to finance the expenditure needed in resisting the coal strike, the outturn on the PSBR has been broadly in line with that envisaged at the time of the Budget.

For this financial year, the figures published on Tuesday of this week confirm that the PSBR ~~is so far well~~ remains on track. For next year I have, exceptionally, gone ~~thought it right to go a little~~ further than is usual at this time of year, ~~and~~ so as to dispel from the start any worry there might be that the increased planning totals ~~might~~ imply a relaxation on public borrowing. I have therefore explicitly reaffirmed the

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government's commitment to the fiscal stance ~~set out in the 1986 MTFS~~, and made it clear that the PSBR next year will be held to $1\frac{3}{4}$ per cent of GDP. ~~So there is continuity on public borrowing just as on public spending, ~~on monetary policy,~~ and indeed on all the elements of economic policy.~~

I turn now to the exchange rate, where there ~~was~~ has already been some interest ~~on the part of~~ expressed by members of the Committee, ~~[in your session on Monday with Treasury officials, in remarks I made on this topic in a BBC interview a week or so ago.]~~

This jars with the defensive nature of this statement

What I said then was no more and no less than what I have said on many occasions in the past. We have a very clear policy on the exchange rate: we take it into account, along with the other indicators, in making our assessments of monetary conditions, and in deciding what action, if any, needs to be taken with the ~~key~~ instruments of monetary policy - particularly short-term interest rates. And we will continue to keep ~~short~~ interest rates at whatever level is necessary to secure monetary conditions which continue to bear down on inflation.

We do not ~~therefore~~ therefore have ~~an~~ target a particular exchange rate ~~target~~ or basket of exchange rates. [Indeed, I do not believe it is possible to have a target outside a fixed exchange rate mechanism such as EMS.] But I ~~have always~~ Certainly reject~~ed~~ the view that we should follow a policy of exchange rate depreciation, in order to accommodate excessive cost pressures in this country relative to

Looks as if competitive with the DM

It follows from our general policy stance

those in our competitors abroad. ~~I have always believed~~, ~~rather~~, that the exchange rate ~~should~~ must ~~play its part in~~ have a ~~relatively~~ bracing effect on domestic costs. ~~But~~ I made it clear, as long ago as 1984, in a lecture I gave in Cambridge, that following a fall in oil revenues there would necessarily be a corrective fall in the real sterling exchange rate. After the ~~collapse in~~ halving of the oil price early this year, the exchange rate has adjusted ~~has now taken place~~. So ~~And that is why I would not wish to see sterling any lower than it is at present. because~~ I wholly reject the misconceived policies, and the vicious ~~downward~~ inflationary spiral of those who advocate continued devaluation.

I realise this is what the Ch has said twice; but I would strongly advise leaving it out of a conscious statement.

Finally, Mr Chairman, I turn briefly to the prospects for growth over the coming year.

There has been a relatively ~~slowing~~ pause ~~during the early~~ pause earlier this year, but that has now ~~passed~~ passed, as I predicted it would,

The past five years since the world ~~recession~~ recession of 1980-81 have seen a remarkable stability in the growth performance of the economy. Growth has averaged almost 3 per cent a year over the whole of this period, without very much variation from year to year. ~~&~~ and the Industry Act forecast ~~predicts~~ suggests that it is set to continue at this rate in 1987. This expected growth is not, as some critics have asserted, the result solely of a fragile and very rapid growth of consumer spending. The forecast is for ~~more balanced growth next year, with~~ a somewhat slower rise in consumer spending next year, much faster growth of non-oil exports - something which has already begun in the second half of the current year - and ~~continuing~~ continuing growth in non-oil business investment from its record level this year, broadly in line with the growth of the economy as a whole. In other words, balanced growth.

The Committee will know that there has been criticism of the Autumn Statement from some quarters for showing what is represented as an excessive growth of demand and activity. This criticism is misconceived: ~~that~~ the Industry Act forecast shows that the growth of money GDP for the economy as a whole in the current financial year seems likely to undershoot the figure I gave at Budget time - at 5½ per cent rather than 6¾ per cent. Only a few months ago, when there were signs that output was ~~very~~ sluggish, some of these same critics argued that policy was too tight and that the halving of the oil price would spell the end of the upswing unless I took action vigorously to expand the economy. I rejected their view then, as I reject it now, and instead took the view that the pause in growth was no more than a pause. Subsequent events have proved that view right, and it has since become clear that this slowdown in growth was something which we were experiencing in common with the rest of the developed world. In recent months there have been more and more signs worldwide that this pause is over - a most welcome development, and not least for the UK.

Mr Chairman, I hope that these opening remarks will provide a helpful framework for the Committee's questions, which I will now endeavour to answer to the best of my ability.

4-20a

Php

OPENING STATEMENT BY THE CHANCELLOR TO THE TCSC ON 20 NOVEMBER

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CE17

TCSC
QUESTIONS

TCSC: QUESTIONS FOR THE CHANCELLOR ON 20 NOVEMBER

MONETARY POLICY

1. Given the overshoot in the growth of £M3, do you intend to set a new £M3 target? If £M3 is an unreliable indicator do you propose to substitute an alternative measure such as PSL2? Wait for budget.

2. Do you share the concern of the Governor of the Bank of England about the build-up of liquidity in the economy? Mansion House speech.

3. Paragraph 61 in Chapter 1 of the Autumn Statement says that for the past six years high rates of growth of broad money have been consistent with appropriately tight monetary conditions and thus a substantial fall in inflation. Is the Government saying that whatever the growth in £M3 it is consistent with low inflation? Lombard speech.

4. What can be done to control the growth of credit given that interest rates are already very high? Can't have it both ways.

5. Recent statements suggest that you think that sterling is at about the right level and that any further decline would be resisted by a tightening of policy. Does that mean both higher interest rates and a tighter fiscal policy? If the exchange rate were to fall further it would seem erratic to try to tighten fiscal policy given the apparent loosening in the Autumn Statement. What is your view on this? NO

6. Do you think that interest rates will need to increase over the next year to maintain sterling? Is there any prospect of interest rates being allowed to fall without undermining sterling? IR set at level needed to meet monetary objectives.

FISCAL STANCE

1. Sir Terence Burns said that the reason for restating the PSBR figure for 1987-88 in the Autumn Statement was to reassure people that fiscal policy had not changed since the Budget. Given that the outlook for the economy is quite different from the beginning of the year, do you think that a different PSBR would now be more valid? Medium term policy not fine tuning.

2. Given your statement that the same £ cannot be used twice, presumably there is now little scope for tax cuts in the next Budget? ~~Less scope, all other things being equal~~. May well do so.

3. There are some grounds for scepticism that the Reserve for 1987-88 will be adequate. If expenditure overruns and there is a risk that the PSBR target will not be met, what will be the Government's response? ~~"Appropriate" action~~ Reserve adequate

4. Some commentators are suggesting that the balance between inflation and growth would be better served by a tighter fiscal policy and a looser monetary policy. What is your view on this? ~~Believe MTFS indicated right balance~~. [illegible]

PUBLIC EXPENDITURE

1. Given that you have not stuck to the policy of keeping public expenditure constant in real terms, does this imply that the Government has changed its view of the importance of reducing public expenditure as a proportion of GDP as fast as possible to help the overall economy? Are you simply recognising that you are unable to control public expenditure as effectively as you would like? Balance.

2. You have said that the ratio of GGE to GDP has fallen this year as for the past four years but real departmental spending is up this year by 3.4 per cent and similarly total expenditure including gross debt interest payments is up by 2.7 per cent. Both measures are above GDP growth this year. Would you not prefer to see an across-the-board decline as a proportion of GDP as opposed to selecting one measure? Picking & choosing their aggregates

Not quite right. Said fall next year as for last 4 years

3. The estimated real increases in planned expenditure next year are calculated by deflating the cash plans by the GDP deflator. There may be a substantial relative price effect against the public sector which would produce a volume squeeze. Will this not add to the difficulty of achieving your plans particularly given the expectation of improvement in service provision? Efficiency etc.

4. Public expenditure in 1987-88 is planned to be 2 per cent higher in real terms than the outturn for 1986-87. But since the last Budget, the plans for 1987-88 have increased by 4 per cent. Is this not a sign of the continuing battle to keep the lid on expenditure? 1987-88 figures exceptional - LA's etc.

5. In your oral statement you said that the average real increase in expenditure over the planning period would be 1¼ per cent a year. But this covers a lumpy profile, growth of 2 per cent in real terms in 1987-88, ¼ per cent in 1988-89, 1 per cent in 1989-90. This looks exactly like the pattern of previous plans ie expenditure slippage in the short term with restraint in the longer term. Is it reasonable for the Committee to be sceptical about this? Special factors - EC payments etc.

6. What is your view of the 1987-88 Reserve? Adequate.

7. The forecast 1¼ per cent a year average real increase in expenditure growth is below the average for the last few years. Why should the Committee not be sceptical of the likelihood of success in getting below the trend of several previous years?

Already builds in significant allowances for LAs, Social security, Teacher Pay etc.

WAGES AND MANPOWER

Everyone recognises special case - and buying specific improvements.

1. What can the Government do to avoid a knock-on effect from teachers' pay to other public sector pay? Is there not a serious risk that a high proportion of the agreed increases in departmental plans will be absorbed by pay without any improvements in output? Running costs etc.

THURSDAY 20 NOVEMBER 1986

Members present:

Mr Terence L Higgins, in the Chair
Mr Anthony Beaumont-Dark
Mr John Browne
Mr Nicholas Budgen
Mr Ralph Howell
Mr Austin Mitchell
Mr John Townend
Mr Richard Wainwright
Mr John Watts

THE RT HON NIGEL LAWSON, a Member of the House, Chancellor of the Exchequer, examined.

SIR PETER MIDDLETON, KCB, Permanent Secretary, HM Treasury, called in and examined.

SIR TERENCE BURNS, Chief Economic Adviser, and MR ANDREW TURNBULL, Under Secretary, General Expenditure Policy Group, HM Treasury, called in and further examined.

Chairman

82. Mr Chancellor, may I welcome you on behalf of the Committee to what has now become a traditional annual event, namely, your evidence on the Autumn Statement in preparation for the report which we hope to prepare for the Floor of the House of Commons. You are indeed most welcome. You will have noticed that, although the view from your present seat has not greatly changed from the previous one, there are a considerably greater number of people sitting behind you. I hope this is advantageous from your point of view, but it does, however, create a bigger problem as far as the acoustics are concerned, because obviously it is difficult for those at the back to hear. That being said, we are glad you are able to come. Perhaps I might first ask you, in very traditional form, to introduce your officials for the benefit of the shorthand writers, and also ask whether there are any preliminary remarks you care to make.

(Mr Lawson) Thank you very much indeed, Mr Chairman, for your words of welcome. As you know, I am always happy to appear before

X your Committee. ~~(I hope those behind me can hear what I am saying.)~~ On my right is Sir Peter Middleton, Permanent Secretary to the Treasury; on my left is Sir Terence Burns, Chief Economic Adviser; and on the far right is Andrew Turnbull, Under Secretary in charge of the General Expenditure Policy Group. You kindly invited me to say a few words and, if I may, I will say a few words about three subjects: first, the continuity of the Government's approach to public spending; secondly, public sector borrowing next year; and, thirdly, the prospects for economic growth. On public expenditure, I have announced an increase in the planning totals for 1987-88 and 1988-89 within the overall constraint of ensuring that total public expenditure continues to decline as a proportion of GDP. Even excluding privatisation proceeds, we have reduced the proportion of national income taken by public spending every year since 1982, and the plans set out in the Autumn Statement carry that process on a further three years. By the end of the current planning period, in 1989-90, the ratio of public spending to national output will be back to the level of the early seventies. Some commentators have professed to see a discontinuity in all of this. There has been, it is true, a discontinuity, but that was back in 1982-83 when general government expenditure as a proportion of GDP stopped rising, as it had been doing continuously once the immediate aftermath of the IMF crisis in 1976 was over, and went on doing until the legacy of the Labour Government had worked its way through the system. Since then this ratio has declined, just as the rate of growth of public spending in real terms has declined, even excluding privatisation proceeds, from about 3% a

|| year in the decade up to 1979 to about 2~~½~~¼% a year during our first Parliament, and about 1¼% a year in the present Parliament so far. The increase envisaged in the Autumn Statement over the next three years is at the still lower rate of 1% a year. The same continuity of policy

may be seen in public sector borrowing. In successive versions of the MTFS my predecessor and I have mapped out a course for the PSBR in which it would gradually diminish as a proportion of GDP. Throughout my time as Chancellor I have stuck firmly to this. In successive budgets I have set the PSBR at or a little below the level given in the previous year's MTFS. And apart from 1984-85, when I allowed public borrowing to expand to finance the expenditure needed in resisting the coal strike, the outturn on the PSBR has been broadly in line with that envisaged at the time of the Budget. For this financial year, the figures published on Tuesday of this week confirm that the PSBR remains on track. For next year I have, exceptionally, gone further than is usual at this time of year so as to dispel from the start any worry there might be that the increased planning totals imply a relaxation on public borrowing. I have therefore explicitly reaffirmed the Government's commitment to the fiscal stance set out in the 1986 MTFS, and made it clear that the PSBR next year will be held to 1¾% of GDP. Finally, Chairman, I turn briefly to the prospects for growth over the coming year. The past five years since the world recession of 1980-81 have seen a remarkable stability in the growth performance of the economy. Growth has averaged almost 3% a year over the whole of this period, without very much variation from year to year. There has been a relatively brief pause earlier this year, but that has now passed, as I predicted it would, and the Industry Act forecast suggests that it is set to continue at this rate in 1987. This expected growth is not, as some critics have asserted, the result solely of a fragile and very rapid growth of consumer spending. The forecast is for a somewhat slower rise in consumer spending next year, much faster growth of non-oil exports - something which has already begun in the second half of the current year - and continuing growth in non-oil business investment from its record level this year, broadly in line with the growth of the economy as a whole; in other words, balanced growth.

83. Mr Chancellor, thank you for introducing your officials. Perhaps I might take this opportunity of expressing our appreciation to Sir Terence Burns and his colleagues who gave evidence on Monday; it was very helpful. I turn immediately to the point you made in your opening remarks regarding the continuity of government policy. I ask you to turn your mind back to early 1980 when you were Financial Secretary, a post much older than that of Chancellor of the Exchequer.

(Mr Lawson) Is it?

84. Yes, indeed. I ask you whether it was the case at that time that the Government's intention was to reduce public expenditure progressively in volume terms?

(Mr Lawson) That aspiration has never been achieved, as you see by looking at the figures, and therefore it was a long time ago that we ceased to talk in those terms. I cannot remember when that was, but it always seems sensible to me that the description should correspond with reality.

What you have referred to

The reality is that, in addition to saying ~~that~~ in 1980, we ~~also~~ said in the 1979 Manifesto, and I think we also said it in the document "The Right Approach to the Economy", which was a ~~stated~~ quasi economic manifesto published before the 1979 Manifesto proper, that we thought that public expenditure was taking an excessive share of GDP and we wished to see it progressively decline. That theme has been there ~~continued~~ continuously and it is that which accurately describes what has happened since 1982/83. It is that which also characterises the public expenditure plans which are published in the Autumn Statement. As I say, this is a remarkable change from the historical trend, which has been towards a steady increase in public expenditure as a share of GDP. It was slightly curious during the Labour Government, when you had an astonishing rise of something like 12 per cent in real terms in the first two years ~~and then~~ followed by the great disaster, the ~~collapse of~~ bailing out by the IMF in 1976 and so on; ~~and~~ then you had an almost equally sharp fall, as capital expenditure was cut drastically. So you had during that period an inverted 'V'. But the long-term trend has been public expenditure rising faster than the growth of the economy as a whole and that is what we have sought to reverse and that is, indeed, what we have reversed. ~~and~~ The plans continue that trend.

85. But if we then look at what happened between 1980 and, say, 1984, the policy then seemed to be to keep the level of public expenditure broadly stable in cost terms, is that correct?

(Mr Lawson) As I say, if you look at what has actually happened there has been a continued growth in real terms of public expenditure, but the growth ever since 1982 ~~was~~ has been less than the growth of the economy as a whole. So the ~~rate of growth~~ share of GDP has been declining; and the rate of growth of public expenditure has been declining, as I say, within that period. ~~We have improved~~ reduced ~~the rate of growth.~~

The rate of growth of public expenditure in real terms during this Parliament has been less than the rate of growth in real terms during the last Parliament, despite the fact that in a sense it is easier to make reductions at the beginning of a period of office, simply because you make the easy changes first and it then gets progressively more difficult. Nevertheless, despite that we have improved our performance if you accept the overall objective. As I say, I think the presentation I used in this Autumn Statement accurately represents the reality not merely of what is planned but also what has been happening since 1982/83.

86. Nonetheless, in terms of the continuity of policy, the objective in 1980 was to reduce public expenditure in real terms, by 1983 it was to hold it constant in real terms and we are now in a situation where it is the growth which has to be reduced rather than the absolute level and it has to be reduced as a percentage of GDP? That is a fair assessment of the way in which the policy has developed, is it not?

(Mr Lawson) I would say it is the way in which the presentation has developed rather than the policy. I think the policy has been consistent throughout and you can see a practically straight line on the graph showing what we have done ~~thought~~. As I say, in so far as there has been any change it has been an improvement. The rate of growth in real terms of public expenditure has slowed down. I think it is the presentation which has changed slightly. I would not want to make too much of it. If you think of the extra-ordinary cataclysmic changes there have been in previous governments with the policy turning round 180° and all you can find here is a minor change in presentation, I think that is quite remarkable.

Chairman: No doubt we will wish to study carefully what you have just said. Can we turn now to the question of manpower, and you will not be surprised that I am going to call on Mr Ralph Howell!

Mr Howell

87. Chancellor, may I congratulate you on the way in which you have presented your Autumn Statement, so that you please practically all your supporters and confound almost all your opponents. I would also like to say how pleased I am that you are maintaining your course of reducing public expenditure as a percentage of GDP. There are two points which I am sure concern us all and one is the fact that local government is not properly under control, having spent 9 per cent. more than was intended, and also that the manpower watch figures show that we are employing more people in local government than we were a year ago and there has been a rise since 1982. What can be done to counter this?

(Mr Lawson) I have no doubt whatever that you have identified a major problem. You will know what we have done already to try and influence local government spending through the way in which the rate support grant operates and through the introduction of rate-capping in the cases of the worst ~~overspending~~ overspenders. We have no control at all over local government manpower, none whatever, and the position is not satisfactory. I have before this Committee previously said that in my opinion the constitutional position we have in this country between local and central government is very unsatisfactory. We have a typically British compromise ~~but this~~ which arguably gives us the worst of both worlds. We neither have the out-and-out centralisation ~~that~~ of a unitary state ~~carries~~ carried to its logical conclusion, as they have in France, nor do we have a federal constitution as they have in Germany. ~~so~~ So there is just a mix and a muddle and nobody knows who is responsible for what, which enables local authorities, if they are so minded - and a number are - to act in a wholly irresponsible manner. This was kept in check in the past by a kind of concordat. It was one of the conventions of the constitution that local government, even though it was not obliged statutorily to do so, nevertheless conformed to the overall economic policy of the government of the day, whatever government it happened to be, but that progressively has broken down and certainly now, with a large number of local authorities under Labour control, many of them, ~~but~~ though? not all, have not the slightest intention of co-operating with the economic policy of the government of the day. As I say, that convention of ~~getting the show on the road~~ co-operation has gone, so we have to think of changes. There are two ways in which this is being approached now. One is the proposals we have made for changes in the method of local government finance, which ~~is~~ are designed to bring a much greater degree of local accountability, accountability by local authorities to their electors. ~~Obviously~~ pretty well everyone will pay the community charge whereas only a relatively small number of people pay rates, ~~so it is to get that local authority accountability that we are going to try and get a change that way.~~ We are seeing another change, too - and I do not know where it will lead at the end of the day - in the situation which has arisen over the pay of teachers. When you think that education is easily the biggest single item in local authority expenditure and ~~the fact~~ that teachers' pay is a very large part of that, the fact that we have now decided to scrap the Burnham machinery altogether and make a major change in this field is an indication of another way in which this problem can be addressed. Meanwhile, we are going to have this problem over local authority spending and it is something we ~~are going to~~ have to live with.

88. The other major subject is the problem of DHSS spending and the open-ended nature of the social security package. Have you any plans for limiting some of the huge amounts of money which are being paid, often to people who are not really, in many cases, in need?

(Mr Lawson) We are certainly taking various steps to try and ensure that money is not paid to people who are not entitled to it, ~~and~~ to strengthen in this respect the administrative side of the DHSS, and also ~~reinstate~~ reinforce - to ~~it has~~ which fell ~~fallen~~ into disuse ~~perhaps~~ through a false economy which we took on the staff side in the early years - the Availability For Work test for Unemployment Benefit and Supplementary Benefit, But there are no plans to deprive people of what they are actually entitled to.

89. But surely something must be done in the case which has recently come to light of a family costing £2,000 a week. Another example was where somebody had got in trouble in his business and had taken out a very large mortgage on his house and was costing the State £1,200 a month. Surely there must be some urgency to put a top limit on such payments so that such examples could never happen again.

Mr Mitchell: Is this the City of London or the DHSS?

Mr Howell

90. I am talking about payments which are being made.

(Mr Lawson) I am not sufficiently familiar with the case you mentioned to know the precise circumstances ~~of~~ and whether the family concerned ~~is~~ was entitled to that amount of money or not. If they were not, then clearly steps need to be taken to see that that does not happen. I think that it is clearly something which has to be kept under review, and we did have a major review of social security, as you know, quite recently under the Secretary of State. ~~and~~ Various changes are to come into operation - I think most of them in April 1988 - as a result of the outcome of that review.

91. Could I turn to the question of wages rising faster than you would like. Do you agree that as long as we have fully indexed benefits, tax-free, that will cause an upward pressure on lower wages, which will ricochet all the way up the scale?

(Mr Lawson) Most of ~~the~~ benefit~~s~~ ~~are~~ expenditure is not now tax-free. Child Benefit is tax-free, but most of the ~~other benefits have~~ rest has either always been tax~~ed~~able, like ~~the~~ pensions, or ~~are~~ is on benefits which we brought into tax, like Unemployment Benefit. But ~~I think~~ certainly a case can be made for saying that the level of benefits does cause the level of unemployment to be higher than it otherwise would be. I cannot quantify how much higher, but ~~I think there have been various academic studies.~~ I know that academic studies done by economists ~~in~~ about the Thirties suggested that what happened was that when you had prices and wages actually falling but benefits staying the same in cash terms, so that they were actually going up in real terms, that was a major contributory cause of the high level of unemployment. But as I say, we have no plans to make any changes other than the plans which have already been announced in the light of the ~~Fowler~~ Secretary of State's Review.

STET

92. My last question is while everybody is concerned at the level of unemployment and wish to do everything possible to reduce it, are you equally concerned at the labour shortages which are developing in many parts of the country? Even in my constituency, where we have above average unemployment, employers are having great difficulty in recruiting in many instances. I feel this is going to cause considerable trouble as the economy tries to expand.

(Mr Lawson) There are some shortages of particular skills, although I must say that my sympathy for employers is slightly tempered by the lack of investment they make in training. The ~~major~~ main answer to a lack of skilled people, if the labour market is working that way, is to train people, ~~and indeed, people have many skills now.~~ Partly because of ~~the~~ developments in technology you can train people far, far quicker to do these jobs than through the old methods, when you had a long apprenticeship; ~~but certainly~~ with modern machinery people can be taught much more quickly. I think it is a great weakness in this country that British industry, and British employers spend so little money on training, and I think this is something which is being increasingly recognised. You may recall I mentioned this in my Budget Speech. It is a weakness, and the time was when profitability in industry was so low that it was understandable; ~~they thought they~~ businessmen could not afford ~~it.~~ to spend money on training. That is no longer the case. There has been a very welcome recovery in profitability, and I would like to see more money spent on training, which is, I think, the answer to ~~that~~ the problem of skill shortages.

Mr Townend

93. I was intrigued listening to your reply to the Chairman when you said the changes in public expenditure policy in the White Paper were presentational. Can I remind you that as recently as the Budget you did say in real terms the planning total is expected to remain broadly constant over the period 1988-89. Most people would consider that is a significant change in policy.

(Mr Lawson) As I said in my opening remarks, we have increased the planning total. If you look at the previous planning totals, the "broadly constant" was a description of a gently rising trend in real terms but by a very small proportion; ~~and~~ it was a very small percentage amount, and it marked a big improvement on the trend previously. That proved in the event to be over-ambitious, and therefore

305.4

the planning totals have had to be increased slightly, although the growth projected is still ~~is~~ less than the growth has been in real terms in the past, throughout the whole of the period we have been in office. ~~a slower rate of real growth than projected.~~

94. Can I turn to this financial year, where despite a very large reserve, we have overrun on expenditure. Would you agree that if you take account of the unwinding of the effect of the coal strike and delete asset sales, in actual fact the underlying increase in expenditure is something like £6 bn over the previous year, which is an increase of some 4.3 to 5 per cent., which is actually greater than the increase in GDP?

(Mr Lawson) I do not. I think that the figures that you take for the effects of the coal strike are figures which we would no longer agree with. We have revised, in the light of greater knowledge, our estimate of the effect of the coal strike in 1985-86, so the growth would not be, on the coal strike adjusted basis, as great as that.

95. What would that be?

(Mr Lawson) I do not know whether Mr Turnbull has the figure in his head; I do not.

Chairman

96. Has it been published?

(Mr Lawson) No, it has not been published.

Mr Townend

97. We were given a figure last year of £1.25 bn.

(Mr Lawson) In the light of greater knowledge, we have revised that downwards. I do not know what the latest estimate is, but it is lower than that. You also have to recall that in 1985-86 public expenditure was exceptionally low. I think that really it is better to look at the two years from 1984-85 to 1986-87 together. There was a marked dip in 1985-86, as is clear if you look at the graph, which ~~I suppose~~ was partly due to inflation being higher in 1985-86 than we expected. In the same way, of course, inflation has been lower in 1986-87 than expected. If you are on a cash planning system, which we are, then - although I do not think this is the only reason - you tend to have fluctuations in real terms of that kind. Indeed, to some extent it ~~inhibits~~ is inherent in the system of cash planning ~~as well~~.

98. Having accepted that, even if the figure for the coal strike were half the figure of £1.25 bn, the increase would still be in percentage terms higher than GDP. Perhaps I can go on to another question.

(Mr Lawson) The plain fact is that the figures are here. The figures in the Autumn Statement would show that even if you exclude privatisation proceeds, then as I say, each year, including 1986-87, on our latest estimates - of course, the year is not over yet - there is a reduction in public spending as a percentage of GDP. If you take a run of three years: 1984-85, excluding privatisation proceeds, 46.25 per cent.; 1985-86, sharp fall to 44.75 per cent.; 1986-87, small further fall to 44.5 per cent.

99. That is not allowing for any unwinding at all of the coal strike.

(Mr Lawson) That is what has actually happened.

Chairman

100. Perhaps we might have a note which would clarify what the figure now is for the coal strike.

(Mr Lawson) I do not know whether Mr Turnbull can help.

Chairman: I think we should move on. Let us have the figure later and we can analyse it.

Mr Townend

101. On Table 1.15 under "General Government Consumption", which is fairly static in the first and second half of 1985 and the first half of 1986, it suddenly jumps sharply in the second half of 1986 and then levels off again. Can you explain why that has happened?

(Mr Lawson) Let me just get the Table.

102. It is page 24 of Table 1.15, "General Government Consumption." Three ~~quarters~~ halves: the first and second ~~quarter~~ half of 1985 and the first ~~quarter~~ half of 1986 it is fairly stable. Then you get a big jump in the second ~~quarter~~ half of 1986, and then it becomes stable again. Can you explain that big jump in those two half-years?

halves.

(Mr Lawson) There may be other factors, but I will ask Mr Turnbull, because it is on the public expenditure side. Perhaps I should not speculate, but public expenditure does have these patterns.

(Mr Turnbull) One possible factor here is the pattern of teachers' pay. During the year 1985-86 there was effectively no increase. If there was a settlement reached in the middle of March 1986, that c~~w~~ould account for some part of this.

Chairman

103. How much?

(Mr Turnbull) I could not give you a figure for that.

Mr Townend: It must be more than teachers' pay with a jump as sharp as that.

Chairman

104. What are the other factors?

(Mr Turnbull) We will have to go into the detailed figures to see what the various increases are.

SDS7

(Mr Lawson) I will be happy to let you have a note on that. There is nothing to hide at all. Quite what the incidence is of various factors I do not know. Teachers' pay ~~will undoubtedly~~ might possibly be one of the factors.

Mr Townend

105. Turning to the reserves, in the current year we have over-run expenditure in spite of reserves; in the coming year the reserves are 20% less. You have said you are confident that that figure will be adequate, but presumably it must depend on public sector pay increases keeping within or perhaps just above inflation. Is that correct?

(Mr Lawson) The reserves are what I consider to be adequate taking into account everything, including departmental running costs ~~and what might happen;~~ elsewhere. All the contingencies are covered ~~there~~. The reserves are, with the exception of last year, the highest we have ever had both in absolute terms and as a proportion of the planning total. Last year, In the first year, plans there was a very, very tight figure given for increases in local authority spending. In the subsequent years there was no further increase at all; the same cash figure was rolled on, and it was explained that this was purely ~~the~~ a convention. We did not expect ~~it~~ that to happen, but we had not at that time been able to ~~come~~ agree to what the figure should be, so we put in a big reserve. This year there is a much bigger increase in local authority current expenditure, ~~which~~ what we believe to be a realistic estimate - and so on for the subsequent years - and therefore reserves on the scale of last year are not required. ~~It is~~ And this year's reserve is bigger than any of the previous years, other than last year. I was interested in reading the various scribblings just before the Autumn Statement where there was a general consensus that reserves of this size - £3bn-~~£1½bn~~ £3½bn - would be necessary, and I was criticised in advance for an alleged desire to bring the reserves down to £2bn. In fact the reserves have been set at a figure which I consider adequate and which before the event the scribblers would have considered adequate as well.

106. Obviously, if public sector wages go up along the line of the recent firemen's settlement of 7% the situation could be different.

(Mr Lawson) I do not think you should draw any conclusions from that.

107. It would seem to me, looking at the figures, that if you were able to stick to the planning totals which were put out in last year's Autumn Statement, at the next Budget it would be well within the realm of possibility for you to be able to achieve your aim of bringing the standard rate down to 25p. Do you agree that by having increased spending in 1987-88 by over £4bn that aim will have to be deferred?

(Mr Lawson) Certainly I would agree with that. As I said in the House in the questioning that followed the Autumn Statement, a pound used in additional public expenditure is a pound which is not available for reductions in taxation, unless you are prepared to ~~extend~~ expand the borrowing requirement, and I have made it clear and explicit that that I will not do.

Chairman

108. Chancellor, I think we want to move on to the fiscal stance about which Mr Wainwright has some questions, but may I say we would appreciate a note about the point made on Table 1.15. We were under the impression that these were figures given in volume terms and therefore they excluded teachers' pay.

They are real terms (ie cash terms) & not 'volume' terms

(Mr Lawson) I am not sure they would ~~include~~ exclude teachers' pay * ~~if they were in volume terms.~~ *

STET

AMEND AS INDICATED

Mr Wainwright

109. It would be helpful in compiling our report if you could describe what are the main instruments of your counter-inflation policy.

(Mr Lawson) The main instrument of counter-inflation

Footnote: * The Treasury note confirms that the rise in teachers' pay would not affect the volume terms figures shown in the forecast but would affect the real terms changes in the planning total and general government expenditure.

policy is, and always has been, monetary policy, and the essential instrument of monetary policy is the interest rate.

110. Moving on to the public sector borrowing requirement, your Autumn Statement very rightly stresses the immense number of uncertainties to which the British economy is unavoidably subject; it is out of British control. In those circumstances, how unconditional is your PSBR target of £7bn?

(Mr Lawson) It is a firm commitment which I have given. I was not obliged to give it but I chose to do so.

111. But apart from extraneous uncertainties, it is a notoriously difficult subject because, as you rightly said in your 1985 Autumn Statement, "the average errors in PSBR forecasts at this time of year [autumn] have been ¾% of GDP, equivalent to £2½bn." That being so, how do you reconcile your statement that the PSBR will not be a penny piece more than £7bn?

(Mr Lawson) I ~~understood~~ thought it was quite clear, and I am sorry that some people do not understand it. What I was talking about was the PSBR which I ~~was~~ will be setting in the Budget in the normal way, which I do every year in the Budget and ~~which~~ previous Chancellors have done likewise. I cannot guarantee that at the end of the year the PSBR will in fact turn out to be what I have said at the time of the Budget. But, as I said earlier, with the exception of the coal strike year, which was quite exceptional and explicitly so, where there was a sudden shock which I decided it would be right to ~~tack~~ take on ~~to~~ the borrowing requirement, the outturn has been pretty close to what I said at the time of the Budget; sometimes a little above and sometimes a little below. Last year's outturn was below it and this year so far it seems to be on track. I did touch on this ~~shock~~ in my Lombard Association speech. Dealing with fiscal policy, I said that one of the guidelines of fiscal policy is to set the PSBR at a level which not merely can be comfortably financed in a non-inflationary way but which has a margin, so if there is a shock of the kind we had because of the coal strike you can still finance it in a non-inflationary way, which is what we did. However, I am not anticipating or expecting a coal strike in 1987-88.

112. Without anticipating a coal strike - God forbid! - you are yourself on record as saying, very rightly, that the PSBR figure, which is the residue of two enormous totals, is subject to errors which average £$2\frac{1}{2}$bn. If there were to be an overshoot of that order, would you finance it by increasing the PSBR or raising taxes?

(Mr Lawson) That is a purely hypothetical question, and the important thing which I think the Committee should focus on is that they have been told that the PSBR will be set at $1\frac{3}{4}$% of GDP; and that is a genuine figure which, within a margin of error, will be the outcome.

Mr Budgen

113. You know that you are widely and rightly admired ---

(Mr Lawson) I did not know that!

114. --- for the medium-term financial strategy and for your Zurich speech as evidence of your implacable determination to eliminate inflation and to make that elimination more important than any other objectives of either economic or political policy. Therefore, we have all been very interested to read your recent statements about monetary policy. The position is at present that you find the monetary aggregates are no longer a satisfactory guide to future inflation?

(Mr Lawson) This is a very important subject and a very complex one and that is why I thought it right - and when I last met this Committee (it was just before then) ~~and~~ I told the Committee I was going to make the speech - to set out how we operate monetary policy and why, very clearly and very lucidly. It is not perhaps ideal bedside reading but ~~that is why there~~ in it I have set out more fully than in most countries how we operate monetary policy. It is all there in my Lombard Association speech. Certainly it is true, if you take broad money, particularly the best-known broad money aggregate, ~~the~~ £M3, ~~but~~ though it is true for the other broad money aggregates as well – there is not a clear relationship between their growth ~~of that~~ and the growth of money GDP, which is what the core of the policy is. ~~and,~~ Therefore, one needs to interpret it carefully. This is not new, incidentally. I think it is becoming increasingly difficult but it happened right from the beginning, from 1980, as I recall, and we have increasingly had to put weight on ~~broad money~~ MO - and I introduced this ~~since~~ as soon as I became Chancellor and it is a useful guide - and on the exchange rate. As I say, the policy and the way it is practised and implemented is set out very fully in my Lombard Association speech. Other countries, too, are experiencing similar difficulties at the moment. Germany started targeting central bank money, as they call it, a composite aggregate~~s~~, in 1975 and they have hit the target every year since 1978. But ~~and, indeed,~~ this year they are well above it. ~~now~~ ~~and~~ yet I do not think there is much fear of a great resurgence of inflation in Germany.

David Peretz tells me they missed in 76-78

115. Can I use an old-style expression, "overheating", and can we look through the indicators in the economy and ask you whether they might indicate overheating. For instance, could you remind us by how much on average London house prices have increased in the last year?

(Mr Lawson) I do not have the figure offhand.

116. Can I suggest about 20 per cent. Might that not be an indication of overheating and loose credit?

(Mr Lawson) I think that if one is trying to assess whether there is what you call overheating - and by that I understand you to mean that the economy is running up against a supply constraint, that it cannot meet the demand that there is in the economy - you have to look at all the evidence. ~~and~~ I must say, looking at all the evidence all over the country, I do not believe there is overheating, nor does it really emerge out of the CBI surveys.

117. But you keep referring to "all the evidence". Let me go through a few of the pieces of evidence and you tell me which of the pieces of evidence I have left out.

(Mr Lawson) A change in relative prices, which is what you are talking about, is not evidence of overheating.

118. Might not house and property prices be one piece of evidence in the mosaic?

(Mr Lawson) Yes, they might.

119. Might share prices be one piece of evidence?

(Mr Lawson) Not of overheating in a direct sense. Certainly share prices might be an indication of financial ~~deficiency~~ laxity.

120. Do you agree with the Governor of the Bank of England that liquidity in the company sector may be an indication of easy credit?

(Mr Lawson) No, I would not say that liquidity in the company sector is evidence of excessive ~~easy~~ credit.

121. Did not the Governor say that there were dangers from the present level of liquidity in his Loughborough speech?

(Mr Lawson) There are two issues here. There is the question of whether the growth of credit is presaging increased inflation, and those who watch it very carefully ~~certainly~~ have to form a judgment about that based on all the other financial indicators and what is happening in the economy. Then there is the quite separate question of whether there are prudential risks in the extension of credit in particular cases.

122. But dangers to the banking system as opposed to dangers to future policy?

(Mr Lawson) That is right.

123. Let us go through a few of these guidelines. For instance, might not wage increases running at between 7 and 8 per cent. - and I am talking about average manual workers not the more favoured sector in the City - be an indication that credit has become fairly lax?

(Mr Lawson) I do not think so. We do have a problem, as I have said on a number of occasions, of an excessive growth of unit labour costs as a result of excessive growth of wages in the economy. But this is something which is not new, and if you are going to say that is a sign of overheating, or inflationary pressure, then you have to say that that has been the case for some years now, ~~and yet~~ yet what we have seen is inflation coming down to the lowest level for something like 20 years. ~~It~~ The pay problem is much more closely connected with the level of unemployment - a point I have made on previous occasions.

124. For instance, yesterday Sir Peter Hordern drew attention to the level of new hire purchase credit - I am sure your advisers have it, it is paragraph 610 - and he said, and I expect he got it right, that the level of hire purchase new credit in 1981 was £7.8 bn, by 1985 it had risen to £13.5 bn and in the first six months of this year it rose 50 per cent. He went on to say that the same sort of figures were to be seen for bank lending. I expect you were present and heard those remarks?

(Mr Lawson) Yes, I was present.

125. If those figures are true, is that not an indication that the economy is enjoying a dangerously fast consumer boom?

(Mr Lawson) First of all, as I say, over the past five years the economy overall has been growing at a pretty steady rate of around 2½-3 per cent a year or thereabouts and there has been no great change in that. The upswing ~~steadiness~~ growth is quite remarkable, both in its steadiness and its duration, which contrasts quite markedly with previous upswings. Then if you look beyond the overall pattern of what has been happening to the economy and look within it, ~~as you are doing in various aspects of it,~~ to see whether you think there is overheating, you point to some factors. One could point to other factors. One could point to the level of unemployment, which is still high, although I am glad to say it now appears to be coming down; one could point to the amount of overtime working, which is ~~relatively low~~ lower than a year ago; the fact that the most recent CBI surveys say that what is most likely to limit output is lack of demand rather than capacity constraints. If you look at the level of unskilled vacancies, which is rising all the time, it is still not historically high. The same is true of skilled vacancies. Despite the shortages, the level of skilled vacancies is not anything like as high as it was when we had overheating in the economy in the past. If you look at land prices throughout the country, there is no sign of overheating there.

126. Chancellor, that is not so.

(Mr Lawson) Yes, it is ~~so~~. If you look at MO, which is a very useful indicator, ~~there is no rising there,~~ it is ~~excess growth~~ edging up a little bit, and this is one of the reasons why I decided the interest rate should go up by one per cent last month. But ~~MO~~ MO is still within ~~the~~ its target range. Outside London, house prices are not rising at anything like the rate at which you indicated they are in Central London - I take your word for it - and, indeed, there are some signs ~~of a rapid~~ that the rate of increase in house prices outside London may be falling off a bit. One has to make an assessment based on all of the evidence and not on a part of it.

127. Just taking up two of the points you made, could you please tell us of any occasion when the CBI has complained that demand has been excessive?

(Mr Lawson) There ~~are~~ have, certainly, been such occasions in CBI surveys.

(Sir Terence Burns) Two of the ~~points,~~ CBI indicators the Chancellor mentioned - skilled vacancies and firms constrained by capacity shortages - ~~a number of those and his Budget of 1972/73~~ showed very high figures in 1972-73. What you have to do is look at these figures relative to the historical average and if you do compare the position today ~~they are~~ relative to the historical average ~~when you look at these~~ you will find there are not the signs of pressure.

128. It is true, of course, as far as agricultural land is concerned, but there is an indication that forces in agricultural land think that eventually the Common Agricultural Policy will come unstuck, is there not?

(Mr Lawson) Maybe Central London is a similar special factor.

129. As far as development land is concerned?

(Mr Lawson) ~~Central London houses,~~ I really do not think that a change in relative prices, as I said earlier, is a sign of overheating~~, you will always find something.~~

130. Just a final point: on development land it is not a question of change in relative prices, development land has gone up very fast throughout the whole of the country, is that not a particular indication of loose credit just as it was in the period 1972 to 1974?

(Mr Lawson) The conditions between 1972 to 1974 and now are as different as chalk and cheese. If you look at MO; if you look at what was happening to public spending and house prices then; if you look at the PSBR as a share of GDP then; if you look at what was happening to money GDP and, perhaps most strikingly, if you look at interest rates, where real interest rates then were, if anything, ~~they were~~ negative, whereas now they are historically high and positive. The differences are quite dramatic.

Chairman

131. I think we should move on. I did not quite hear the date of the comparison which Sir Terence Burns made?

(Sir Terence Burns) I was speaking about the same period Mr Budgen was mentioning which was 1972/73.

Mr Browne

132. I believe you are on record as saying you do not wish to see sterling fall further, can you tell us against which benchmark you are looking, is it against the US dollar, the deutschemark or the trade weighted index? Could you tell us if there is a psychological floor in your book for sterling and is there also a psychological ceiling?

(Mr Lawson) I suppose the thing I look at most is the index. You are quite right. ~~I do think as~~ As far as the exchange rate is concerned, the view which I have expressed to this Committee before, I think last year, is that ~~I believe that~~ the exchange rate should always be exercising a financial discipline on the economy; I do not believe in a weak exchange rate. We are pursuing ~~I think you will be seeing~~ an anti-inflationary policy and it is desirable to have an exchange rate which is reinforcing ~~exercising~~ it. What we had to do earlier this year was to allow the exchange rate to fall because of the sharp collapse of the oil price. There clearly had to be a step change in the exchange rate and that duly occurred. ~~and~~ This is something I pointed out ~~that~~ as far back as 1984 when I gave a talk in Cambridge entitled "What will happen when the oil runs out". ~~I pointed out~~. There had to be an exchange rate adjustment, though ~~judgment.~~ I was then envisaging ~~the thing~~ it happening more gradually than has in fact happened, ~~perhaps, and~~ Again, I said the same thing when I gave evidence to the Aldington Committee in the other place. This adjustment has duly happened, but it has now come to an end and the ~~that~~ step~~ping~~ change has occurred. So we ~~and we~~ are back to the policy of having an exchange rate which is exercising a financial discipline and that means that I do not wish to see it fall further. I do not know whether you call that psychological or not; it is ~~apparently.~~ operational.

133. If we could now turn to the subject of the European Monetary System. Would you agree for a currency such as sterling, whether or not it is actually perceived as a petrol currency, that going into EMS is not an easy policy and would not be automatic, we would have to negotiate entry and we would effectively link ourselves with the deutschemark block in a mechanism which would reduce our options for the Government and whilst the United Kingdom economy is much more competitive purely from a marketing mix point of view instead of purely from a price point of view it is still not competitive enough <u>vis a vis</u> Western Germany? Therefore, if we were to join United Kingdom interest rates

would become potentially much more volatile and subject to strong upward pressure and our counter-inflationary policy you have outlined in a question previous would be out of our determined, democratic hands and subject to the vagaries of the marketplace.

(Mr Lawson) First of all, of course, the EMS is not solely composed of Germany but also contains France, Belgium, Holland, Italy, Denmark and Luxembourg Ireland. I think that is the lot.

134. It is effectively a deutschemark block.

(Mr Lawson) They are all ~~parties~~ members and I think one has to bear that in mind rather than thinking of it solely as Germany although certainly the deutschemark is far and away the most important currency within the ~~EMS~~ ERM. That is ~~the right~~ a necessary qualification ~~in~~ is the way in which you were expressing it. Secondly, there has to be financial discipline. If you are going to keep on top of inflation ~~I do not think~~ you ~~can~~ cannot run the economy successfully without financial discipline any more than you are can run a company successfuly without financial discipline. ~~There~~ There has to be financial discipline and no form of financial discipline is a soft option. One has to make a judgment as to whether this particular form of financial discipline on balance is more desirable, or more helpful, or more useful than the forms of financial discipline which one can, and does, apply outside ~~EMS~~ the ERM. I notice this Committee ~~did report~~ itself reported on this matter a little while back and came to the conclusion it was not desirable to join ~~EMS~~ the ERM. I notice your Chairman in his interesting speech yesterday said he had changed his mind.

Chairman: With respect, the Committee's report did not say that and what I pointed out was the relevant exchange rates have changed since.

135. Could I turn you to page 18 of the Autumn Statement, Table 1.7, to look at the figure on the fourth quarter under housing, $10\frac{1}{4}$ per cent. Could you give us some idea of your underlying assumption as to the interest rate used for that?

(Mr Lawson) No. We do not forecast interest rates.

Mr Browne: Thank you.

Mr Mitchell

136. I was interested in what you said to Mr Wainwright, interest rates are a central weapon against inflation, echoed now by what you have said to Mr Browne when you said the exchange rate is a financial discipline. That means there has been a basic change in Government attitudes towards the exchange rate, does it not, because in 1980 you were telling us you had no policy for the exchange rate. It was a kind of residual. Now, clearly the strategy seems to be to keep it up by high interest rates, interest rates heavier and higher than our competitors and to stop the tendency for market forces to bring it down in order to fight inflation by presumably making imports cheaper.

(Mr Lawson) I do find that this continual harking back to 1980 when - as you reminded the Committee - I was Financial Secretary to the Treasury, has a nostalgic charm which appeals to me greatly. I am happy to talk about that for some time. What happened in 1980 was interesting. There were a combination of factors: you had a totally discredited Labour Government replaced by a Conservative Government in which there was great worldwide confidence at a time when we were in the latter period of the Carter regime in the United States which had lost all international confidence completely. Coinciding with those factors you had this sudden rather belated discovery by the markets that Britain was a substantial oil producer, likely to be so for some time, at a time when ~~this~~ that was a rather desirable thing to be. So that led to the market pushing up sterling very substantially indeed; greater - I readily conceded - ~~far more~~ than we had expected at the time, certainly far more than I had expected. There was very little~~, because of the power then,~~ we could sensibly do about it without really undermining ~~the~~ our monetary policy ~~very considerably~~ and ~~the~~ financial policy very considerably. We also recognised very quickly, and indeed this was said a number of times, that the pressure from the exchange rate was one of the reasons why we could take a relatively relaxed view ~~with~~ of the fact that sterling M3 was overshooting by quite a wide margin. the target range, ~~shall we say, and~~ that we would still get - as a result of the overall balance of financial discipline as such - inflation down. ~~and~~ Indeed that proved to be the case. I have no doubt whatever that the high exchange rate at that time, looking back, was a very important instrument in getting inflation and inflationary expectations down.

We saw

137. Just that it was not avowed. Thank you for the fascinating history lesson. Is the exchange rate being kept now at a level higher than market forces would have it, at higher interest rates than our competitors, in order to fight inflation?

(Mr Lawson) Certainly ~~the~~ interest rates are set at the rate needed to fight inflation, that is absolutely right. The level of the exchange rate, what is happening to the exchange rate is an important determinant of that; that ~~we have made clear on a number of occasions and~~ I have made clear on a number of occasions.

138. Two questions arise from that: you mentioned the step change produced by the fall in oil prices, why should there not be a decline in interest rates by the fact our labour costs are going up faster than our competitors? Surely that too would require the pound to come down?

(Mr Lawson) If you wish simply to surrender to the potential ~~inflation force~~ inflationary forces in the economy, that is indeed what you would do and you would have steadily increasing inflation. The whole essence of the battle against inflation can be summed up in one hyphenated word, and that is "non-accommodation". That is what it is all about. What you are advocating, and what I resist, is ~~an operation~~ a policy of accommodation.

139. I am advocating not going back to the mistakes of 1980 and 1981 when the over-valued exchange rate was ruinous for industry and destroyed our manufacturing by 78 per cent of our manufacturing capacity. What is the logic of hitting industry with high interest rates to punish it for the increase in labour costs? First of all, this hits manufacturing rather than services; secondly, manufacturing cannot control its labour costs and Government cannot either because all it does is preach sermons; thirdly it penalises investment; fourthly it puts up RPI by higher mortgage rates and fifthly it means we have to carry a double burden, high interest rates and over-valued exchange rates; what is the virtue to industry of that?

(Mr Lawson) The virtue to industry of that is that it benefits from low inflation instead of high inflation which there would be under the policies which you are advocating. It is perfectly true, and I search for common ground always with you Mr Mitchell ---

140. Might be rather muddy!

(Mr Lawson) ~~I will tread it.~~ I am intrepid. It is absolutely true that if industry were to get a better grip of its costs, in particular its pay costs, then I do think that it would be necessary, ~~to,~~ as part of the anti-inflationary strategy, to have interest rates as high as they are today.

141. It is a form of salvation through suicide: inflicting damage on the economy which we need to survive as oil falls away.

(Mr Lawson) It is a curious form of suicide when ~~the~~ industry is growing steadily and is more profitable than it has been for decades (not years, more profitable than it has been for decades). Indeed, I notice - quite astonishingly really because I do not think they normally do take sides in the party political battle at all - that at their recent conference, the CBI came out in unequivocable support of the Government's economic policy, which I do not think they would be doing if it was actually a policy of industrial suicide because they are not stupid. If you look at what is happening to the economy, in terms not merely of inflation but the steady growth, the steady improvement in profitability, the fact that ~~you say this policy is inimical but this policy~~ investment is at all time record levels, then I think it is quite impossible to sustain the thesis which you are putting forward.

142. The Government too, of course, engaged us in some element of double talk on this issue. It is not only my thesis. In 1980 the Government was saying that the over-valuation of 1980 and 1981 would inflict no great harm on industry and would bring effects in the form of discipline. Now you are saying in the projections in the Financial Statement, there are going to be effects on the fall and rise of the value of the pound, exports will increase next year and imports will be restrained

next year. Why should not those processes, those benefits, go further by allowing the pound to come down to counteract the increases in labour costs?

(Mr Lawson) I have explained why this would be a complete surrender to inflationary pressures and it would also remove all financial discipline which is necessary if industry is going to become more competitive and the country is going to prosper in the long run. ~~It~~ Yours is an essentially short-term approach which we have seen all too often in the past. ~~because it has been forecast in the past~~. It has produced not merely high inflation but a weakened and debilitated industry in contrast to the more vigorous and healthy industry we have today.

143. In terms of projections, particularly on balance of payments which do seem rather optimistic, are we at risk of a very tight balance of payments constraint which will produce a sterling crisis in its wake, you are surely more vulnerable? In other words, the financial statement and, indeed, the Chancellor's act is rather like a highwire act on the wire of high interest rates, I think, keeping a rickety show on the road.

(Mr Lawson) Nothing rickety about it.

144. What is in many respects a rickety show on the road is like the marvellous Buster Keaton thing of "pretending all is well 'til ...", keeping everything apropos before the deluge.

(Mr Lawson) There will never be a deluge if this Government is returned.

145. It does not matter which shower is in, Chancellor, there will be consequences from the fact that things have been allowed to let slide to keep the mood happy until the election.

(Mr Lawson) You seem to have done an extraordinary U-turn. A moment ago you were accusing me of having everything far too tight and crucifying industry and now you are saying that everything is being loosened up for the election. I wish you would make up your mind.

146. It is being kept going for the election, this somewhat rickety show, and the only way to regenerate it is to bring down interest rates and stimulate investment in manufacturing, particularly in the exporting industry and make the economy competitive again.

(Mr Lawson) I will bring down interest rates when it is prudent and safe to do so and not before then. ~~I was emphasising this idea and~~ I would have thought your own strictures about the high level of interest rates, ~~I would have thought this~~ should dispose of any idea somehow that what we are engaged in is some great relaxation because we think that will be helpful in the context of the election. There has been no change in the policy stance at all, as I indicated in my opening remarks; and this is the policy stance that we will be continuing after we have won the next election, whenever that may be.

147. That is just in terms of this relaxation. Can we take it, therefore, if the PSBR overshoots, I am talking about the whole stance across ? 1987-88 ~~1977/78~~, can we take it that success will be clawed back in principle in 1988/89 thus maintaining your commitment to the seven billion PSBR?

(Mr Lawson) That is a purely hypothetical question, ~~on which~~ I will have to decide what action is right in the light of the circumstances at the time as I have done each year since I have been ~~the~~ Chancellor of the Exchequer.

Mr Watts

148. I would like to pursue your answer to Mr Wainwright about the interest rate being the essential instrument of monetary policy. In your view is the main role of the interest rate to reduce the demand for borrowing by making it more expensive, or is the major way it exercises an influence by maintaining sterling at a level which keeps up the pressure?

(Mr Lawson) The role is to keep financial ~~commitments~~ conditions sufficiently stringent to ensure that inflation remains low and ultimately to eliminate inflation altogether and have stable prices. There are various indicators of ~~the~~ financial conditions of which narrow money and the exchange rate are particularly important. The interest rate ~~It~~ clearly does have an effect ultimately on the amount of credit in the economy, but the relationship there is far more complex, far less clear and is difficult to ~~steer.~~ establish.

Also, ~~you have to,~~ when you are thinking of broad money, the question on ~~to~~ which one has to make a judgment is the extent to which ~~the~~ holders of broad money are willing holders of broad money; ~~and~~. Where there has been ~~a~~ ~~simple~~ shift in the propensity to hold broad money that, itself, does not pose any inflationary dangers. If, on the other hand, you judge that they are unwilling holders - and it was the Governor of the Bank of England at some stage before this Committee who had a colourful expression about an "avalanche" --- a glacier -

Chairman

149. Frozen glacier.

(Mr Lawson) Then, of course, you have to take rapid ~~repeat~~ action because otherwise there will be very real inflationary dangers, but I see no sign of the glacier being about to melt.

Mr Watts

150. As the monetary aggregates are no longer considered to be such a reliable indication.

(Mr Lawson) It is ~~the~~ broad money which is a particular problem in this country. Monetary aggregates are proving difficult in most countries. Not only the Germans but the Americans are exceeding their targets both ~~in~~ for M1 and M2 and the French are exceeding their's. It is pretty much a worldwide disease. In so far as ~~it~~ the difficulty is linked with financial liberalisation and innovation, I think it is fair to say there is no country in the world which has gone further along the path of financial liberalisation and innovation than the United Kingdom.

151. In view of that, and the emphasis you were giving to the importance of the exchange rate as one of the indicators of monetary conditions, have you given consideration to setting the exchange rate target range in the same way we had a target

range for sterling M3, both to give an indication of where you intend that exchange rate discipline to be exercised and to remove uncertainty?

(Mr Lawson) The reality of foreign exchange markets,
and this does not apply to monetary
~~which makes it very different from~~ targets, ~~the reality of the foreign exchange market~~ would make that in my opinion an unwise course of action. I think there is a case clearly ~~- Mr Browne has left the room -~~ for being part of an explicit regional fixed exchange rate system. Alternatively, you can have the sort of policy which we have at the present time. I do not actually think there is a viable halfway house.

? 152. You reasserted earlier today in your oral statement you did not wish to see sterling fall further.

(Mr Lawson) That is right.

153. I believe when you made the statement the basket

check was 69½ and I believe today it is 67½. I understand that when you say "not fall any further", you do not want to stay exactly on that spot for the whole of the year. When there is such a variation over a relatively short period of time, I think that adds to uncertainty as to precisely what is intended in the period.

6 November
69.5

(Mr Lawson) The question of uncertainty is a very difficult one. I can quite understand that good people with all the best motives would like greater certainty as to at what point one would act in order to affect the exchange rate. On the other hand, that degree of certainty would also be playing into the hands of the short-term operators. In practical market management, I do not think it is sensible to be any more explicit than I have been.

Mr Watts: Thank you.

Chairman

154. Thank you very much Chancellor, I wonder if I might take up one or two of the points which have been raised already? I think you are aware there are some colleagues who have to be elsewhere in the House which is why we are slightly like an Agatha Christie thriller where the characters keep disappearing. This is in no sense my colleagues being discourteous to you.

Could I ask you a couple of points which came up in the earlier discussion: in Paragraph 61 of the Autumn Statement it says: "for the past six years, high rates of growth of broad money ..... have been consistent with appropriately tight monetary conditions and thus a substantial fall in inflation."

(Mr Lawson) Yes.

155. Are you now saying that regardless of what is happening to M3 that might be consistent with low inflation or continuing to battle against inflation?

(Mr Lawson) Yes, that is what is implied here, certainly. I do not have the figures in my head but the change in the velocity of sterling M3 as between, say, the 1970s and 1980s~~, I am not sure where the turning point was but it~~ is quite remarkable ~~and~~. I quoted the figures for ~~to you~~, one five year period and another five year period, in my ~~the~~ Lombard Speech, showing ~~saying~~ that the ratio between the growth of ~~what we have in~~ money GDP and the growth of sterling M3 in one period and the ratio in another was ~~is~~ quite different. This overrunning of the sterling M3 targets has been pretty well a feature of the period we have been in office, except for a short period when it was kept down by very heavy overfunding. I think this Committee was among those who queried whether that was achieving anything and I think it was partly this Committee's views on that which led us to abandon overfunding as a way of life. There has been this general tendency for ~~in~~ broad money to grow very ~~money~~ rapidly and yet, and this is the important thing, inflation has come down and come down very markedly and that is the proof of the pudding.

(Sir Peter Middleton) It is also true of Europe as a whole, or OECD as a whole.

156. You began by speaking of continuity of policy, the views you express now are radically different to those expressed at the beginning of the Government's period of office.

(Mr Lawson) I think that it is perfectly true to say that right at the beginning we did not expect to see such a sharp change in the velocity of sterling M3, but it actually happened very ~~quickly~~ early on and we very quickly realised that things were changing. ~~and,~~ Indeed, in ~~the~~ my Zurich speech to which Mr Budgen referred I alluded there to the fact that sterling M3 was giving a false reading. Although it is perfectly true we did not expect to see this sharp change when we first took office in 1979 it is something that became apparent very quickly thereafter: ~~and~~ you will remember the abolition of the corset and the growth which continued in sterling M3 after it. This is not in any sense a new development, although it has become more pronounced so far as broad money generally is concerned as financial liberalisation and financial innovation have developed much further.

(Sir Peter Middleton) One might say that inflation has come down.

Chairman: Yes, we understand that. Chancellor, we have, as you have noticed, gone back quite a bit to the situation in the earlier years of the present Government because it seemed to us perhaps there could be some lessons to be learnt as I think you indicated perhaps some of them have been learnt. Obviously we will need to consider very carefully the various points you have made before producing our report for the House. We would appreciate the couple of notes we mentioned earlier on in order to help us in reaching our conclusions. Having said that, can I express my thanks to you and your colleagues for coming this afternoon. Thank you.

FROM: Miss C Evans
DATE: 21 November 1986

MR ALLAN
SIR PETER MIDDLETON
SIR TERENCE BURNS
MR TURNBULL

cc Mr Cassell
Mr Scholar
Mr Odling-Smee
Mr Sedgwick
Mr Peretz
Miss O'Mara

TCSC AUTUMN STATEMENT ENQUIRY 1986:
ORAL EVIDENCE BY THE CHANCELLOR OF THE EXCHEQUER AND TREASURY OFFICIALS

I attach a copy of the transcript of the Chancellor's evidence to the Committee on Thursday 20 November 1986.

2. I would be gratful if you could look through the evidence and make any corrections which you think necessary, by **noon Wednesday 26 November.** I will prepare a master copy with all the necessary changes for transmission to the Committee.

Caitlin Evans
MISS C EVANS

Ch
I will liaise with the others and we will let you have a master copy with all suggested corrections marked (what is below is some quick ones by me on first half). But you may like to see now.

AA

from Rt Hon Terence L Higgins MP

PMP

HOUSE OF COMMONS
LONDON, SW1

21 November 1986

Dear Chancellor.

The Committee have asked me to thank you for being so good as to come and give evidence to them recently on the Autumn Statement. I know that all Members found the exchanges of considerable interest and are very grateful to you.

As ever.

Terence

RT HON TERENCE L HIGGINS
Chairman to the Treasury and Civil Service Committee

Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
SW1P 3AG

CH/EXCHEQUER	
REC.	26 NOV 1986 ✓26/11
~~ACTION~~	CST SIR P MIDDLETON
COPIES TO	SIR T BURNS MR F E R BUTLER MR ANSON MR SCHOLAR MR TURNBULL MR P GRAY MR CULPIN MISS C EVANS

FROM: Miss C Evans
DATE: 21 November 1986

MR ALLAN
SIR PETER MIDDLETON
SIR TERENCE BURNS
MR TURNBULL

cc Mr Cassell
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AA

CE34

No. This must be wrong. Table 1.15, wh. is what was being discussed, does not claim to be volume terms, but real terms (constant 1980 prices). That was my point. "Volume terms" was a shorthand years ago. N.

FROM: MISS C EVANS
DATE: 25 NOVEMBER 1986

MR ALLAN

Ch
OK? I have marked new amendments in green (Miss Evans unhelpfully used red biro)
AA

cc Chief Secretary
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr Cassell
Mr Kemp
Mr Scholar
Mr Turnbull
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Miss O'Mara
Mr S J Davies
Miss Noble

TCSC AUTUMN STATEMENT: CHANCELLOR'S EVIDENCE

I am returning the Chancellor's amended copy which you gave me this morning. I have added a small number of amendments suggested by officials - these are sidelined.

2. Mr Turnbull is submitting separately drafts of the two notes requested by the Committee, on the cost of the miners' strike and on the pattern of general government consumption in Table 1.15. The latter note confirms that the rise in teachers' pay is not a factor in the movement in general government consumption in volume terms. We therefore recommend that the transcript of the answer to question 104 (p. 16) should be amended as indicated but that the answer to question 108 (p. 17) should stand unamended, with a footnote referring to the Treasury paper.

3. There is only one other point of substance sidelined on page 23. This reflects the fact that overtime is currently higher than the average for 1980-84 but it is lower than the average for 1985 and lower than this time last year.

4. May we send these amendments to the Committee please.

CE

MISS C EVANS

PS. On page 11 Miss Noble has pointed out that it is not the case that most benefits are taxable. She has amended the answer to say that most benefit expenditure is taxable.

CE

CONFIDENTIAL

FROM: A Turnbull
DATE: 25 November 1986

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Scholar
Mr Sedgwick
Mr Mowl
Mrs R Butler
Mr Gray
Mr M L Williams
Mrs Diggle
Mr G C White
Mrs Dunn
Miss Evans

FURTHER NOTES FOR TCSC

In examining the transcript you want to consider the terms in which we reply to the Committee on the two points where further notes were requested:

(i) Mr Townend's argument that if one takes out the impact of the coal strike in 1985-86, the real terms change in 1986-87 is greater than the increase in GDP;

(ii) the increase in general government consumption in volume terms between 1986 HI and 1986 HII, and whether increases in teachers' pay provide part of the explanation.

?

2. On (ii), a draft note for the Committee by Mr Mowl is attached. Part of the explanation is a small discontinuity between the two halves of 1986 resulting from the forecast partly discounting the provisional data for the first half. The rest of the explanation stems from a relatively large volume increase of 2½ per cent expected for financial year 1986-87 - to some ? extent lower than expected inflation - followed by a smaller increase of ½ per cent in 1987-88. Teachers' pay is not relevant. The draft note avoids discussion of financial year profiles, concentrating instead on the steady growth forecast for calendar years 1986 and 1987.

3. On (i), Mr Townend is contending that in real terms the planning total increased in 1986-87 by 2.2 per cent; excluding privatisation proceeds it rose by 3.5 per cent; and if one takes out of 1985-86 the £1¼ billion which was the estimate of a year ago for the cost of the coal strike, the ex privatisation proceeds, ex coal strike increase is about 4½ per cent.

4. A year ago we told the Committee that the effect of the coal strike on the planning total was £2½ billion in 1984-85, and £1¼ billion in 1985-86. We did not provide any estimates of the effect on GGE. For 1984-85 we estimate that this was only about £1 billion because about £1½ billion of the ESI's increased EFL was financed by temporary market borrowing.

5. For 1985-86, we now think the impact in the planning total is only about £¾ billion, the main difference being the improvement in the finances of British Coal towards the end of 1985-86 as it was able to transfer a large amount of coal stock to the electricity industry. While this reduces the 1986-87 increase in the planning total, ex privatisation proceeds, ex coal strike to 4.1 per cent, it still leaves an increase above the growth rate of GDP (2½ per cent).

6. Another approach would be to inject the coal strike corrections in to GGE which increases by 0.8 per cent and 2.0 per cent, with and without privatisation proceeds. The inclusion of debt interest helps improve the growth rates. The difficulty is that while the impact of the coal strike on GGE in 1984-85 is <u>less</u> than on the planning total, the impact in 1986-87 is <u>greater</u>. Instead of £¾ billion, the impact on GGE is £2 billion. This is because the ESI repaid about £1¼ billion of market debt, much of it by drawing on the NLF, which <u>adds</u> to GGE. Thus the GGE strike corrected numbers do not rebut Mr Townend's argument. The differential impact on the two aggregates has not been raised with the Committee as last year GGE was not shown in real terms, only as a proportion of GDP.

7. I sugest the following approach:

(i) quote the planning total figures in real terms, with and without privatisation proceeds;

(ii) quote the GGE number, with and without, mentioning that these include debt interest;

(iii) mention £¾ billion as our revised estimate of the effect of coal strike on the planning total, but say nothing about the impact on GGE, and provide no revised growth rates;

(iv) point out that with cash planning, sharp differences between forecast and actual movements in the GDP deflator can exaggerate the real terms changes;

(v) indicate that the best measure of the underlying trend is to look at the movement over 1983-84 to 1986-87, which skips the strike affected years and evens out the real terms changes between 1985-86 and 1986-87;

(vi) compare (v) with the growth of GDP in real terms over the same period.

8. A draft note for the Committee is attached.

AT

A TURNBULL

	Per cent	
	1985-86	1986-87
PT cum privatisation proceeds	-2.9	2.2
PT ex privatisation proceeds	-2.5	3.5
PT ex pp, ex coal strike	-1.2	4.1
GGE cum privatisation proceeds	-0.3	0.8
GGE ex privatisation proceeds	0.0	2.0
GGE ex pp, ex coal strike	-0.7	3.3
GDP in real terms	3½	2½

Effect of coal strike

		£ billion
		1984-85
1985-86		
Planning total	2.6	0.7
GGE	1.0	2.1

Ch
I have (ie in "inflation" terms)

GENERAL GOVERNMENT CONSUMPTION: NOTE BY HM TREASURY

Table 1.15 of the Autumn Statement gives a forecast of general government consumption at constant 1980 prices. This forecast is fully consistent with the path of public expenditure in 1985-86 and 1986-87 set out in chapter 2 of the Autumn Statement.

2. General government consumption is general government current expenditure on goods and services, accounting for about [50] per cent of total general government expenditure. It excludes such items as capital expenditure and transfer payments, such as social security benefits. The constant price estimates of general government consumption are an attempt to measure the volume of expenditure. They are produced either by deflating the cash figures by indices of pay and prices or by using volume indicators. Eh? What?

3. It is not easy to find appropriate price indices for each category of general government consumption. Volume figures for individual quarters can as a result be unreliable and the provisional data in particular is subject to revision. It is not advisable therefore to put much weight on precise quarterly, and to some extent half yearly, profiles. The Autumn Statement forecast partly discounts the provisional data for 1986 first half, shown in table 1.15, as too low, thus exaggerating the increase in the second half of the year.

4. In these circumstances the forecast claims to be no more than a guide to broad movements from one year to another. The forecast in table 1.15 should be interpreted therefore as fairly steady growth of around 1½ per cent a year, [a little higher than the average growth of recent years].

5. To calculate the real terms changes in the planning total and general government expenditure, cash spending is deflated by the GDP deflator, a measure of inflation in the economy generally. The forecast figures discussed above are in volume terms, derived using specific pay or price indices. A faster than average increase in pay for one public sector group would generate an increase in expenditure in real terms but not volume

terms. The pay increases for teachers pay do therefore affect the year to year changes in the planning total or general government expenditure in real terms but do not affect the changes in specific categories of expenditure in volume terms shown in the forecast.

NOTE FOR TREASURY AND CIVIL SERVICE COMMITTEE

At the hearings with both officials and the Chancellor of the Exchequer, Mr Townend argued that the underlying increase in real terms in public expenditure in 1986-87 after correcting for privatisation proceeds and for the effect of the coal strike was greater than the growth of GDP in real terms. The Committee asked for a note on this point.

2. In real terms the change in the planning total was as follows:

	1985-86	1986-87
	Per cent	
Planning total, including privatisation proceeds	-2.9	2.2
Planning total, excluding privatisation proceeds	-2.5	3.5

The corresponding figures for general government expenditure, which includes debt interest, are:

GGE excluding privatisation proceeds	-0.3	0.8
GGE excluding privatisation proceeds	0.0	2.0

3. At the time of the hearings in November 1985, the Treasury estimated that the impact of the coal strike on the planning total would be £2½ billion in 1984-85 and £1¼ billion in 1985-86. The Treasury now estimate that the figure for 1985-86 would be £¾ billion, principally reflecting the sharp improvement in the finances of British Coal.

4. In his evidence the Chancellor of the Exchequer pointed out that, under a system of cash planning and control, there can be fluctuations in the year to year real terms increases if the GDP deflator moves differently from what was expected at the time the plans were made. For example, the GDP deflator in 1985-86 increased by 6 per cent, against the 5 per cent projected at the time of the 1985 Budget. This change in inflation would have made very little difference to the level of cash spending in that year, the change being reflected in

a bigger than expected fall in real terms. Similarly, the GDP deflator for 1986-87 is now expected to rise by 3 per cent against 3¾ per cent in the 1986 Budget, while for large parts of the public sector cash spending in this year will be unaffected.

5. To establish the underlying trend it is necessary to look at the developments over a number of years. Between 1983-84 and 1986-87, a period which is unaffected by the coal strike and during which unanticipated movements in the GDP deflator even out, GGE excluding privatisation proceeds - which is the aggregate giving the best guide to underlying movements - increased by 1¾ per cent a year in real terms. Over this period, GDP increased by 2¾ per cent a year in real terms.

3694/32

FROM: ALLEN RITCHIE
DATE: 27 November 1986

pmp

MISS C EVANS

cc PPS/Chancellor
PS/Chief Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mr Mowl (o.r)
Miss O'Mara

TCSC AUTUMN STATEMENT: CHANCELLOR'S EVIDENCE

Mr Allan's note to you of today attached a shortened version of Mr Mowl's note for the Committee on the forecast of general government consumption.

2. As the earlier draft of the note made some observations about CSO data, we decided to show the note to the CSO. Of the comments they made, one is still relevant to the shortened version. In the second sentence of paragraph 3, they expressed a preference for replacing 'each' [category of general government expenditure ....] with 'every' - the point being that difficulties in finding appropriate deflators apply for some categories of general government expenditure but by no means all categories. The point is a fairly trivial one, and I would not want to press it, if you do not feel inclined to make any more changes.

3. You can also delete the square brackets in paragraph 2 - "about 50 per cent" is accurate. (In fact, the proportion was 47 per cent in 1985-86).

4. Otherwise, PSF are content with the shortened version.

Allen Ritchie

ALLEN RITCHIE

CC → PS/CHANCELLOR
PS/CST
SIR P. MIDDLETON
SIR T. BURNS
MR. F.E.R. BUTLER
MR. TURNBULL
MR. SCHOLAR
MR. SEDGWICK
MR. MOWL
MRS. BUTLER
MR. GRAY
MR. M.L. WILLIAMS
MRS. DIGGLE
MR. G.C. WHITE
MRS. DUNN

H M Treasury

Parliament Street London SW1P 3AG

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Direct Dialling 01-233 ....

PMP

W McKay Esq
Clerk to the Treasury
& Civil Service Committee
Committee Office
House of Commons
LONDON SW1A 0AA

28 November 1986

TCSC

Dear Bill

AUTUMN STATEMENT 1986

As requested during the Chancellor's evidence on 20 November, I enclose notes on the effects of the coal strike and on the forecast of general government consumption.

Yours sincerely

Carys Evans

MISS C EVANS

NOTE FOR TREASURY AND CIVIL SERVICE COMMITTEE

At the hearings with both officials and the Chancellor of the Exchequer, Mr Townend argued that the underlying increase in real terms in public expenditure in 1986-87 after correcting for privatisation proceeds and for the effect of the coal strike was greater than the growth of GDP in real terms. The Committee asked for a note on this point.

2. In real terms the change in the planning total was as follows:

	1985-86	1986-87
		Per cent
Planning total, including privatisation proceeds	-2.9	2.2
Planning total, excluding privatisation proceeds	-2.5	3.5

The corresponding figures for general government expenditure which includes debt interest are:

GGE excluding privatisation proceeds	-0.3	0.8
GGE excluding privatisation proceeds	0.0	2.0

3. At the time of the hearings in November 1985, the Treasury estimated that the impact of the coal strike on the planning total would be £2½ billion in 1984-85 and £1¼ billion in 1985-86. The Treasury now estimate that the figure for 1985-86 would be £¾ billion, principally reflecting the sharp improvement in the finances of British Coal.

4. In his evidence the Chancellor of the Exchequer pointed out that, under a system of cash planning and control, there can be fluctuations in the year to year real terms increases if the GDP deflator moves differently from what was expected at the time the plans were made. For example, the GDP deflator in 1985-86 increased by 6 per cent, against the 5 per cent projected at the time of the 1985 Budget. This change in inflation would have made very little difference to the level of cash spending in that year, the change being reflected in

a bigger than expected fall in real terms. Similarly, the GDP deflator for 1986-87 is now expected to rise by 3 per cent against 3¾ per cent in the 1986 Budget, while for large parts of the public sector cash spending in this year will be unaffected.

5. To establish the underlying trend it is necessary to look at the developments over a number of years. Between 1983-84 and 1986-87, a period which is unaffected by the coal strike and during which unanticipated movements in the GDP deflator even out, GGE excluding privatisation proceeds - which is the aggregate giving the best guide to underlying movements - increased by 1¾ per cent a year. Over this period, GDP increased by 2¾ per cent a year in real terms.

GENERAL GOVERNMENT CONSUMPTION: NOTE BY HM TREASURY

Table 1.15 of the Autumn Statement gives a forecast of general government consumption in volume terms at constant 1980 prices. This forecast is fully consistent with the path of public expenditure set out in Chapter 2 of the Autumn Statement.

2. General government consumption is current expenditure on goods and services, accounting for about 50 per cent of total general government expenditure. It excludes such items as capital expenditure and transfer payments (eg social security benefits).

3. There are well-known difficulties about converting cash plans into volume figures. It is not easy to find appropriate price indices for every category of general government consumption, and the provisional data in particular is subject to revision. There are additional complications over linking together the CSO's early published estimates for the first half of the calendar year, and the forecast of spending over the financial year as a whole. It is therefore not advisable to put too much weight on the precise half-yearly profiles.

4. In these circumstances the forecast claims to be no more than a guide to broad movements from one year to another. The year-on-year changes in table 1.15 show fairly steady growth.

5. Since the figures in table 1.15 are <u>volume</u> forecasts, they are not affected by changes in teachers' pay.

MINISTRY OF DEFENCE
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Minister of State
for Defence Procurement

Copy to
PPS/Chancellor of The Exchequer.

D/MIN/DGT/14/15

CH/EXCHEQUER
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SIR P MIDDLETON
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SIR G LITTLER
MR F E R BUTLER
MR LAVELLE MR SCHOLAR
MR A EDWARDS
MR MORTIMER
MISS SIMPSON
MR CROPPER

21 November 1986

Dear Donald,

During our exchanges on the Autumn Statement on 6th November, you asked me whether the figures the Chancellor announced took any account of a forecast overspend on CAP expenditure, and whether the existence of that overspend would have any effect on our EC abatement entitlement for the current year. I explained to you the position on our 1986 abatement and the present situation on the 1987 budget, and undertook to write to you about the calculation of our 1987 abatement.

The 1987 draft budget includes provision for our abatement next year of 1,633 million ecus, or about £1,125 million. The Council has now agreed to the payment of that sum, and the Autumn Statement figures take due account of this. In fact, we already know that this figure is an underestimate of our true entitlement. After the Commission calculated it and published it in their preliminary draft budget, the United Kingdom made on 1st August a large additional VAT payment, called a 'VAT adjustment' to correct underpayments of VAT in previous years. Because of the way the abatement system works, the effect of this payment is to increase our abatement entitlement. The agreed methodology for calculating

/ and ...

The Rt Hon Lord Bruce of Donington

and correcting our abatement, however, makes no provision for any correction before September next year. Even then, a correction is only optional; we cannot insist on mandatory correction until September 1988.

The Council recognised that it would not be fair to ask the UK to wait that long and has therefore agreed that to the extent it is not possible to make any correction in 1987, they will include the provision in the 1988 draft budget. The Autumn Statement figures for 1986-87, 1987-88 and 1988-89 assume that this is what in fact happens. Any overrun on the CAP in 1987 would not affect our 1987 abatement entitlement.

Yours,

David.

Lord Trefgarne

Minister of State
for Defence Procurement

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SIR G LITTLER
MR F E R BUTLER
MR ANSON MR SCHOLAR
MR HAWTIN
MR PIRIE
MR FELLGETT
MR CROPPER

21 November 1986

Dear David,

On 6th November you asked, following the Autumn Statement, about the actual and estimated effects of the changes in local government which were made by legislation the year before last. I presume you were referring to the provisions for rate limitation in the Rates Act 1984 - but if you had some other point in mind do let me know.

Rate capping has forced local authorities to keep their spending lower - both to avoid selection for the scheme and as a result of it. In nearly all areas which were subject to rate limitation in 1985-86 and in 1986-87 ratepayers have seen a cash cut in their rate bills. And in all cases rate demands have undoubtedly been lower than they would have been if authorities had been allowed to spend as they wished. It is difficult to put any hard figures on the saving achieved because we do not know what local authorities would have decided to spend if they had had a free rein. But the savings are likely to run into hundreds of millions of pounds.

Yours,

David

Lord Trefgarne

The Rt Hon The Lord Renton KBE TD QC

Minister of State
for Defence Procurement

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Copy to: PPS / Chancellor of The Exchequer

D/MIN/DGT/14/15

21 November 1986

Dear Jack, (if I may)

During the repeat of the Autumn Financial Statement on 6th November I undertook to write to you about interest rates.

Short term interest rates are the essential instrument of monetary policy, and will be held at whatever levels are necessary to maintain monetary conditions that place steady downward pressure on inflation. The success of this strategy is clearly demonstrated by the fact that inflation is now around 3 per cent, the lowest level for twenty years.

Real interest rates are difficult to measure, since they depend on expectations about future inflation. But it does seem that they are at present historically high in the United Kingdom and throughout the industrialised world. One reason for the high level of the UK real interest rates is that UK unit labour costs are still rising faster than those of our major competitors.

Yours,

David

Lord Trefgarne

The Rt Hon The Lord Diamond

FROM THE LEADER OF THE HOUSE

HOUSE OF LORDS

26 November 1986

Dear Jack

I am sorry that I was unable, during my reply to the debate on the Address, to deal with the important questions you raised and I hope you do not mind my replying to them by way of letter.

I entirely agree with you that our objective must be to consolidate the gains made in the economy over recent years and that is why we remain committed to a prudent approach on public expenditure. You expressed concern over the consequences for the economy of even a small overrun in public expenditure in the next two years, and whether the planning totals did not depend on the assumption that public sector pay would rise by no more than 3.5 per cent.

Our record is a good one. The average overspend over the last six years has been less than 0.5 per cent. In 1985-86 there was a half billion underspend. Sizeable additions to the Autumn Statement plans were made where necessary and substantial reserves have been established to help ensure future spending will stay within the plans.

As to public sector pay the Autumn Statement plans do not make central assumptions about public sector pay rises. "Running costs" cover not only pay but all accommodation, manpower and other administrative costs. If one element of these costs increases by more than the relevant amount, the money available for other elements is correspondingly reduced. The 1987 Public Expenditure White Paper will show running cost targets for each Government Department for the next three years.

More generally, I can assure you the Government remains committed to a firm fiscal stance in order to maintain the steady downward pressure on inflation that we all desire. I think you would agree that the Government's record has shown we will not hesitate to take whatever steps are necessary to this end.

The Lord Simon of Glaisdale

You also asked about the effect of demographic factors on the unemployment figures. Certainly the increase in numbers of young people coming out of full time education has had an impact on the figures, as you surmise. But we agree with your view that this is not the only factor: as I said in my speech, jobs have had to be shed because of chronic overmanning under the previous Government. However, the prospects for unemployment are improved, as you suggested, by the slower growth in the labour force projected for the rest of the decade. The extent of any reduction will depend crucially of course on what happens to pay.

As to the latest statistics of those entering the labour market for which you asked, I attach a table showing the population of working age between 1979 and 1985. The figures relating to the period 1979 to 1984 are slightly different from those given in Jean Trumpington's reply to Lord Diamond's written question earlier this year. This has arisen because of revisions to the population estimates for Northern Ireland and Scotland in the light of the 1981 Census results.

I am sorry to have written at such length but I did want to do justice to your important points.

I am arranging for a copy of this letter to be put in the Library.

Yours ever

Willie

POPULATION OF WORKING AGE

Mid-year	Size	Net change from previous year
1979	33,460,900	263,100
1980	33,633,000	172,100
1981	33,779,900	146,900
1982	33,930,000	150,100
1983	34,188,100	258,100
1984	34,461,000	272,900
1985	34,646,700	185,700

Alex

We spoke.
I mentioned
that I was sending a
copy direct to Craig
Pickering

Privy Council Office,
Whitehall,
London, SW1A 2AT

With the Compliments

of the

Private Secretary

to the

Lord President of the Council

Joan.
1/12

From: The Right Honourable The Lord Simon of Glaisdale

Allex Allan

PWP

27th November 1986

Dear Willie.

Many thanks for your most helpful letter of 26th November 1986.

I entirely agree with you - indeed I said so in the debate - that the Government's control of public expenditure, and indeed in general management of the economy, has been good - I think the best of any Government since the war.

Nevertheless, I still feel concerned about the implications of the Autumn Statement. Does the Government still maintain any objectives in regard to growth of the money supply? Moreover, the Chancellor's claim that borrowing will still be within the planned total seems to me to rest on some questionable assumptions. Even a small overrun will falsify the computation. I should like to think - you do not say - that steps have been taken to ensure that there is no overrun. This is particularly relevant to local authority spending, where certain controls seems clumsy and inadequate. Then the Contingency Reserve has been whittled down. I note what you say about "running costs" in the public sector. But public sector pay is the principal element; an estimated rise of 3.5 per cent. seems to me to be unrealistic; and I can hardly believe that, if it is exceeded, accommodation, manpower and other administrative costs will be appropriately reduced. I look forward to reading the 1987 Public Expenditure White Paper early next year (incidentally, and frivolously, why does it not have a white cover?).

Although I think that we have every reason to be confident in the judgment of the Chancellor of the Exchequer (his judgment as to the necessary rise in interest rates recently was better than the City's), I should like to be assured that there are plans to deal with any balance of payments crisis. This could well ensue if there is an overrun in expenditure or unfavourable trade balances, or even merely from pre-election jitters.

Thank you letting me have a more up-to-date and revised statistics on those entering the labour market. They strongly suggest still that the major

continued

cause in unemployment has been, as you say, previous over-manning - also, I think, continuing pay settlements unjustified by increased productivity. You do not say what policy the Government has as to this last matter. Nor do you deal with the point I ventured to make in the debate - namely, that, in so far as unemployment is an international problem, it demands an international solution - in particular, that any country attempting a vastly expansive policy on its own is likely to run into balance of payments difficulties (as was shown by France).

Thank you for placing a copy of your letter in the Library. I hope you will not think it presumptuous if I add a copy of this to it - if they will accept it.

Again, many thanks for your full and helpful reply.

Yours ever

Jack

The Right Honourable
The Viscount Whitelaw CH MC
House of Lords

pup

CONFIDENTIAL

FROM: D N WALTERS
DATE: 1 DECEMBER 1986

CHANCELLOR OF THE EXCHEQUER 14/12.
SIR PETER MIDDLETON
SIR TERENCE BURNS
MR CASSELL
MR SEDGWICK
MR TURNBULL
MR ODLING-SMEE
MR SCHOLAR

TCSC'S DRAFT REPORT ON THE AUTUMN STATEMENT

The draft TCSC report which I circulated this morning makes a number of references in the footnotes to information prepared by Terry Ward. I now attach a copy of his paper.

D N Walters

D N WALTERS

TR 273

Notes on the 1986 Autumn Statement

Terry Ward

Specialist Adviser

1. The plans announced by the Chancellor in his Autumn Statement entail an increase in total public expenditure in real terms for the first time since the Government came to power seven years ago. But since, in contrast to what was intended, real expenditure has in fact risen every year over this period (except for 1985-86 which is a special case in being affected by the natural reduction in spending after the miners' strike), it is arguable that this year's plans reflect not so much a policy reversal on the part of the Government towards a new expansionary attitude to public spending as a more realistic acknowledgement of what in practice is feasible.

2. Even so it is questionable whether the Government has gone far enough in this direction, especially as regards the plans for the years after 1987-88, which show very little growth. Indeed the average rate of departmental expenditure growth now planned for the next three years is actually less than that experienced since 1979, despite the plans being widely received as signifying a new expansionary phase in public spending.

3. Nevertheless it is not clear what has changed since March when the last set of expenditure plans were confirmed and when the emphasis of policy was to keep government spending broadly constant in real terms over the short and medium term. While Government spokesmen have tended to present the planned increase in spending as being justified by the buoyant, healthy state of the economy, in practice economic growth is now expected to be lower this year than forecast at Budget time and, though the forecast of growth for next year has been revised upwards, the projected level of national income is no higher. Moreover the longer term outlook, in the light of the significant deterioration in the balance of payments during 1986 and the failure of the world economy to respond to the fall in oil prices, seems to have worsened rather than improved.

4. At the same time, the level of prices is now expected to be lower over the Survey period than in March, which ought to mean that the cash plans then decided would finance the purchase of more real inputs than initially intended. But more rather than less cash has been provided.

5. Given this lessening of inflation, the large over-spend now estimated for the present financial year, 1986-87, perhaps raises even more questions than the upward revision in plans for next year and the years after. But hardly any mention of this is made in the Autumn Statement, let alone any explanation provided of why such a substantial over-run has occurred.

?

6. This lack of explanation for what has happened is symptomatic of the unsatisfactory nature of the Autumn Statement as a statement of Government policy. If past Government statements are to be believed, these expenditure plans, like their predecessors, were presumably determined by how much revenue is expected to be available in the years ahead. But since as last year no projections are given of what this is likely to be, the principal basis for assessing Government policy with regard to overall spending is denied to both Parliament and the public generally.

The Planning Total

7. Table 1 shows revisions to the planning total for public expenditure since the March Budget and the new growth path which is now planned. All the figures in the table are before the deduction of receipts from the sale of assets which represent a distorting influence on the official figures. Accordingly they show what is happening, and what is planned to happen, to the total of departmental spending.

8. As can be seen, expenditure in 1985-86 seems to have turned out lower than estimated at the beginning of the year, by around £0.5 billion, and total departmental expenditure fell in real terms for the first time since the Government took office.

9. In the present financial year, however, total spending is turning out to be significantly higher than planned in March. In cash terms, the over-run is at present estimated at £1.3 billion. But since the estimate of inflation has been revised downwards the figure in real terms is around £1 billion higher than this, at £2.2 billion at 1984-85 prices - an increase of almost 2 per cent over what was planned. On the other hand it should be noted that since part of this reduction in inflation is the result of lower prices for North Sea output it does not necessarily reflect a similar fall in the rate of increase in the costs of public sector purchases. Indeed there may well have been a rise in such costs since the Budget and accordingly a larger relative price effect than was then anticipated. This seems likely to be more so in respect of expenditure in 1986-87, given the rate at which public sector pay rises appear to have been running. But since there is no information whatsoever about relative costs in the Autumn Statement, it is hard to judge how important this factor

is and and therefore to assess the implications for the volume of inputs of the current set of cash plans.

10. The over-run on departmental expenditure, however, is offset to some extent by debt interest turning out to be around £0.5 billion lower than forecast at Budget time. Table 2 shows that if this is taken into account the upward revision in total spending is reduced to under £1 billion in cash terms and to just over 1 per cent in real terms.

11. The effect of this overspend is to push up the rate of real growth in departmental expenditure between 1985-86 and 1986-87 from just over 1 per cent, as was estimated at Budget time, to 3.4 per cent. Total expenditure including gross debt interest payments is now expected to rise by 2.7 per cent in real terms in the present financial year. Both figures are rather more than the latest Treasury estimate of the likely growth of real output in 1986, which implies that the Government's stated aim of reducing total expenditure as a proportion of GDP will not be achieved this year, on this definition of total spending at least.

12. On the General Government definition on which the Government has chosen to focus attention, however, some reduction in this ratio may be registered. But this definition is not altogether satisfactory in that it includes the depressing effect of asset sales (which showed a large rise in 1986-87), excludes the market and overseas borrowing of nationalised industries and includes certain notional sums.

NO

fall even excluding privatisation proceeds

13. So far as the coming financial year is concerned, some £5 billion has been added to the plans prepared at the beginning of the year. In real terms, this amounts to an upward revision of just over 4 per cent and it means that, instead of falling slightly between 1986-87 and 1987-88, real departmental expenditure is now forecast to grow by 2 per cent.

14. For the two years after 1987-88, however, the plans imply little growth in real spending - almost none at all in 1988-89 and just 1 per cent in 1989-90. This means that, over these two years, the average growth rate of departmental expenditure now planned (0.6 per cent) is significantly less than the trend growth of around 1.5 per cent a year experienced over the past seven years of the present Government's period in office. This is illustrated in the graph which, but for the effects of the miners' strike, shows a remarkably stable growth of departmental spending since 1978-79.

15. Accordingly, even though the spending plans have been revised upwards substantially since March and for that reason may be a more realistic representation of the likely final outturn, they still entail restraining growth to a greater extent than the Government has managed to achieve in the past. From the detail of the plans, it ssems that part of this restraint is to be achieved by providing a smaller Reserve than last year. Thus for 1987-88 a Reserve of £3.5 billion has been included as opposed to one of £4.4 billion for 1986-87 this time last year - a reduction of £0.9 billion. For 1988-89, the Reserve is £5.5 billion, £0.75 billion less than the equivalent amount included in last year's plans, and for 1989-90, it is £7.5 billion, £0.5 billion less. It is clearly important to investigate the reason for this change, though it may be that the Treasury believe that the more realistic nature of this year's figures will give rise to less need for supplements.

Expenditure by Programme

16. Table 3 shows the revisions to expenditure by programme since the March Budget, all the figures being expressed in real terms. It indicates that in 1985-86, spending turned out to be significantly less than estimated at the end of last year for Defence and Social Security and significantly more for Housing and Contributions to the European Community. No explanation is given for these differences.

17. In 1986-87, expenditure in a number of areas now seems to be substantially higher than forecast at the beginning of the year. in the case of Environment, the increase is over 13 per cent in real terms and in the case of Education, over 12 per cent, presumably reflecting the inadequate provision incorporated for local authorities in the initial plans. Perhaps significantly no programme appears to be showing any reduction in spending in relation to the initial plans, despite the fall in inflation since they were prepared.

18. The upward revisions to expenditure are even greater for 1987-88 and 1988-89, five programmes showing additions of around 10 per cent or more - Education (20 per cent higher in 1988-89), the Home Office, Environment, the Chancellor's Department (13 per cent up in 1988-89) and, for 1987-88, Housing. Only Contributions to the EEC have been revised downwards, and then mainly because of an apparent acceleration in payment. Apart from the programmes included in Table 3, there are also large additions to the financial limits of nationalised industries of £0.7 billion in 1987-88 and £0.4 billion in 1988-89, perhaps largely as a reflection of the fall in oil prices and the implications of this for the coal industry. But no details of the changes are given and no account of the thinking behind them.

19. Table 4 shows the effects on expenditure growth of these revisions and relates the real changes which are now planned to average growth rates over the past seven years. The significant growth taking place in many programmes in the present financial year is evident. On the latest estimates, expenditure on Education will rise by 7 per cent in real terms between last year and this, presumably in large measure because of teachers'pay increases, while spending on Health, Social Security, Transport and the Home Office will go up by between 4 and 5 per cent. How much of each of these increases is the result of high relative cost rises is not revealed, nor is it clear that the information is any longer readily available.

20. In most cases, the rates of increase in spending taking place this year are higher than those recorded over the past seven years - Defence being the notable exception. But the changes planned for 1987-88 and the two years following that are for the most part lower - in the case of Health, Social Security and Employment substantially so. Indeed for the latter two programmes little if any real growth is planned after this year, in contrast to the rises which are now taking place. It is notable that for 1988-89 and 1989-90, hardly any programmes are planned to grow in real terms, which is very much in line with previous plans published by the present Government and which may well imply that substantial calls on the Reserve are anticipated.

21. A further feature to emerge from Table 4 is the somewhat erratic pattern of change planned for a number of programmes. For Environment, for example, spending is planned to fall considerably between this year and next, by almost 9 per cent in real terms, and then to decline less sharply in the subsequent two years, while spending on Housing is planned to increase slightly in 1987-88 but to be cut back markedly the year after, by 10 per cent. Why this should be remains obscure. It hardly seems conducive to stability and rational planning.

Economic Prospects

22. The forecast set out in the Autumn Statement is for a higher rate of growth in real output next year than this year or than was projected at Budget time. Though at first sight this seems encouraging, there are a number of features of the forecast which give cause for concern about the longer term prospects for high and stable growth.

23. In particular, the balance of payments has deteriorated rapidly during 1986 and though this is largely the result of the sharp fall in oil prices it is also the consequence of a significant worsening of the balance on manufacturing trade. On

the Treasury's forecast, the deficit on this account will be some £4.5 billon more in 1987 than in 1985, at £7.5 billion. While this is partly attributable to the slow growth of UK overseas markets following the collapse in the oil price - which might cause a re-assessment of the benefits to the UK of low oil prices alleged by the Chancellor at the time of the Budget - it is also an indication of the continuing weakness of British industry in world markets, which raises considerable doubts about the sustainability of growth at present rates.

24. A particularly disturbing feature of the recent past is that despite a substantial growth of company income (see Chart 8,p.16 of the document on Economic Prospects published with the Autumn Statement), manufacturers have not responded by increasing investment by anywhere near as much. Consequently it is by no means clear what the benefits to the economy of this marked shift to profits have been.

24. There is as yet little sign that producers are taking advantage of the large fall in the exchange rate vis a vis European producers that has occurred over the past year. To a significant extent it is already in the process of being dissipated by the relatively high rate of inflation in the UK, which if it persists, will entail a need for continuing exchange rate depreciation to maintain recent gains in cost competitiveness. The dilemma the Chancellor faces is that the exchange rate has become the Government's main weapon against inflation, but so far it has failed to have any discernible depressing effect on cost increases and to continue to use it for this purpose is likely to make it even more difficult to sustain growth.

25. Nevertheless the Treasury is more optimistic about the prospects for inflation than most outside forecasters, for reasons which are not altogether clear. "Growth in average earnings is expected to fall somewhat in the present pay round" (para.50 of the document on Economic Prospects),but why is not really explained. Moreover the marked rise in profit margins which has been evident for the past two years in particular (see Table 6 of the same document) is expected to come to an end in 1987 and to restrain the rise in output prices accordingly. Again why this should happen is not explained.

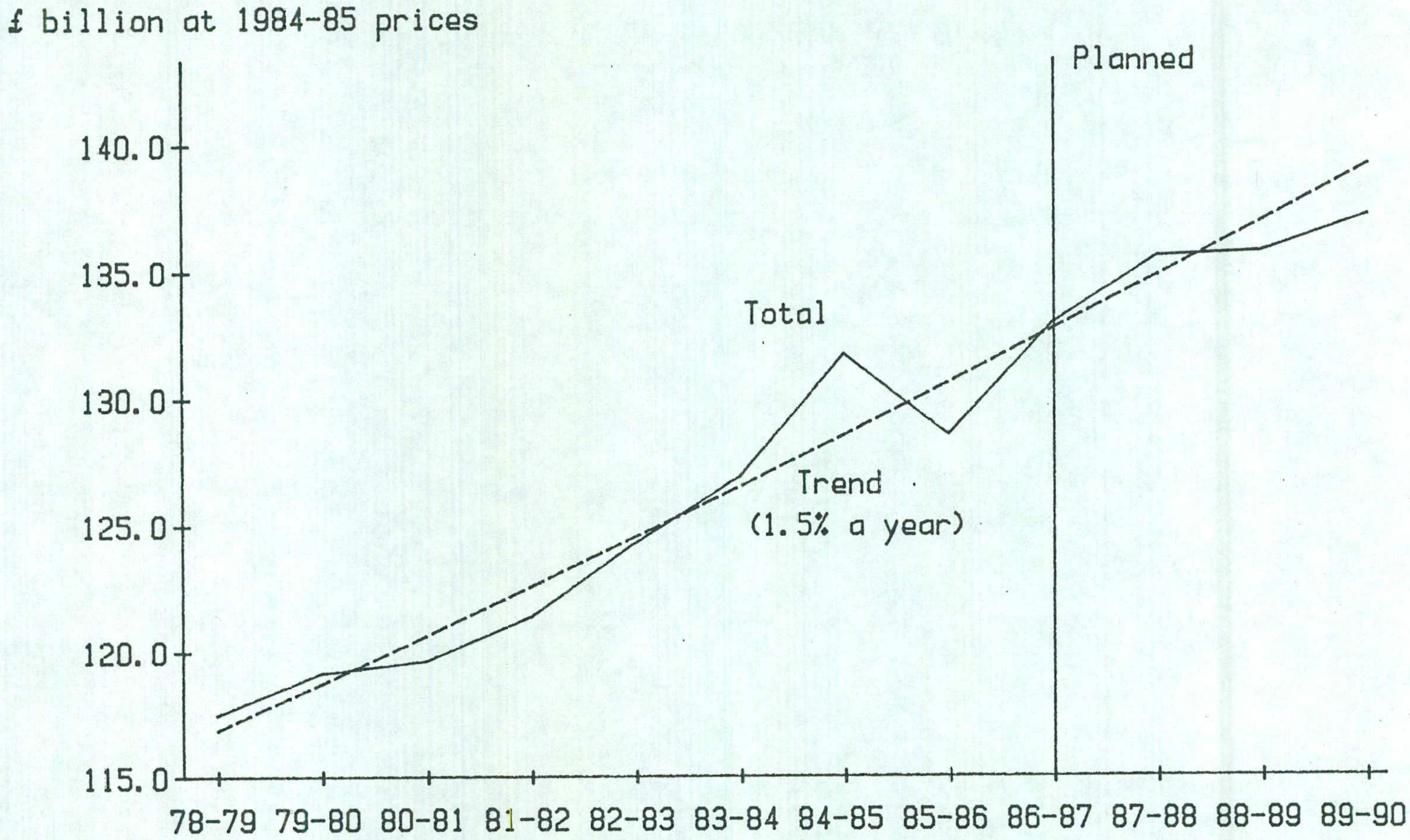
26. In sharp contrast to the statements issued in the early years of the present Government's term in office, relatively little mention is made of monetary policy - except, of course, that, whatever the growth in £M3 might imply, it will continue to be consistent with continuing low inflation. According to the Government, "for the past six years, high rates of growth of

broad money...have been consistent with appropriately tight monetary conditions and thus a substantial fall in inflation" (op.cit. para.61). There is,however, some difficulty in judging the significance of this statement, given that the fall in inflation has been universal in developed countries and is largely attributable to sharp falls in the prices of primary products. Indeed since the rate of inflation has recently been higher in the UK than in most comparable countries, it might equally well be argued that this implies that monetary conditions have in fact been laxer here than elsewhere.

Cambridge

12 November 1986

Growth of Public Expenditure Planning Total, 1978-79 to 1989-90



Note: Total is measured before deducting asset sales

Table 1 Public Expenditure Planning Total, 1985-86 to 1989-90

	1985-86	1986-87	1987-88	1988-89	1989-90
			£ Biilion		
Total, 1986 Budget	136.8	143.8	148.6	153.4	na
New Total, Nov. 1986	136.3	145.1	153.6	159.2	166.5
Difference	-0.5	1.3	5.0	5.8	na
		£ Billion at 1984-85 Prices			
Total, 1986 Budget	129.1	130.8	130.3	129.9	na
Annual % Change	-2.0	1.3	-0.4	-0.3	na
New Total	128.6	132.9	135.6	135.8	137.2
Annual % Change	-2.4	3.4	2.0	0.1	1.1
Change since Budget	-0.5	2.2	5.3	5.8	na
% Revision in Plans	-0.4	1.7	4.1	4.5	na

Note: The Planning Total is measured before the deduction of asset sales and therefore relates to departmental spending

Table 2 Revisions to Public Expenditure including Debt Interest

	1985-86	1986-87
	£ Billion	
1986 Budget	154.5	162.0
Nov. 1986	154.0	162.9
Difference	-0.5	0.8
	£ Billion at 1984-85 Prices	
1986 Budget	145.8	147.3
Nov. 1986	145.3	149.2
Difference	-0.5	1.8
% Revision	-0.3	1.2
Year-to Year % Growth	-0.3	1.6

Table 3 Revisions to Public Expenditure Plans in Real Terms, 1985-6 to 1988-9

	1985-6	1986-7	1987-8	1988-9
	% Difference from Budget Plans			
Defence	-1.4	1.2	0.6	0.7
Home Office	3.2	6.7	11.3	13.5
Education	0.1	12.3	16.2	20.8
Health	-0.3	2.1	4.3	4.5
Social Security	-1.6	2.2	2.2	1.9
Environment	-0.7	13.3	9.9	10.1
Housing	4.3	4.4	14.0	5.6
Employment	0.4	1.7	1.2	1.2
Transport	-0.3	3.5	7.0	6.4
Chancellor's Dept.	0.0	3.7	9.6	12.9
EEC Contributions	3.8	68.9	-23.8	-53.3
Other*	-0.9	3.2	6.7	7.2
Planning Total	-0.4	1.7	4.1	4.5

Note: The difference between the Autumn Statement figures expressed at 1984-85 prices as now estimated and the White Paper figures, adjusted for Budget changes, at 1984-85 prices as then estimated.

*Northern Ireland, Scotland, Wales and other departments.

Table 4 Public Expenditure Growth by Main Programme, 1978-79 to 1989-90

	1978-9 to 1985-6	1985-6 to 1986-7	1986-7 to 1987-8	1987-8 to 1988-9	1988-9 to 1989-90
	Average	% Growth per Year			
Defence	4.3	0.5	-2.6	-2.4	-0.9
Home Office*	5.3	4.2	1.8	-0.1	-0.1
Education	-0.2	6.9	0.3	1.0	-0.6
Health	2.4	4.8	2.5	0.4	0.9
Social Security	3.8	4.6	-0.4	-0.4	0.5
Employment	7.5	15.4	-1.7	1.2	-1.1
Transport	-1.4	4.5	0.7	-4.5	-2.2
Environment	-1.1	1.1	-8.8	-2.4	-2.4
Housing+	-7.1	-4.2	1.3	-10.0	-1.8
Planning Total	1.3	3.4	2.0	0.1	1.1

Note: The Planning Total is before the deduction of asset sales. Social Security is adjusted for the effect of the change from child tax allowances to child benefits in 1979-80 and for changes in the accounting of housing and sickness benefits from 1982-83.

*Including Lord Chancellor's Department.
+Before deducting net receipts from housing sales, as estimated in the White Paper.

CONFIDENTIAL

FROM: SIR T BURNS
DATE: 1 DECEMBER 1986

MR WALTERS

cc Chancellor
Sir P Middleton
Mr Cassell
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Turnbull

TCSC'S DRAFT REPORT ON THE AUTUMN STATEMENT

I have a few comments on the TCSC's draft report on the Autumn Statement.

2. **Paragraph 17:** This suggests that the exchange rate is the instrument used to control inflation. This both mis-states the present policy and exaggerates the change from earlier formulations of the MTFS.

? factual

3. **Paragraph 24:** I suspect this is a misleading account of the reasons for higher non-oil revenues. I suggest you consult Mr Mowl.

4. **Paragraph 42:** The final sentence does not quote accurately from the Autumn Statement. It excludes the words **"So far in the published figures for the underlying** rate of growth in average earnings".

5. Generally the quotes do not take account of amendments to the transcript. And in the case of my own quotes I spotted two mostakes in the footnotes; **footnote 9 on page 5** should refer to Q4, not Q3; and **footnote 54, on page 27,** should refer to Q60, not Q65.

T BURNS

CONFIDENTIAL

FROM: D L C PERETZ
DATE: 1 DECEMBER 1986

MR WALTERS

cc Chancellor
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Odling Smee
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mr Kelly

TCSC's DRAFT REPORT ON THE AUTUMN STATEMENT

A few points on the monetary policy section of the draft.

2. Paragraphs 6-8 seek to demonstrate that monetary policy has in some way changed recently, in a manner not forseen in the early statements of policy, using selective quotes from the 1980 Green Paper on Monetary Control and the 1980-81 MTFS. It is easy enough to find quotes to demonstrate that, in fact, things have changed remarkably little:

i) Paragraph 10 of the 1980 Green Paper says explicitly, about £M3, that "the definition may need to be adjusted from time to time as circumstances change"; and that it may not "remain the most appropriate aggregate in the face of long-term changes in the institutional structure".

ii) The 1982-83 MTFS describes the role of the exchange rate in monetary policy in the following terms "The behaviour of the exchange rate can help in the interpretation of monetary conditions, particularly when different aggregates are known to be distorted.... and the Government considers it appropriate to look at the exchange rate in monitoring domestic money conditions and in taking decisions about policy".

3. Paragraph 10 suggests that interest rates have taken on an

enhanced role as a policy instrument, referring to passages in the 1980-81 MTFS which in fact do not deny the importance of interest rates as a policy instrument, but discuss the need for fiscal policy to bolster monetary policy in order to avoid "excessive" reliance on interest rates. The 1980 Green Paper on Monetary Control (paragraph 5) says "the main instruments [of monetary policy] must continue to be fiscal policy and interest rates". Fiscal policy is set at the time of the Budget. That leaves interest rates as the essential instrument for use during the year. So not much has changed since 1980.

4. **Paragraph 13** (penultimate sentence) compares the recent performance of M0 with the behaviour of M1 in 1972-74. It would surely be better to compare the recent performance of M0 with the performance of M0 in 1972-74. (The 12 month growth rate of M0 rose from a very low level at the beginning of the 1970s to around 15% in 1972-73, and did presage the subsequent inflation).

5. So all in all **paragraph 17** greatly overstates the change there has been in policy. It also mis-states what the policy now is.

6. I am not sure to what extent these various points count as correcting "factual innacuracies".

DLCP

D L C PERETZ