PO-CH/NL/0140

PART B

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SECRET

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Begins: 7/1/87.
Ends: 9/1/87

PO -CH /NL/0140

PART B

Chancellor's (Lawson) Papers:

ECONOMIC FORECASTING AS POLICY BACKGROUND FOR THE 1987 BUDGET

Disposal Directions: 25 Years

23/8/95.

PO -CH /NL/0140

PART B

ZERO UK LABOUR COST INFLATION

'87 01/07 11:15 ☎01-623-2363 C S F B LONDON

CSFB Economics

Economic Comment

1

PSC put in file for meeting with Salomons & CSFB on Fri.

Zero U.K. Labour Cost Inflation

- U.K. manufacturing unit labour costs were unchanged over the nine months from January to October 1986. We estimate that the twelve-monthly increase is now approximately zero.

- These figures represent a genuine improvement in performance – they are not a statistical quirk. We forecast that during 1987 the figures will remain close to zero, out-performing the Treasury's projection.

- The containment of labour costs has occurred because productivity is booming. This entirely offsets the effect of high wage rises.

- Labour costs provide a forward-looking indicator of price inflation. These figures for U.K. unit labour costs mean that real yields are now very high. Subtracting the rate of unit labour cost inflation from the redemption yield on U.K. medium-dated government bonds gives over 10 percent.

- Comparable figures for Germany, Japan and the U.S. are about 1.5 percent, 1.5 percent and 7.5 percent respectively. This means that the U.K. market is attractive in international terms.

SOURCE: The latest U.K. unit labour cost data in this note are taken from the official Department of Employment press notice dated 18 December 1986.

Ch

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AA

good!

P4

2

Recent Data

The chart below shows data for U.K. manufacturing unit labour costs (measured as wages and salaries per unit of output). The labour cost index stood at 131.0 (1980=100) in January and was virtually unchanged at 131.1 in October (the latest date for which data are available).

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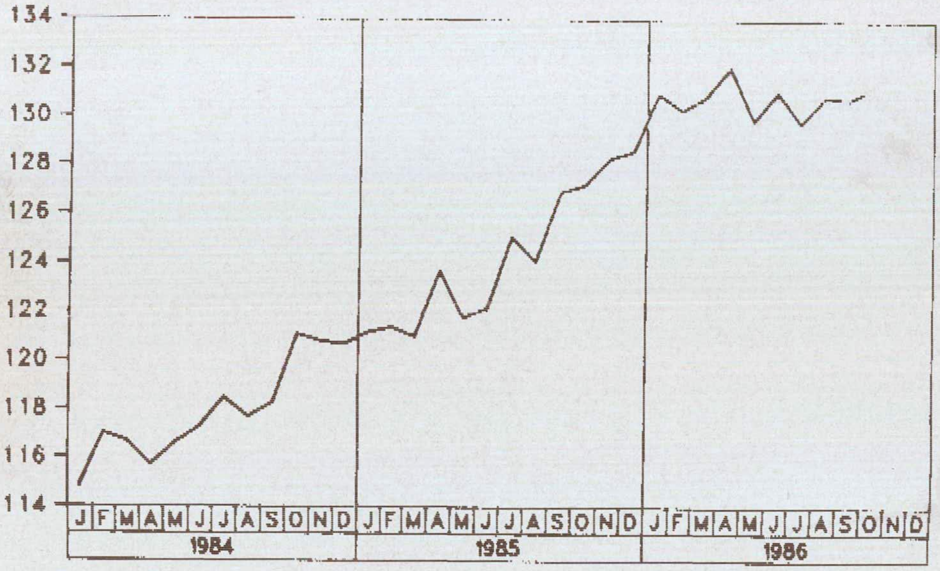
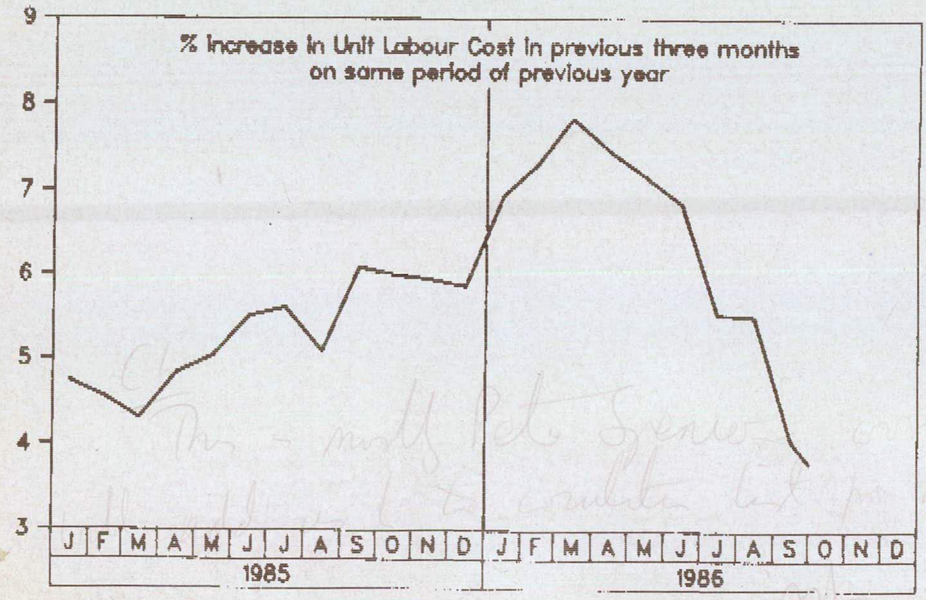
in U.K. Manufacturing Industry
(Index 1980=100)



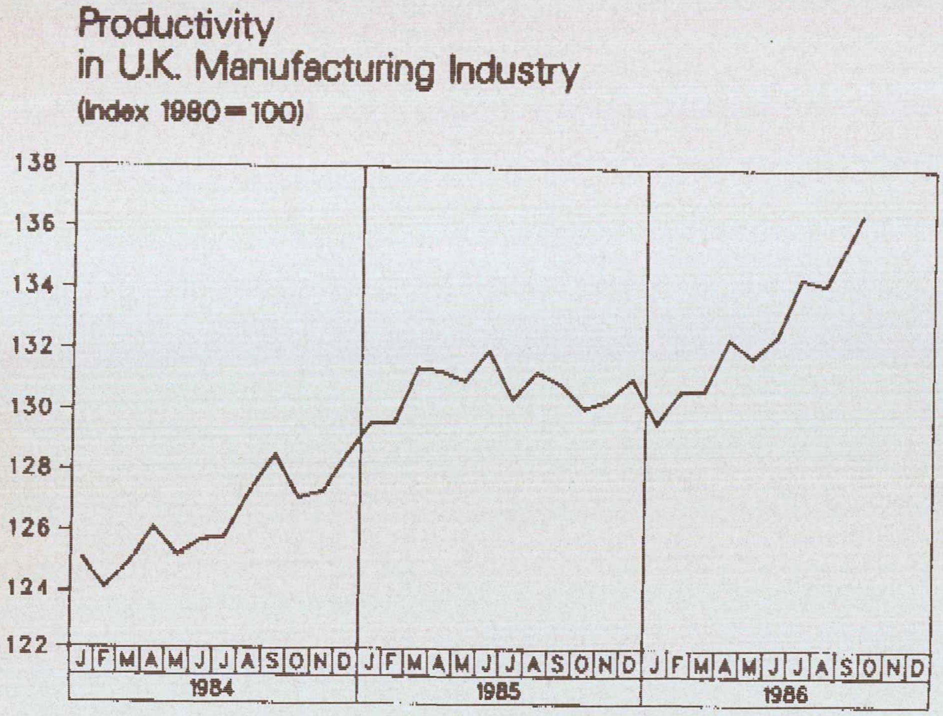
Labour costs on this measure have thus been broadly unchanged for nine months, apart from small random monthly movements. Since these figures were first compiled in 1970, there has been only one comparable period of stability, in 1983.

Labour Cost Inflation
in U.K. Manufacturing Industry



PS (3)

The remarkable nature of this development has been obscured by the less dramatic movement in the annual percentage change. Comparing the most recent three months with the same period a year ago, the chart opposite shows a 3.9 percent rise in labour costs. This hides the fact that unit labour costs have been unchanged since early 1986, although it does represent a substantial improvement on the high annual growth rates recorded earlier in 1986.



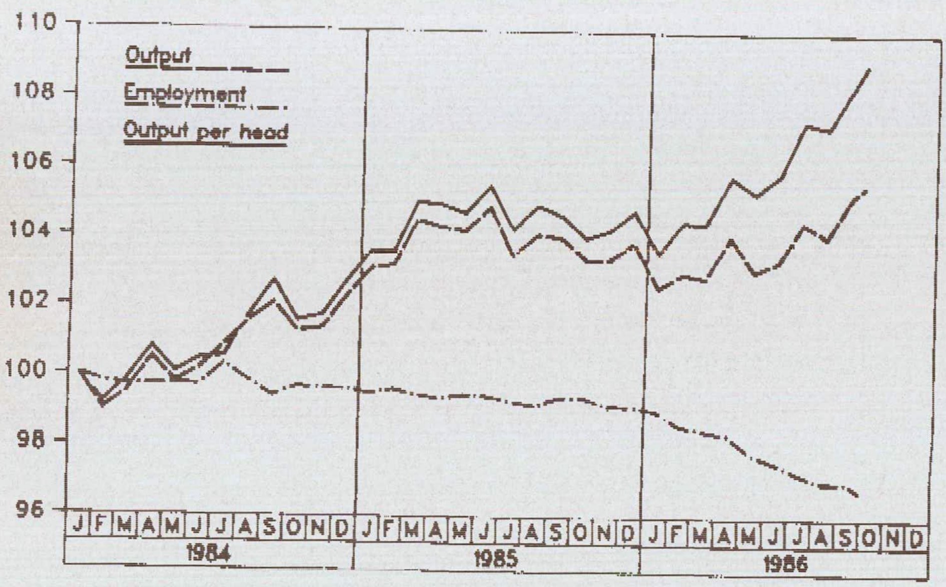
The containment of labour costs has occurred despite continued growth in average earnings. Zero change in labour costs has been possible because of a remarkable improvement in output per head. This measure of productivity rose 3.6 percent between the most recent three months and the same period a year ago. More noteworthy, the October figure was up 5.3 percent on January (7.2 percent at an annual rate).

P6 (4)

Why Have Unit Labour Costs Stopped Rising?

Unit labour costs have stopped rising because manufacturing productivity is increasing steeply. The reason for rapidly growing productivity is that output, after a period of stagnation in late 1985 and decline at the start of 1986, started to grow again very rapidly. Between January and October 1986, manufacturing production rose 2.9 percent, or 3.9 at an annual rate. Meanwhile, manufacturing employment fell throughout 1986.

Output, Employment and Productivity in U.K. Manufacturing Industry
(Index Jan 1984=100)



The sharp rise in manufacturing output during 1986 was triggered by the exchange rate fall, combined with the rise in demand in the U.K. and in overseas markets. In particular, demand from Germany rose strongly in the second and third quarters of 1986 after earlier weakness.

Many commentators are currently asking whether U.K. industry will respond to the devaluation. With manufacturing output rising at an annual rate of almost 4 percent between January and October 1986, and much faster than that on a three-monthly comparison, it seems clear that industry is already responding.

Doubts over the ability of U.K. manufacturing industry to respond to the devaluation are based largely on the poor performance in response to previous depreciations. We think that the circumstances of the current devaluation are different, because this time U.K. industry was in a strong position when the devaluation began.

P7 (5)

Evidence for this is given by growth in manufacturing productivity (output per person employed) over the five years prior to the time when each devaluation began. For the 1986 devaluation, U.K. manufacturing productivity had risen 34.1 percent over the five years to end-1985, an annual rate of 6.0 percent. Comparable figures at an annual rate for the three previous big devaluations in 1967, 1972-73, and 1976 are 4.2 percent, 4.2 percent and 2.4 percent respectively. The improvement in manufacturing productivity growth during the 1980's is, in part, attributable to the change in attitudes towards innovative working practices.

A further crucial difference between the 1986 devaluation and the earlier depreciations is that the labour relations environment has changed and there is also a background of falling worldwide inflation. Over the twelve months to October 1986, there were 952 recorded stoppages, resulting in the loss of about 2 million working days. In sharp contrast, at the time of the last large devaluation, there were 2016 stoppages in the twelve months of 1976, leading to a loss of over six million working days (whole-economy figures). The latest figures from the CBI pay databank suggest that the rate of pay settlements in manufacturing industry is now slowing significantly.

The Outlook

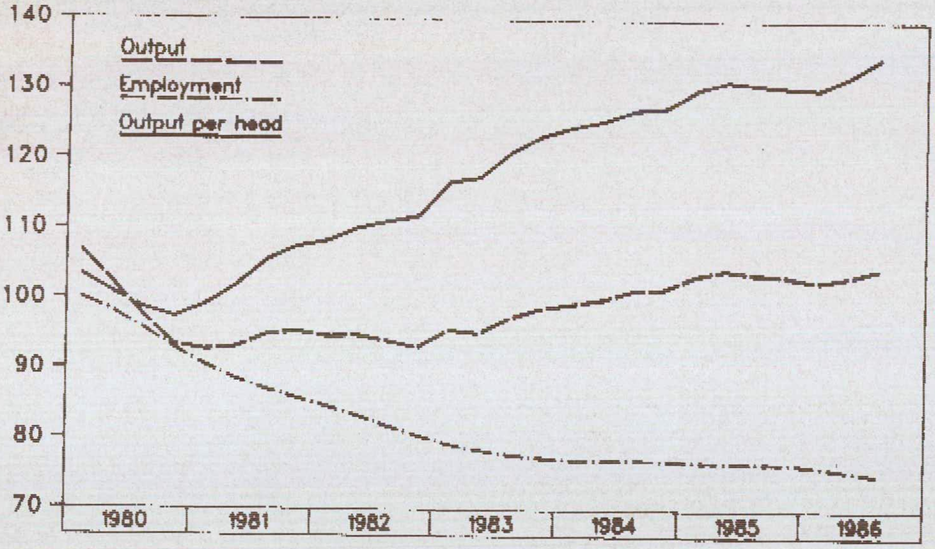
The U.K. labour cost and productivity performance during 1986 is impressive. Some commentators may believe that this is a temporary phenomenon, but in our view the 1986 data represent part of a trend that will continue.

When interpreting the 1986 data, it should be noted that using January 1986 as a base date for comparisons tends to overstate the case slightly because that month was a low-point for productivity and hence a high-point for labour costs. Putting this another way, there is some element of cyclical recovery in the remarkable 1986 productivity figures.

However, manufacturing industry has achieved large rises in productivity in every year from 1981 onwards, suggesting that much of the productivity growth in 1986 was a continuation of the underlying trend, with only a small cyclical element.

P8 6

Output, Employment and Productivity in U.K. Manufacturing Industry
(Index 1980 = 100)



Over the five years to end-1985, the annual average growth in output per head was 6.0 percent. Over the nine months from January to October 1986, this measure of productivity grew 7.2 percent at an annual rate. On the simple assumption that the underlying trend of a rise in productivity in 1986 was the same as the 6.0 percent recorded in the previous five years, only 1.2 percentage points (at an annual rate) of the total productivity rise is attributable to cyclical factors.

For 1987, we expect that output per head will grow by 6 percent (between the end of 1986 and the end of 1987). We interpret this as a continuation of the recent underlying trend of 6 percent per annum growth combined with zero cyclical growth. We expect it to be achieved through a rise of 4 percent in output and a fall of 2 percent in employment. The same productivity figure could, of course, be achieved by other plausible combinations of output and employment growth, and of cyclical and underlying growth. In our view, this forecast for productivity is cautious. If anything, we expect that the out-turn is more likely to be above 6 percent than below, as industry takes advantage of the devaluation by raising output faster.

For average earnings, our central forecast is for a one percentage point reduction, from the current underlying rate of 7.75 percent in manufacturing, to 6.75 percent. There is already evidence from the CBI pay databank and from the engineering industries' pay settlement that a reduction of this size will be achieved, and such a reduction would be modest compared with the fall in price inflation that has occured between t current pay bargaining period and the same period a year ago.

With output per head of 6.0 percent and average earnings growth of 6.75 percent, wages and salaries per unit of manufacturing output will rise by less than 1 percent next year. The rise in unit labour costs is likely to be smaller, or negative, as increasing numbers of firms cut costs by taking contribution holidays on their pension schemes.

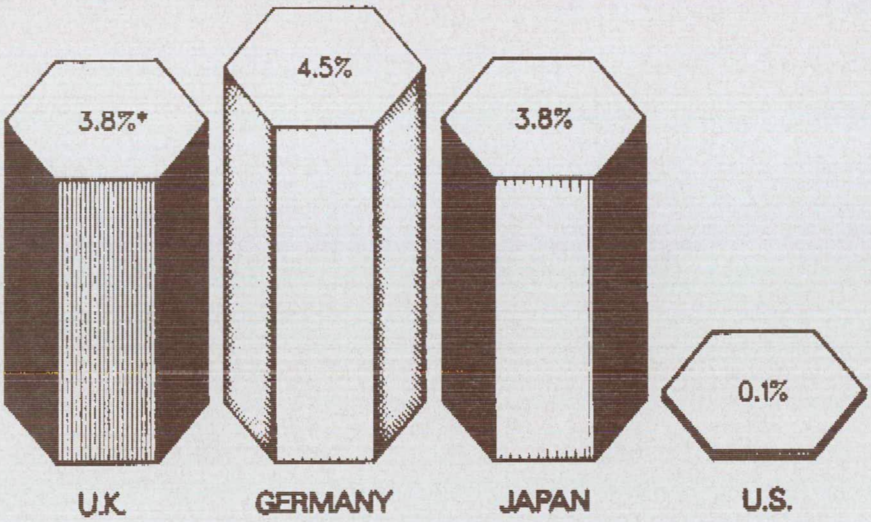
pa (7)

International Comparison

We have recently made a detailed international comparison of unit labour cost increases (see 'The Autumn Statement', CSFB Research, November 1986). The chart below reproduces our results, updated with the latest available information.

Unit Labour Costs in Manufacturing

Percent rise, 1986 Q3 on 1985 Q3



* August – October on same 3 months of previous year

The crucial result from the comparison is that while labour costs in the U.S. were virtually unchanged over the year to the third quarter of 1986, those in Germany and Japan rose at a similar rate to those in the U.K. The reason for the poor performance in Japan and Germany is the weakness of industrial output in those countries, caused by currency appreciation. Comparing cost rises over a shorter period, unit labour costs in both Germany and Japan are continuing to rise, while those in the U.K. are static.

Using unit labour costs as a forward-looking, or underlying, measure of price inflation, these data suggest that real yields on U.K. government bonds now stand at a very high level by international standards. The current U.K. figure for medium-dated bonds is now over 10 percent, compared with comparable figures of about 1.5 percent for Germany and Japan and about 7.5 percent for the U.S. respectively.

This international comparison of unit labour costs also suggests that cost developments in domestic currencies, far from offsetting some of the effect on the U.K. of sterling's depreciation in 1986, are actually reinforcing it. This, in turn, suggests a rapid and strong recovery in the U.K. manufacturing trade balance, providing support for sterling in 1987.

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FACSIMILE TRANSMISSION CONTROL SHEET

FROM: PETER SPENCER

DATE: 7.1.87

TO: COMPANY NAME: HM Treasury

ADDRESS: Parliament St, SW1

ATTENTION: Mr. ACS Allan, Room 12/2nd

FACSIMILE TELEPHONE NUMBER: 839 2029

NUMBER OF PAGES INCLUDING THIS TRANSMISSION CONTROL SHEET: 9

CHARGE TO:- ISSUE OR DEPARTMENT: Res

REMARKS:- You clearly did not see last Friday's piece, attached. All the best for '87.

AUTHORISING SIGNATURE: P Spencer NAME(PRINT): SPENCER

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WE HAVE THE FOLLOWING FACSIMILE EQUIPMENT TO RECEIVE YOUR TRANSMISSIONS:-

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S08/7/12

End of industry's long winter in sight

If 1986 was the year in which falling oil prices made the world economy hesitate, 1987 should be the year in which cheaper oil puts a tiger back in the tank.

That, at any rate, is the theory on which economists are basing their hopes for an expansionary world in the New Year. So far, oil-importing countries have been uncomfortably slow to spend the increase in their real incomes caused by cheaper oil.

But both theorists and practical men agree that 1987 promises to be a considerably better year for industry than 1986 and particularly good for manufacturing.

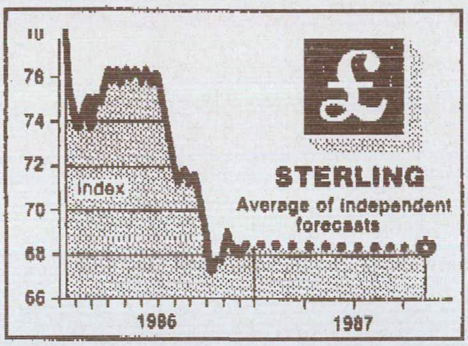
In Britain, this is good news after manufacturing's long retreat. And it is good news for a government seeking re-election. Though inflation will rise, unemployment should fall. Despite a large and not unpopular increase in public spending, Government borrowing is well under control and the prospects for tax cuts are growing.

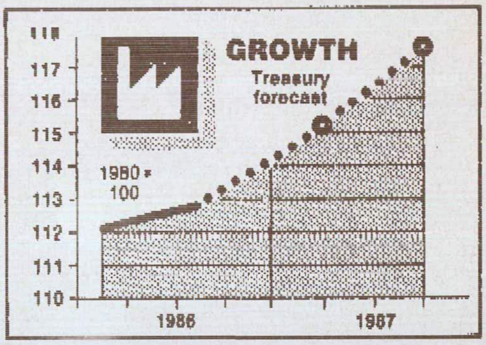
The main threat to this attractive outlook is the stability of the pound. Opec and North Sea oil between them have effectively kept the balance of payments out of the headlines for several years. This year, Britain's current account will move back into deficit and sterling may again become vulnerable to worries about trade.

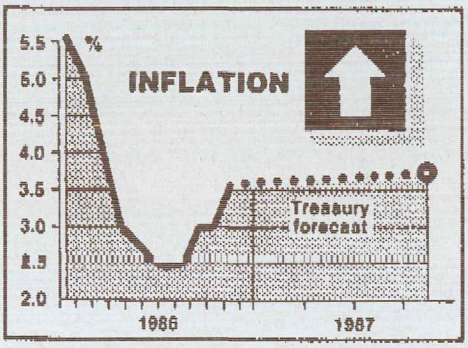
On the world stage, there is also the formidable problem of the trade imbalance between the US and the other two major leading economic powers of the West, Germany and Japan. This prompts protectionist pressures in the US and continually undermines currency stability, threatening loss of confidence and higher interest rates.

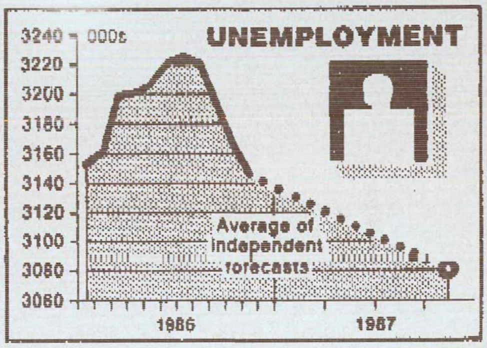
Barring a collapse of confidence in the dollar, however, world trade this year – weighted by British shares – could grow by 4½ per cent compared with only 2 per cent last year, according to the Treasury's latest published forecast.

Faster growth in world trade combined with some improvement in competitiveness from the fall in sterling should help exporters. On the Treasury's reckoning, exports of goods and services could grow by 3 per cent (and non-oil exports by 5½ per cent) against only 1 per cent last year.









on growing while pay increases show further signs of slowing down. Settlements in manufacturing monitored by the Confederation of British Industry have slowed from 6¼ per cent in the first half of last year to 5½ per cent in the third quarter and only 4⅔ per cent in the fourth quarter.

According to Mr Peter Spencer of Credit Suisse First Boston, the Treasury's forecast of a 2½ per cent rise in manufacturers' unit labour costs may now be too pessimistic, suggesting that most of the strong gain in competitiveness from the sharp fall in the pound will be retained.

On the domestic side, consumer spending, fuelled by high, real pay increases, will continue to grow rapidly – by 4 per cent, according to the Treasury against 5 per cent last year. A high level of company profitability will maintain non-oil investment, though lower oil prices will continue to depress North Sea spending. And as output rises some stockbuilding is expected.

It all adds up to a year of more balanced growth in the economy compared with last year's consumer boom and probably faster growth. The consensus among independent forecasters is for growth in GDP of 2.7 per cent, not far from the Treasury's estimate of 3 per cent compared with 2½ per cent last year. Nobody

sixth successive year of sustained expansion.

Views about inflation and the balance of payments, however, are much more varied.

Everyone expects growth in the retail price index to be higher by the final quarter of the year, but expectations vary from 3½ per cent forecast by the LBS to 5¼ per cent expected by the NIESR. The Treasury is at the optimistic end of the range, with 3¼ per cent. Much will depend in the short-term on movements in the mortgage rate and in the slightly longer term on the exchange rate.

Views on the balance of payments are even more divergent. Lower oil prices mean lower earnings on North Sea exports, while buoyant consumer spending means a hefty import bill – everyone agrees that. But how energetically British industry will be able to take advantage of demand both at home and overseas sharply divides optimists from pessimists.

Gloomiest is the National Institute, whose last forecast predicted a deficit of £5.6 billion. Most optimistic is the Treasury with a deficit of £1.5 billion. But, again, readings from the most recent tea-leaves are not discouraging. Imports of consumer goods in the latest three months appear to have fallen compared with the previous three months.

These uncertainties will

think about the Budget. Already he has made it clear that there will be no overt reflation. The public sector borrowing requirement, he promised at the time of the Autumn Statement, will be no higher than its previously-planned level of 1¾ per cent of GDP. In that sense, Mr Lawson has already made his Budget judgement.

Given this apparently stern attachment to fiscal orthodoxy, can we expect tax cuts in this year's Budget? Almost certainly we can, though the picture could change radically between now and Budget time.

Revenue is running strongly ahead of forecast in the current financial year, to such an extent that, despite an overrun on public spending, the PSBR is expected to be below the target of £7 billion – perhaps well below it. Revenue from indirect taxes has benefited from the consumer spending boom while the take from Corporation Tax, at one time minimal, has risen strongly in proportion to rising company profitability. The recent increase in the oil price will also boost revenue.

Another massive swing in oil prices, a dollar crisis, or concern about the policies of a Labour government, could all upset this happy prospect. But, for the time being, 1987 does not look at all bad.

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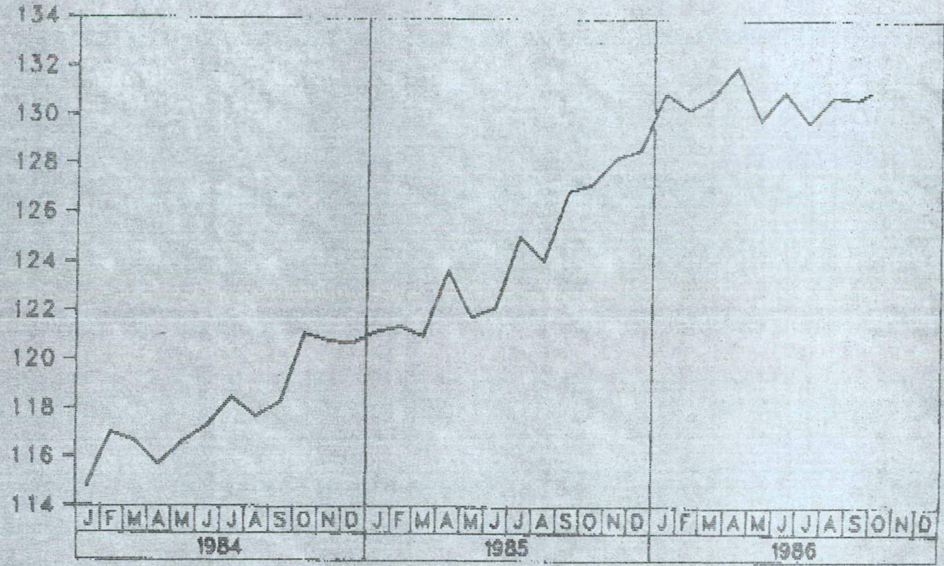

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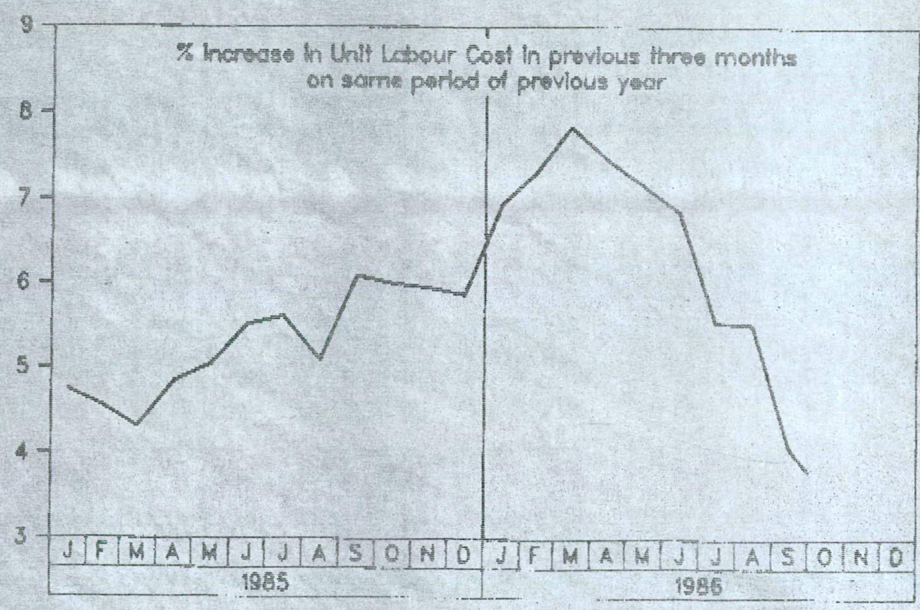

P5 3

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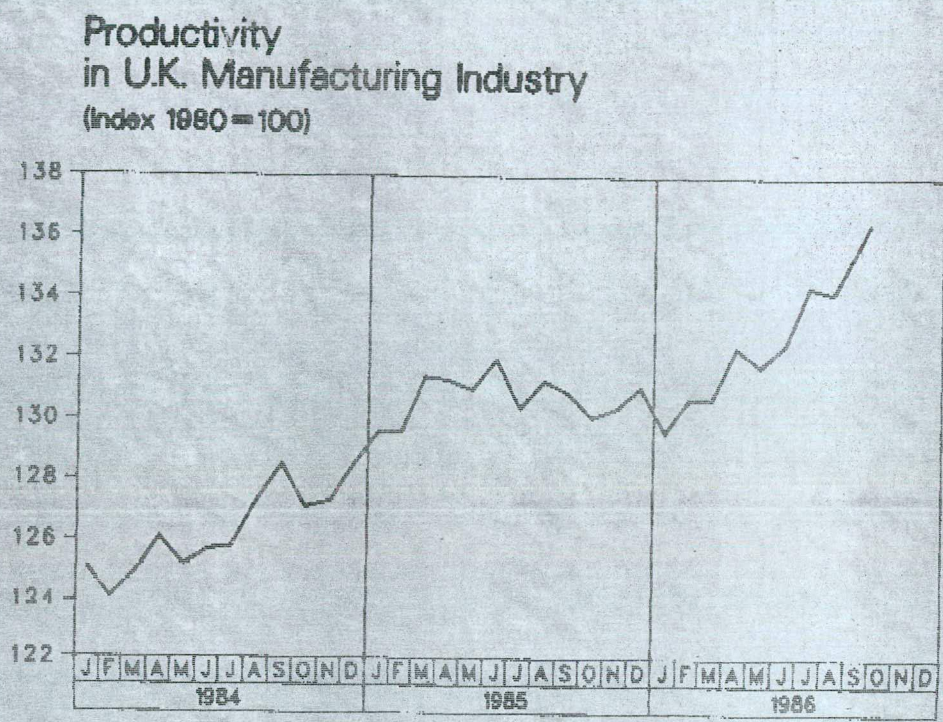

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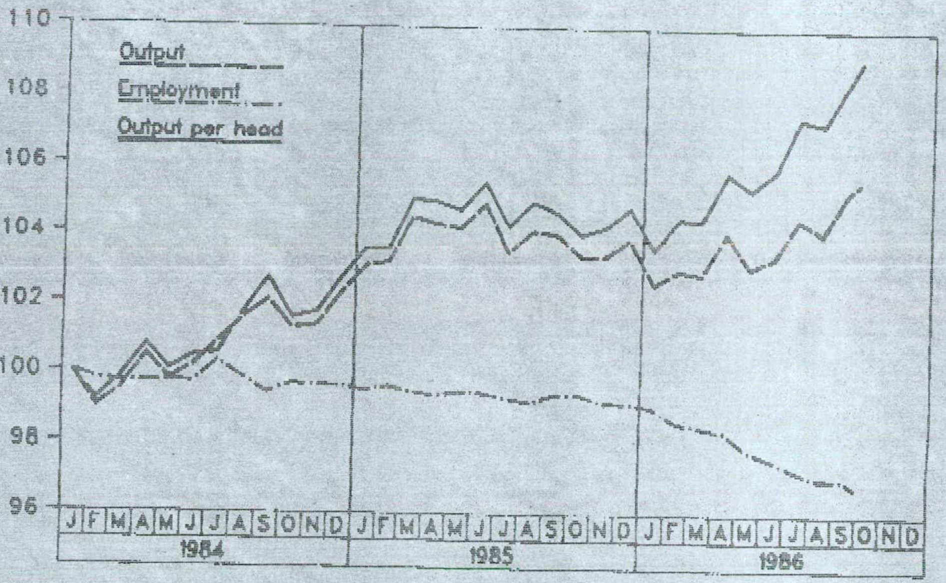

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P8 6

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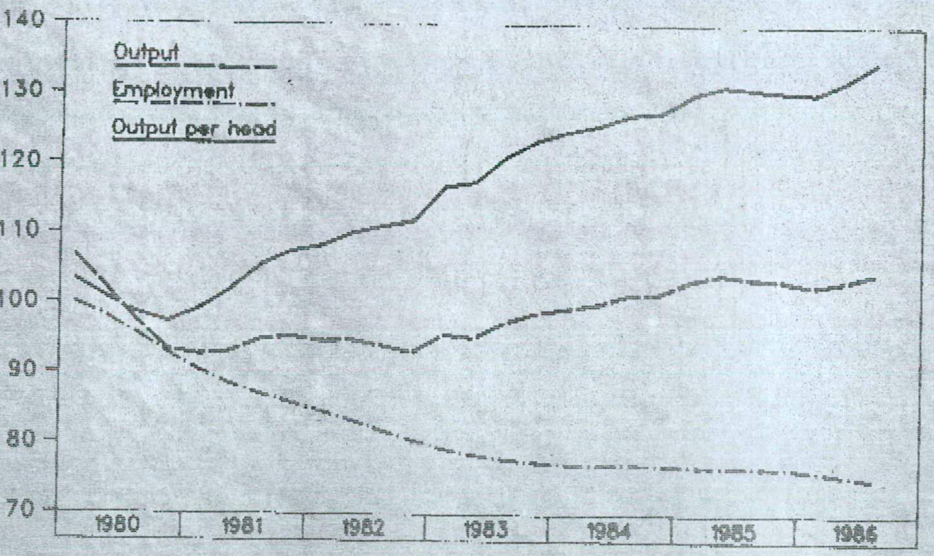

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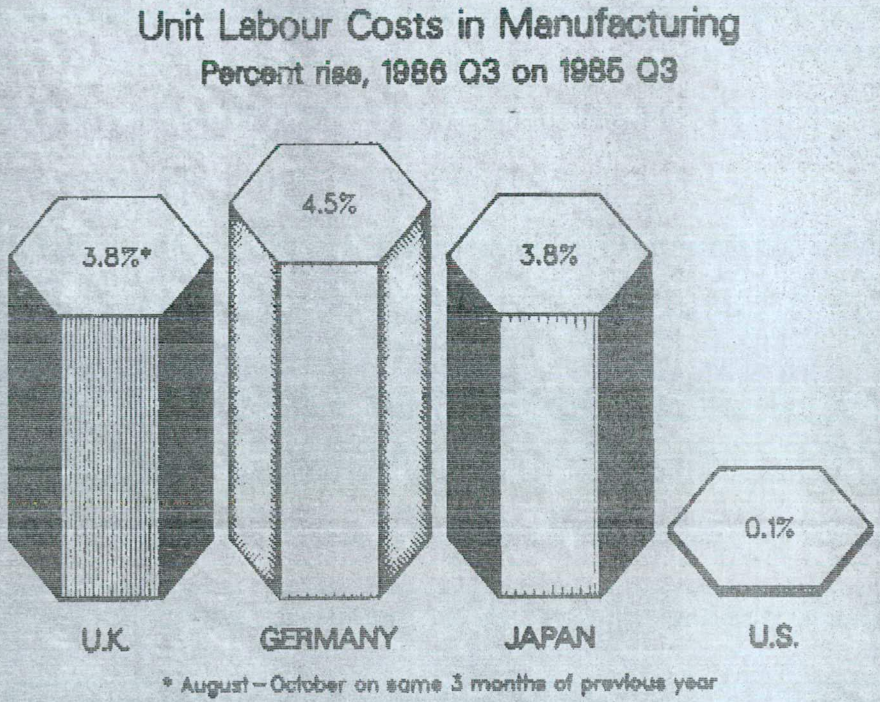


The crucial result from the comparison is that while labour costs in the U.S. were virtually unchanged over the year to the third quarter of 1986, those in Germany and Japan rose at a similar rate to those in the U.K. The reason for the poor performance in Japan and Germany is the weakness of industrial output in those countries, caused by currency appreciation. Comparing cost rises over a shorter period, unit labour costs in both Germany and Japan are continuing to rise, while those in the U.K. are static.

Using unit labour costs as a forward-looking, or underlying, measure of price inflation, these data suggest that real yields on U.K. government bonds now stand at a very high level by international standards. The current U.K. figure for medium-dated bonds is now over 10 percent, compared with comparable figures of about 1.5 percent for Germany and Japan and about 7.5 percent for the U.S. respectively.

This international comparison of unit labour costs also suggests that cost developments in domestic currencies, far from offsetting some of the effect on the U.K. of sterling's depreciation in 1986, are actually reinforcing it. This, in turn, suggests a rapid and strong recovery in the U.K. manufacturing trade balance, providing support for sterling in 1987.

CREDIT SUISSE FIRST BOSTON
LIMITED

LONDON

S08/7 P1

FACSIMILE TRANSMISSION CONTROL SHEET

FROM: PETER SPENCER

DATE: 7.1.87

TO: COMPANY NAME: HM Treasury

ADDRESS: Parliament St, SW1

ATTENTION: Mr A CS Allan, Room 12/2nd

FACSIMILE TELEPHONE NUMBER: 839 2029

NUMBER OF PAGES INCLUDING THIS TRANSMISSION CONTROL SHEET: 9

CHARGE TO:- ISSUE OR DEPARTMENT: Res

REMARKS:- You clearly did not see last Friday's piece, attached. All the best for '87.

AUTHORISING SIGNATURE: P Spencer NAME(PRINT): SPENCER

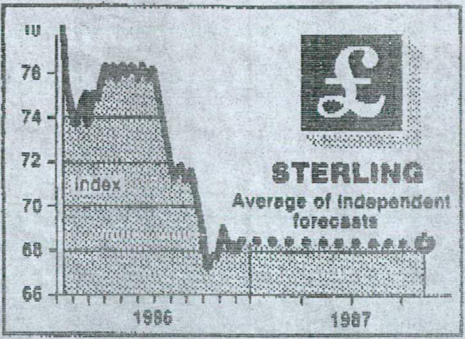
IF REPEATS REQUIRED PLEASE PHONE 01-634 3078 QUOTING FAX. NO:-

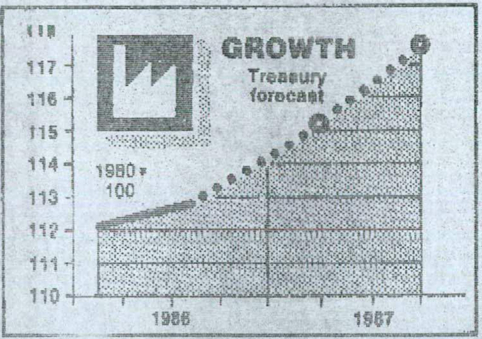
WE HAVE THE FOLLOWING FACSIMILE EQUIPMENT TO RECEIVE YOUR TRANSMISSIONS:-

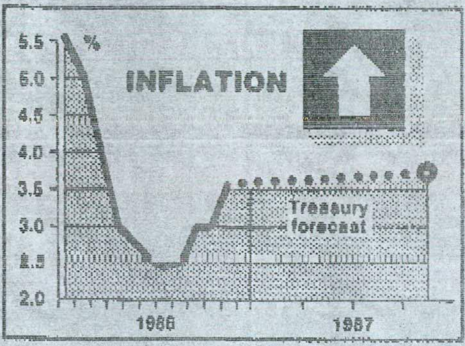
INFOTEC (RAPIFAX) 6100	GP II/III 01-283 7369
DEX 3500	GP II/III 01-623 2363

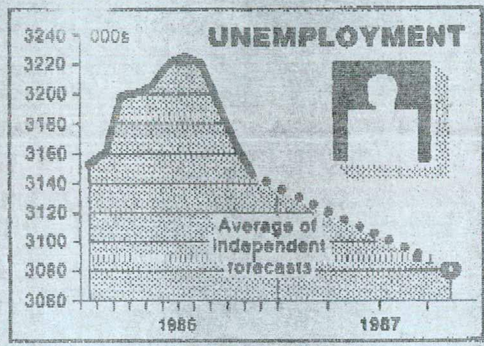
S08/71

End of industry's long winter in sight









If 1986 was the year in which falling oil prices made the world economy hesitate, 1987 should be the year in which cheaper oil puts a tiger back in the tank.

That, at any rate, is the theory on which economists are basing their hopes for an expansionary world in the New Year. So far, oil-importing countries have been uncomfortably slow to spend the increase in their real incomes caused by cheaper oil.

But both theorists and practical men agree that 1987 promises to be a considerably better year for industry than 1986 and particularly good for manufacturing.

In Britain, this is good news after manufacturing's long retreat. And it is good news for a government seeking re-election. Though inflation will rise, unemployment should fall. Despite a large and not unpopular increase in public spending, Government borrowing is well under control and the prospects for tax cuts are growing.

The main threat to this attractive outlook is the stability of the pound. Opec and North Sea oil between them have effectively kept the balance of payments out of the headlines for several years. This year, Britain's current account will move back into deficit and sterling may again become vulnerable to worries about trade.

On the world stage, there is also the formidable problem of the trade imbalance between the US and the other two major leading economic powers of the West, Germany and Japan. This prompts protectionist pressures in the US and continually undermines currency stability, threatening loss of confidence and higher interest rates.

Barring a collapse of confidence in the dollar, however, world trade this year – weighted by British shares – could grow by 4½ per cent compared with only 2 per cent last year, according to the Treasury's latest published forecast.

Faster growth in world trade combined with some improvement in competitiveness from the fall in sterling should help exporters. On the Treasury's reckoning, exports of goods and services could grow by 3 per cent (and non-oil exports by 5½ per cent) against only 1 per cent last

on growing while pay increases show further signs of slowing down. Settlements in manufacturing monitored by the Confederation of British Industry have slowed from 6¼ per cent in the first half of last year to 5½ per cent in the third quarter and only 4⅔ per cent in the fourth quarter.

According to Mr Peter Spencer of Credit Suisse First Boston, the Treasury's forecast of a 2½ per cent rise in manufacturers' unit labour costs may now be too pessimistic, suggesting that most of the strong gain in competitiveness from the sharp fall in the pound will be retained.

On the domestic side, consumer spending, fuelled by high, real pay increases, will continue to grow rapidly – by 4 per cent, according to the Treasury against 5 per cent last year. A high level of company profitability will maintain non-oil investment, though lower oil prices will continue to depress North Sea spending. And as output rises some stockbuilding is expected.

It all adds up to a year of more balanced growth in the economy compared with last year's consumer boom and probably faster growth. The consensus among independent forecasters is for growth in GDP of 2.7 per cent, not far from the Treasury's estimate of 3 per cent compared with

sixth successive year of sustained expansion.

Views about inflation and the balance of payments, however, are much more varied.

Everyone expects growth in the retail price index to be higher by the final quarter of the year, but expectations vary from 3½ per cent forecast by the LBS to 5¼ per cent expected by the NIESR. The Treasury is at the optimistic end of the range, with 3¾ per cent. Much will depend in the short-term on movements in the mortgage rate and in the slightly longer term on the exchange rate.

Views on the balance of payments are even more divergent. Lower oil prices mean lower earnings on North Sea exports, while buoyant consumer spending means a hefty import bill – everyone agrees that. But how energetically British industry will be able to take advantage of demand both at home and overseas sharply divides optimists from pessimists.

Gloomiest is the National Institute, whose last forecast predicted a deficit of £5.6 billion. Most optimistic is the Treasury with a deficit of £1.5 billion. But, again, readings from the most recent tea-leaves are not discouraging. Imports of consumer goods in the latest three months appear to have fallen compared with the previous three months.

think about the Budget. Already he has made it clear that there will be no overt reflation. The public sector borrowing requirement, he promised at the time of the Autumn Statement, will be no higher than its previously-planned level of 1¾ per cent of GDP. In that sense, Mr Lawson has already made his Budget judgement.

Given this apparently stern attachment to fiscal orthodoxy, can we expect tax cuts in this year's Budget? Almost certainly we can, though the picture could change radically between now and Budget time.

Revenue is running strongly ahead of forecast in the current financial year, to such an extent that, despite an overrun on public spending, the PSBR is expected to be below the target of £7 billion – perhaps well below it. Revenue from indirect taxes has benefited from the consumer spending boom while the take from Corporation Tax, at one time minimal, has risen strongly in proportion to rising company profitability. The recent increase in the oil price will also boost revenue.

Another massive swing in oil prices, a dollar crisis, or concern about the policies of aLabour government, could all upset this happy prospect. But, for the time being, 1987 does not look at all bad.

CHART B.1

ps2/77R

B/F 9/1

FROM: CATHY RYDING

DATE: 7 January 1987

MR ODLING-SMEE

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr F E R Butler
Sir G Littler
Mr Cassell
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Riley
Mr Allan
Mr Cropper
Mr Ross Goobey
Mr Tyrie
Mr Battishill (I/R)
Sir A Fraser (C&E)

POLICY BACKGROUND TO THE 1987 BUDGET

The Chancellor was grateful for your minute of 6 January attaching a redrawn version of Chart B.1.

2. The Chancellor would be grateful if the Chart could be re-done on a quarterly basis, in time for Chevening.

CR

CATHY RYDING

ps3/59K

SECRET

CHANCELLOR OF THE EXCHEQUER

FROM: A W KUCZYS
DATE: 7 January 1987

CHANCELLOR

INCOME TAX HIGHER RATES

You asked what would be the effect of the options under consideration on:

(a) the number of taxpayers whose marginal rate is over 50 per cent; and

(b) the number of taxpayers whose marginal rate is 50 per cent or more.

2. As compared with indexation, the number of taxpayers over 50 per cent would fall slightly, from 210,000 to 200,000. The number of taxpayers on 50 per cent or above would fall more substantially, from 400,000 to 200,000. (This would enable you to say that the number of people facing a marginal rate of 50 per cent or more had been halved.)

AWK

A W KUCZYS

AWK TO CH/EX 7/1 INCOME TAX HIGHER RATES

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

FROM: B H KNOX

DATE: 8 January 1987

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Ross Goobey
PS/Inland Revenue

BUDGET 1987 - EXCISE DUTIES

Cathy Ryding's minute of 2 January recorded your comments on my paper of 18 December. You may find the following clarifications helpful before Chevening.

Tobacco

2. As you noted, since my submission two cigarette companies have announced price cuts for some brands instead of their usual seasonal increases. We have been doing some work on the possible implications for Budget decisions and I am minuting you separately. We have noted your views on cigars.

RPI

3. Lorry VED is not in the RPI, nor are we aware of any plans for it to be included (it is not a normal item of family expenditure). We do not yet know what weight the Department of Employment will finally give to derv. They will have to decide in the next couple of weeks but all the indications are that it will be small enough for any conceivable increase in the duty to have a negligible impact effect on the RPI.

/4. It may

Internal distribution:

CPS Mr Jefferson Smith Mr Wilmott Mr Bone Mrs Hamill

4. It may be useful if I spell out the meaning of 'negligible' here. In our calculations of RPI effects we work to three places of decimals. In our submissions to you these are rounded to two places, with the result that anything with an impact effect of less than 0.005 per cent is scored as negligible. Public presentation of RPI figures is conventionally to one place of decimals.

Derv

5. The individual components of the possible increase in pump price for derv are as follows :-

	Pence per gallon		
	Duty	VAT*	Total
Switch from VED (£100m off VED, lorry neutral - ie £125m net yield after bus fuel grants)	8.2	1.2	9.4
Revalorisation	2.4	0.4	2.8
Recoupment from VED non-revalorisation	0.9	0.1	1.0
Totals	11.5	1.7	13.2

* Most derv users can reclaim VAT

As I said in my submission the UK's derv duty is already very much at the top end of the Community scale. Increases of 12p or 13p are indeed large and can only make such comparisons look worse. However, the point is that the bulk would come from a switch in the burden from the standing charge to the running cost, with the remainder from maintaining the real value of the duty. It is essentially a matter for political judgment whether the shift could be publicly justified.

Alcohol

6. A revenue shortfall is in prospect if you are aiming for a revenue yield equivalent to across-the-board revalorisation but wish to under-index one group. Perhaps the first question to be addressed is whether you are in fact seeking such a revenue yield.

/7. If you are,

7. If you are, and if you wish to finance some leniency on drinks, then, as you suggest, cigarettes and/or petrol (though not presumably, in the light of your comments, derv) are the likeliest candidates for over-indexation. A variety of packages can be constructed and we shall be happy to provide them when we have a steer but the following may be a helpful illustration. It combines a standstill on spirits with under-indexation of the remaining drinks, balanced by over-indexation of cigarettes. The RPI impact effect is similar to revalorisation.

	Revalorisation 3.25%		Package 2.5% except spirits, offset by tobacco		Scorecard	
	1987-88	1988-89	1987-88	1988-89	1987-88	1988-89
Beer	55	60	45	45	-10	-15
Cider	neg	neg	neg	neg	nil	nil
Spirits	25	25	0	0	-25	-25
Wine	15	20	10	15	- 5	- 5
Total drinks	95	105	55	60	-40	-45
Tobacco	85	90	125	135	40	45
Overall totals	180	195	180	195	0	0

PRICE INCREASE IN PENCE

		Revalorisation 3.25%	Package 2.5% except spirits, offset by tobacco
Beer	per pint	0.7	0.5
Cider	per pint	0.3	0.3
Spirits	per 75cl	17.7	nil
Wine	per 70cl	2.6	2.0
Cigarettes	per 20KS	3.0	4.4 (Duty increase = 4.75%)

Annex A (ii) of my earlier submission gives a ready-reckoner which will enable you to consider variations.

8. As the oil companies have recently announced an increase of about 7p in the pump price of petrol to take effect later this

/month

month, you may feel that, whatever the taxable capacity, you would rather not add arbitrarily to petrol duty. A modest over-indexation of cigarette duty on the other hand might be more politically palatable, though we would not recommend that the balance be skewed too far.

Bryce Knox

B H KNOX

Thanks. Table 2 is v. striking indeed. See the ratio line I have added. I should be interested in the 1979 stock figs, too, to compare with those for 1986 in para 8. I shall use this paper in the Chancellor file. (Pls also copy to Culpin)

M

FROM: C J RILEY
DATE: 8 JANUARY 1987

CHANCELLOR

Ch Table 2 is the interesting one.

AA

cc Sir P Middleton
Sir T Burns
Mr Cassell
Mr Odling-Smee
Mr Peretz
Mr Bottrill
Mr Grice
Mr C Kelly
Mr Hurst

cc Mr Culpin

PUBLIC AND PRIVATE SECTOR BORROWING

You have asked for information on the relative scale of public and private sector borrowing in recent years.

2. Borrowing can be defined on either a gross or net basis. Table 1 below shows data since 1979-80 on a net basis - ie the net acquisition of financial liabilities. On this basis the private sector (excluding financial institutions) is a creditor rather than a debtor. Apart from statistical errors and omissions, the sum of the two rows of the table equals the surplus of the overseas sector (the current account deficit) and the financial institutions.

Table 1: Net Borrowing by the Public and Private Sectors

£billion	1979-80	80-81	81-82	82-83	83-84	84-85	85-86
Public Sector	8.6	11.9	5.7	8.8	11.8	14.2	8.9
Private Sector*	-9.6	-17.0	-13.8	-16.4	-17.1	-19.9	-16.2

3. If the private sector's demand for financial assets is essentially a net demand this is the appropriate definition of borrowing for assessing the impact on interest rates. For given levels of income and wealth, higher public sector borrowing matched by higher private sector net saving requires a higher general level of real interest rates if there is no change in

RILEY TO CH/EX 8/1 PUBLIC + PRIVATE SECTOR BORROWING

* Excluding banks, building societies and other financial institutions - ie persons plus industrial and commercial companies.

underlying private sector saving behaviour. However, if there is an increased propensity to save by the private sector, higher net saving will tend to be accompanied by lower real rates. For given levels of net borrowing, higher gross borrowing matched by higher gross lending within sectors would affect only the margin between borrowing and lending rates.

4. But this analysis assumes that all members of the private sector are savers and all parts of the public sector borrowers. In practice interest rates are affected by the behaviour of savers as a whole and by borrowers as a whole, and these will span the sector boundaries. To some extent, this problem can be ameliorated by considering gross borrowing for each sector.

5. A rise in the gross demand for credit requires a rise in interest rates in order to bring forth a rise in the supply of funds by creditors. But conversely if an increase in gross borrowing reflects an increased supply of funds by creditors, interest rates would tend to fall. Changes in gross borrowing may also reflect variations in the degree of regulation of financial institutions. Deregulation has increased the scale of gross lending by financial institutions and the deposits they take. If they previously rationed funds by quantitative restriction rather than by price, this is likely to have raised both deposit rates (as they bid for funds to on-lend) and lending rates.

6. Recent data for gross public and private sector borrowing are set out in table 2. The appropriate definition of gross borrowing for each sector is not clear cut. Credit transactions within the private sector (and the public sector) may be relevant to determining interest rates, but it is difficult to get adequate data. Typically such transactions are netted off in the published statistics. For present purposes I have used the following definitions, after consulting with MG and EA:

Public Sector	-	the PSBR
Private Sector	-	bank borrowing
		plus borrowing from building societies and other financial institutions
		plus Issue Department purchases of commercial bills

If further work is to be done on this it would be necessary to consider the definitions more carefully than has been possible so far.

Table 2 Gross Borrowing by the Public and Private Sectors

£billion	1979-80	80-81	81-82	82-83	83-84	84-85	85-86
A Public Sector	10.0	12.7	8.6	8.9	9.8	10.2	5.8
B Private Sector*	15.1	15.6	22.5	22.8	24.2	31.1	34.3
Ratio B:A	1.5	1.2	2.6	2.6	2.5	3.0	5.9

7. Although the data in table 2 do not pick up all credit flows within the economy, they provide a better indication of the relative scale of new public and private borrowing than the data on net borrowing in table 1. It is evident that the flow of private borrowing has been significantly larger than public borrowing in recent years - by a factor of 3 or more.

8. In stock terms, however, the difference is less great. The stock of gross private sector debt in 1986 is of the order to £250 billion, compared with gross public sector debt of around £200 billion. Stocks as well as flows influence interest rates.

STOCKS	Private	Public	
1979	80	110	0.7
1986	250	200	1.33

CJR

C J RILEY

CONFIDENTIAL

FROM: **S J DAVIES**
DATE: 8 JANUARY 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir T Burns
Sir G Littler
Mr F E R Butler
Mr Cassell
Mr Monck
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Bottrill
Mr Matthews
Mr Mowl
Mr Riley
Mr Cropper
Mr Ross-Goobey
Mr Tyrie

Mr Battishill - I/R
Sir A Fraser - C/E

Ch
(pretty much as expected)
AA

DAVIES TO CH/EX 8/1

WINTER FORECAST : PRELIMINARY INDICATIONS

WINTER FORECAST: PRELIM. INDICATIONS

As the winter forecast is under way EA and PSF have prepared the attached note to serve as a background to your Chevening discussions.

2. The note concentrates on the new information that has become available since the completion of the October and Autumn Statement forecasts and on the main changes we expect in the prospect for 1987. It deals in turn with the world and domestic economies and public sector finances.

S J D

S J DAVIES

WORLD ECONOMY

RECENT DEVELOPMENTS

attached

The note on "World Economic Developments" sets out the most recent world economic indicators.

(a) **Activity and demand:** In the third quarter of 1986 G5 domestic demand was nearly 4 per cent higher than a year earlier (mainly as a result of buoyant consumers' expenditure), while real GNP had grown by a more modest 2½ per cent. Large terms of trade changes have resulted in G5 import volumes rising considerably faster than their exports. Industrial production, always sensitive to export growth, continued to grow more slowly than GNP, and has remained flat in each of the three major countries - the US, Japan and Germany.

(b) **Trade:** Data on world visible trade for the second half of 1986 are sparse. A rebuilding of oil stocks in industrial countries may have temporarily inflated total world import volumes, which were perhaps 4-4½ per cent higher than a year earlier in the first half of 1986. OPEC and other oil producers' imports probably continued to fall. Trade in manufactured goods appears to have increased more slowly, by only 2½-3 per cent over the same period.

(c) **Current accounts:** The current account surpluses in Japan and Germany have continued to grow. The US deficit may have ceased rising.

(d) **Inflation:** Consumer price inflation in the G5 has levelled out at a little over 1 per cent, with negative inflation in Japan and Germany. Real commodity prices have failed to recover as expected when completing the Autumn Statement.

(e) **Oil prices:** The Brent price was within the $14-$15½ range in the autumn, but rose in late-December in response to OPEC's agreement to make further production cuts, and is now just over $18. Markets at the moment seem confident that the OPEC agreement will substantially achieve its aims over the next few months.

PROSPECTS

2. No major changes in policy are yet in prospect. The German Parliament has passed a restrictive budget for 1987, and interest rates are unlikely to fall soon. The new Japanese budget has also been described as being "austere". In the US we still expect significant overshooting of the Gramm Rudman Federal deficit targets.

3. Our provisional conclusions on the prospect for 1987 are as follows.

(a) **Activity:** Growth of G5 domestic demand may be a little lower in 1987 than 1986. Growth in G5 GNP is likely to be about 3 per cent, a little above the likely outcome for 1986 of 2½ per cent. G5 industrial production should grow rather faster than in 1986 as exports to non-oil developing countries stop falling.

(b) **Trade:** In 1987 the prospect is for growth of total world trade to be slightly lower than in 1986, but for world trade in manufactures to grow more strongly at 3-4 per cent.

(c) **Inflation:** The outlook for 1987 is for another year of very low consumer price inflation. Real commodity prices are expected to rise less than expected at the time of the Autumn Statement.

THE UK

RECENT DEVELOPMENTS

4. Monitoring recent developments is complicated by large discrepancies between the CSO's estimates of the various measures of GDP in the third quarter of 1986. The output measure of GDP probably gives a better idea than the present estimate of average GDP of what the CSO will eventually record for the average measure. In other words the expenditure and income measures are likely to be revised up as the CSO acquire more information. Bearing this in mind there is evidence of a strong growth in activity occurring during 1986, while the current account moved into deficit, and inflation behaved much as envisaged in the Autumn Statement.

(a) **Activity and domestic demand:** Growth in both GNP and manufacturing output since the spring of 1986 has been more vigorous than was apparent a few months ago. The behaviour of the output measure of GDP suggests that growth in 1986 now seems likely to turn out between 2½ and 3 per cent; not far, after all, below the FSBR forecast. The recorded growth of domestic demand in the UK in the first three quarters of 1986 has been a little below what was expected at the time of the Budget, but we suspect the CSO's figures understate the actual growth of demand. The volume of consumer spending in recent months seems to be running a little higher than forecast in the Autumn Statement, investment spending lower, and both export and import volumes significantly higher.

(b) **Money GDP:** Money GDP growth in 1986-87 may not after all significantly undershoot the $6^3/4$ per cent growth envisaged in the 1986 MTFS.

(c) **Inflation:** Both RPI and producer price inflation may currently be slightly above the path consistent with the Autumn Statement forecast. The last two CBI surveys have shown some rise - above what can be accounted for entirely by seasonal factors - in the proportion of firms expecting to raise prices. The RPI figures for the last two months have shown a perceptible upward shift in the trend increase in prices of some consumer goods.

(d) **Pay:** Pay settlements monitored by the Department of Employment in manufacturing industry have fallen by about a point so far in this pay round. However, as in other respects, manufacturing appears to be behaving differently from other sectors of the economy. There has so far been only a marginal fall in settlements in the rest of the private sector. The fall in settlements in the private sector as a whole has been no greater than that allowed for in the internal October forecast, and less than was implicit in the Autumn Statement forecast.

(e) **The exchange rate and competitiveness:** The depreciation of the exchange rate during 1986 has been accompanied by a marked improvement in competitiveness. The exchange rate is currently a little above the value assumed in the Autumn Statement forecast for early 1987.

(f) **The current account:** The current account has been in deficit in recent months with a steep increase in the volume of imports more than offsetting the strong recovery in exports through most of 1986. The surplus on invisibles rose sharply during 1986. Our best guess is that the current account deficit for 1986 was close to £½ billlion. Given the somewhat confused signals on the behaviour of world trade in 1986 it is not clear whether the recent strong growth in UK exports reflects principally an upsurge in world demand, or whether there has been an increase in the UK's share of world trade, possibly in response to improved competitiveness.

PROSPECTS

5. The new forecast is not showing any major change to the prospects for activity and inflation in 1987 as compared with our view in the autumn, although the outlook for the current account has worsened.

(a) **Activity:** For 1987 the prospect is still for GDP growth of around 3 per cent as envisaged in the Autumn Statement. The forecast for consumer spending is little changed, with growth in spending at around 4 per cent. Business fixed investment should rise by more than envisaged two months ago given the encouraging December Intentions Survey. Investment in non manufacturing industry and services (especially in distribution) and residential investment look likely to be particularly strong in 1987. The relative weakness of manufacturing investment this year and next reflects the recent pattern of output growth which since early 1985 has been weighted towards the other three quarters of the economy.

(b) Inflation and pay: The increase in the RPI over the year to 1987 (4) is likely to be a little higher than in the Autumn Statement. On the basis of no change in mortgage rates during 1987 (as assumed in the Autumn Statement) total RPI inflation could be a little over 4 per cent in the fourth quarter of 1987 after a period earlier in the year when it is rather higher than this. Recent evidence on pay settlements seems to confirm the view that we took on earnings growth in the October forecast: there should be a small fall in underlying earnings growth over the next year to around 7 per cent.

?

Only if so the better this

(c) The exchange rate and current account: The improved level of competitiveness should help to restrain the growth of imports and encourage exports during 1987. Nevertheless the prospect of buoyant UK demand compared with more modest growth in markets abroad suggests that the trade deficit may continue to widen. The forecast for the current account as a whole in 1987 is likely to show a larger deficit than the £1½ billion forecast in the Autumn Statement. For the moment we are working on the assumption that there will be no significant further decline in sterling over the year: the forecast widening in the current account deficit is probably no greater than markets currently anticipate, and we expect the present large real interest differential to persist.

(d) The oil price: The forecast has been constructed on the basis of the oil price averaging \$15 over the next year. If the oil price were to remain at its present level of \$18 a barrel for the rest of 1987, government revenues from the North Sea would be about £1-1¼ billion higher in 1987-88. The current account deficit in 1987 might be £½-¾ billion lower with an unchanged exchange rate; but the improvement would be less than this to the extent that the exchange rate appreciated in response to the higher oil price. RPI inflation might be about ⅓ percentage point higher at the end of 1987.

(e) Monetary conditions: In the light of M0's recent behaviour and the prospect of continued strong growth of personal income and consumers' expenditure it could prove difficult to keep it within the range for 1987-88 set out in the 1986 MTFS. The prospect is for money GDP growth clearly above the MTFS rate. If something else went seriously wrong, for example if there were a run of trade figures that were much worse than expected, a deterioration of expectations in financial markets could pose a serious problem. However we are currently assuming that interest rates will remain at their current levels, at least until the end of 1987.

PUBLIC FINANCES

1986-87 TO DATE

6. Figures for the CGBR to December are now available. The provisional December outturns for the LABR and PCBR, and therefore the PSBR as a whole, will be available on Friday, January 9.

7. The central government story has not changed much in recent weeks.

(a) **Non-oil taxes** to December are £2¼ billion above the Budget profile. VAT and corporation tax (CT) more than account for this excess. Little of this unexpected buoyancy can be explained, on current data at least, in terms of what has happened to consumer spending and past profits. We suspect however that the profits data will in time be revised upwards. Upward revisions to consumer spending are also possible, but the more likely explanation is that 1986-87, like 1985-86, will be a year in which VAT has grown significantly faster than consumer spending. It does look therefore as if the effective rates of tax on consumers' expenditure and profits have risen. For CT one possibility is that the sustained rise in profits over a number of years has brought down the proportion of tax exhausted companies faster than expected.

(b) Most of the £1 billion shortfall on **oil taxes** compared with the Budget profile reflects an oil price in the first half of 1986-87 below $15 a barrel.

So what is it?

(c) Little, if any, of the £½ billion additional **national insurance contributions** (NICs) is thought to reflect higher than expected wages and salaries. This fits in with the experience on PAYE, which is roughly on track.

(d) An overrun of £3/4 billion on **supply and other expenditure** compared with the Budget profile is largely accounted for by social security (£0.5 billion) and net EC payments (£0.3 billion).

(e) **Central government debt interest** payments net of receipts are broadly on track.

(f) The timing of **privatisation proceeds** in the Budget profile is fairly arbitrary and departures from profile are not particularly meaningful. The annual target may be just missed however. (See below.)

8. At end December the **CGBR(O)** was about £1 billion below the Budget profile, with higher expenditure and lower oil taxes more than offset by higher non-oil taxes and NICs.

9. Both the **LABR** and **PCBR** are below profile. Information on LA's and PC's accounts is patchy. On the LA side higher than expected capital receipts from council house sales and the delay in the teachers settlement could account for some

of the shortfall. In the case of public corporations lower capital spending is a more likely explanation than higher profits.

1986-87 AS A WHOLE

10. Forecasts for 1986-87 as a whole are still subject to significant margins of error. Average errors on internal January forecasts of the PSBR over the last ten years have been equivalent to £1½ billion. Although in recent years the error has been less there has been a tendency to overpredict the outcome, by about £¾ billion on average. A relatively large margin of uncertainty will remain right up to, and including the Budget because of the possibility of very large receipts and payments switching between the end of March and the beginning of April.

11. The latest forecast for 1986-87 assumes

(a) privatisation proceeds of £4.6 billion (ie just below the previous assumed total of £4¾ billion);

(b) expenditure on Rover (repayment of debt) of £650 million (only £100m was allowed for as a contingency in the Autumn Statement).

The forecast is consistent with a public expenditure planning total of £140.5 billion This is the same as in GEP's December assessment, but our figuring here assumes slightly lower privatisation proceeds offset by lower central government current expenditure than GEP assumed.

12. The PSBR in 1986-87 is now forecast to be about £6 billion, 1.6 per cent of GDP, the same as last year's ratio. The downward revision to the PSBR since the Autumn Statement is due to higher receipts, especially for CT. The present forecast assumes mainstream CT receipts of no less than £4 billion in January alone, not far off total receipts for a whole year only a few years back.

1987-88

13. We are still assessing the prospects for 1987-88, which are very uncertain at this stage of the forecasting exercise. At present the picture in broad terms is as follows.

(a) The forecast envisages overspending on programme plans in 1987-88 arising mainly from continued higher than planned take-up of social security benefits (partially offset by lower unemployment than the plans assume) and higher than assumed inflation, including public sector pay (other than the teachers). If in addition some allowance is made for genuine contingencies, such as Airbus launch aid and Space, a small total overspend on the planning total of £½ billion is suggested.

[illegible] how does this affect 87/8 PX?

(b) If the oil price averages \$15, **North Sea revenues** could be a little higher than projected in the FSBR. There is a new possibility of a higher price for at least some of the year. (The oil price for calendar 1987 will determine oil revenues for financial year 1987-88.)

(c) Although the buoyancy of **non-oil taxes** in 1986-87 is by no means fully understood it seems sensible to assume that a good deal of the buoyancy in 1985-86 and 1986-87 will carry forward into later years.

(d) On the assumption of a PSBR ratio of $1^3/4$ per cent of GDP, the prospect is for a **fiscal adjustment** in 1987-88 possibly twice as large as projected in the 1986 MTFS. However, the upward revision to the fiscal adjustment will probably not carry over to later years of the MTFS period to anything like the same extent.

ie £4 bn

PROSPECTS FOR THE DOMESTIC ECONOMY

	FSBR MARCH 1986	AUTUMN STATEMENT NOVEMBER 1986	PRELIMINARY VIEW JANUARY 1987
GDP			
1986	3	2½	2 3/4
1987	2½ (first half)	3	3
Money GDP			
1986-87	6 3/4	5½	6½
1987-88	6½	7	7½
Current balance, £ billion			
1986	3½	0	-½
1987	1½*	-1½	-2 - -4
RPI			
1986)change over previous)year to the fourth	3½	3¼	3½
1987)quarter	3¼**	3 3/4	4¼
Short-term interest rates** (per cent)			
1986 Q4	11	11	11
1987 Q4	9½	10½	11
MO **			
1986-87)financial)year	2½	4	4½
1987-88)averages	4	4	6

* First half of 1987 at annual rate

** not published

HM TREASURY

WORLD ECONOMIC DEVELOPMENTS

Summary

1. Latest figures suggest that industrial production has picked up in Germany and France.

(per cent change over six months)

	REAL GNP (85Q4–86Q2)	INDUSTRIAL PRODUCTION (Dec 85/Feb 86–June/Aug 86)
US	1¼	-1
Japan	½	-¼
Germany	¼	3½
France	¾	3
UK	1½	+½
G5	1	+¼

2. G5 consumer price inflation has stabilised at just over 1 per cent.

3. There are some indications that the trade imbalances of the US, Japan and Germany may have stopped expanding.

4. The Bank of Japan cut its discount rate by ½ per cent to 3 per cent. This is the fourth cut this year.

5. Of the various measures of monetary growth targeted by the G5 countries only MO in the UK and M2 in the US are growing within their target ranges.

6. In the United States Congress and the President have passed a budget for fiscal 1987 and signed into law the tax reform package.

7. In Japan a package of economic measures designed to boost domestic demand was announced, but a later supplementary budget suggested they would have only a small impact on domestic demand.

JOHN COLENUTT

TONY DOLPHIN

6 November 1986

SECTION A: NOMINAL AND REAL GNP

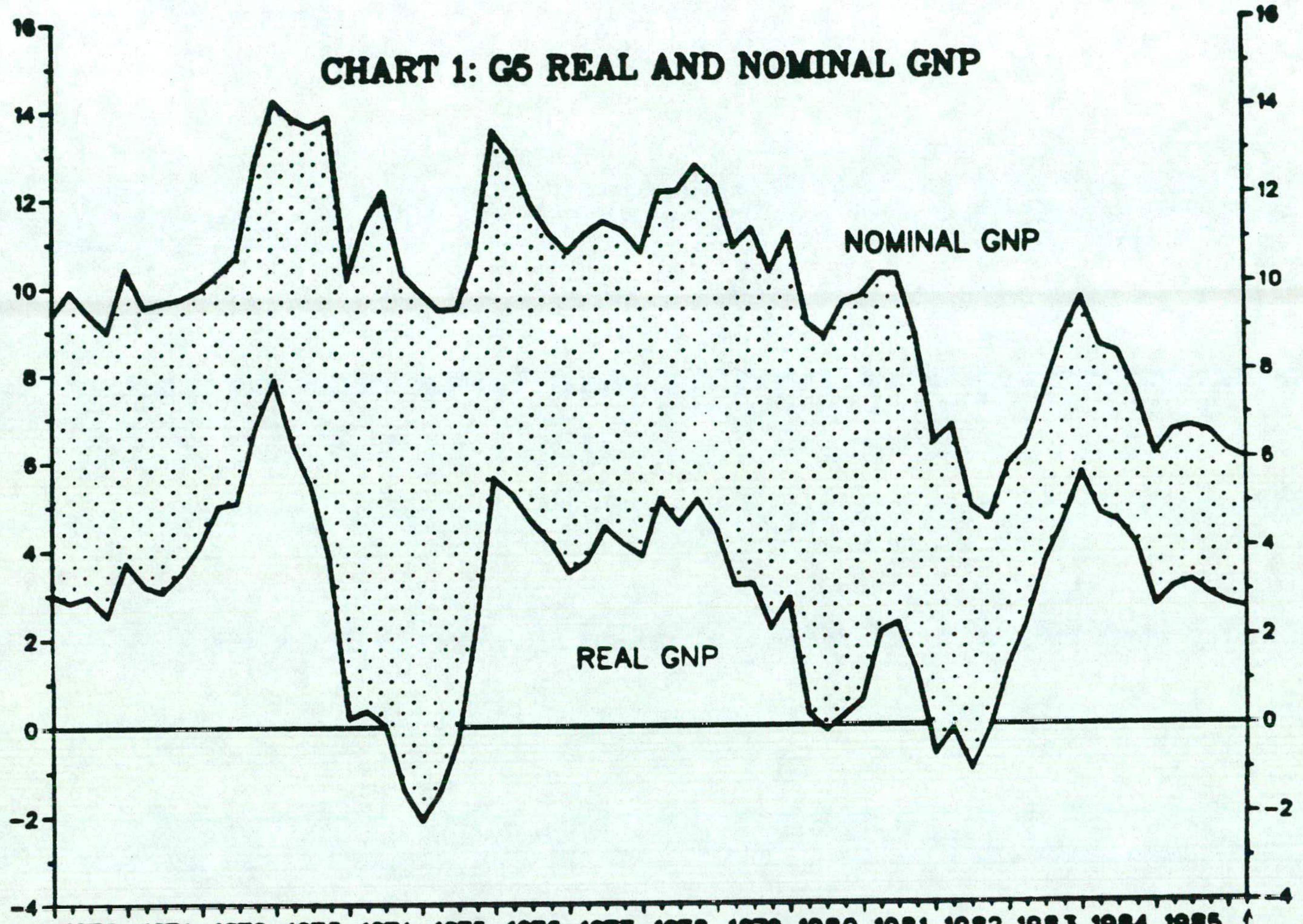
1. The annual growth rate of <u>nominal GNP</u> in the G5 countries has been between 6 and 6½ per cent for the past 18 months. Inflation, as measured by the GNP deflator has been around 3¼-3½ per cent. Thus, although the collapse of oil prices has brought sharp falls in consumer price inflation (see Section B), which includes the effects of lower import prices, the growth rate of the GNP deflator, which measures domestically generated inflation, has not yet fallen.

Table 1: Nominal GNP growth in the G5 countries*

		Nominal GNP	Real GNP	GNP Deflator
Annual percentage change				
1980		9.6	0.8	8.7
1981		9.7	1.5	8.0
1982		5.7	-0.5	6.1
1983		7.1	3.0	3.9
1984		8.5	4.7	3.5
1985		6.5	3.0	3.4
Change from four quarters earlier (per cent)				
1984	Q1	9.6	5.7	3.7
	Q2	8.6	4.8	3.6
	Q3	8.4	4.6	3.6
	Q4	7.4	4.0	3.3
1985	Q1	6.1	2.7	3.3
	Q2	6.6	3.1	3.4
	Q3	6.7	3.2	3.3
	Q4	6.6	2.9	3.5
1986	Q1	6.2	2.7	3.3
	Q2	6.0	2.6	3.3

* G5 weighted averages are calculated using GNP in 1980 prices converted to a common currency using average 1980 exchange rates.

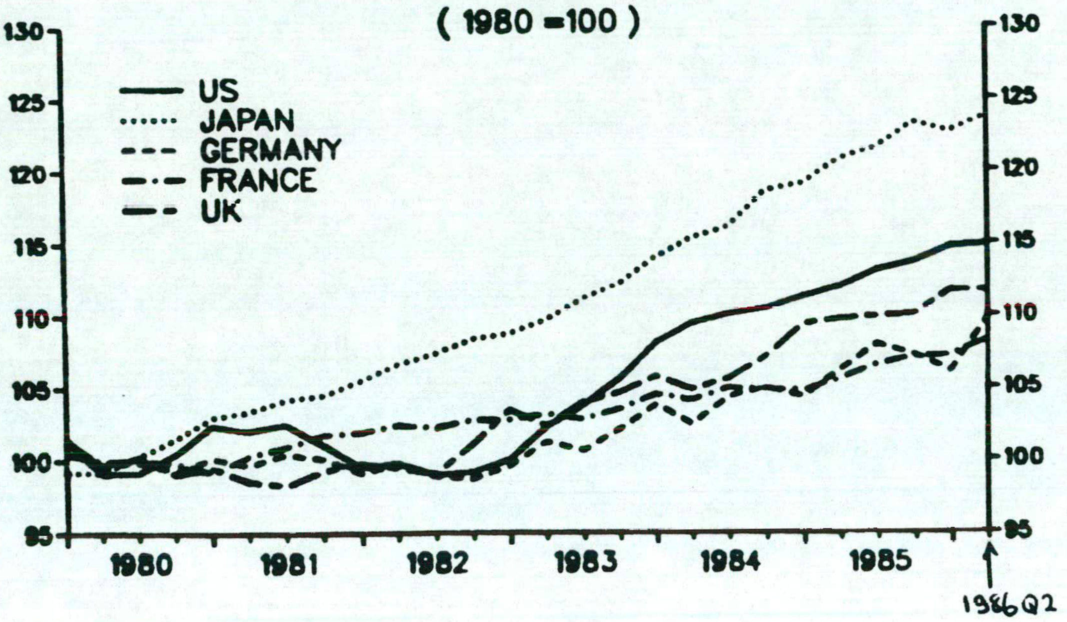
CHART 1: G5 REAL AND NOMINAL GNP



PERCENTAGE CHANGE OVER YEAR EARLIER

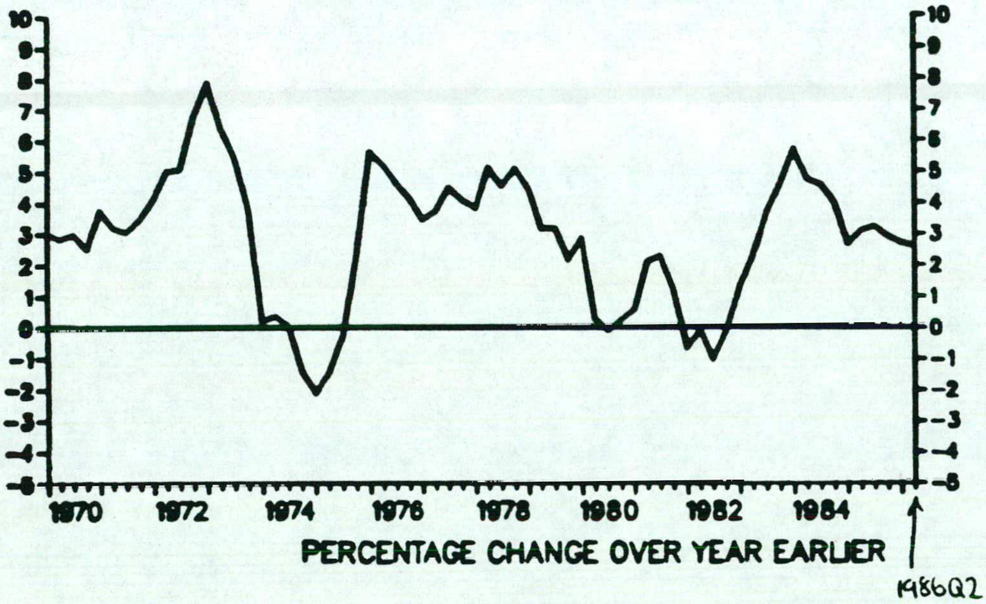
CHART 2: GNP IN THE G5 COUNTRIES

(1980 =100)



2. Real GNP growth in the G5 picked up in the second quarter, with output in Germany and Japan markedly above Q1 levels. In the US GNP was virtually the same in Q2 as in Q1 but the provisional estimate suggests that GNP grew by 2½ per cent (at an annual rate) in the third quarter.

CHART 3: G5 GNP GROWTH



PERCENTAGE CHANGE OVER YEAR EARLIER

Table 2: GNP growth in individual countries

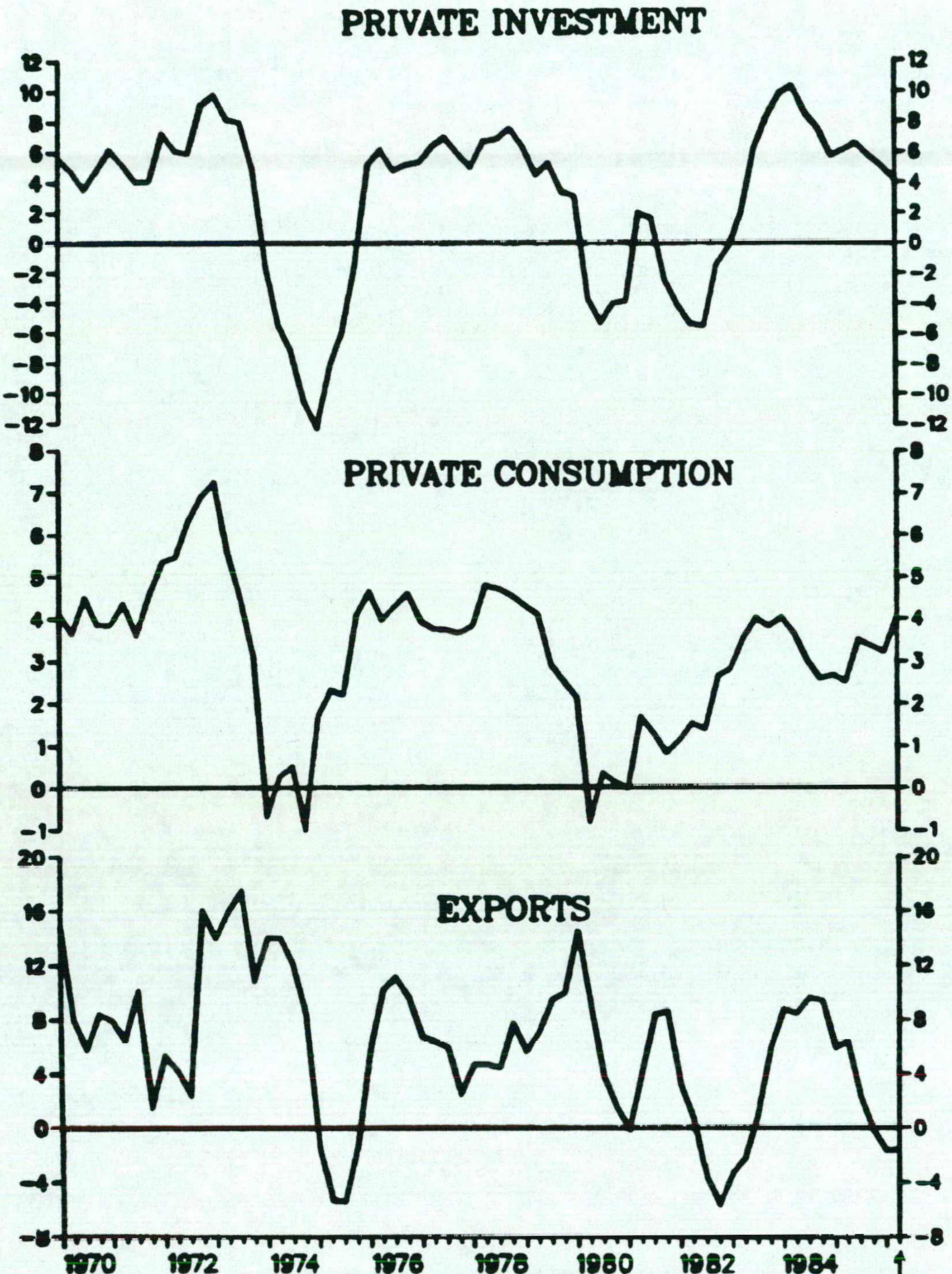
		US	Japan	Germany	France	UK	G5
Annual percentage changes							
1983		3.6	3.3	1.8	0.7	3.8	3.0
1984		6.4	5.0	3.0	1.5	2.2	4.7
1985		2.7	4.5	2.5	1.3	3.8	3.0
Change from four quarters earlier (per cent)							
1985	Q1	3.0	4.5	0.6	0.3	3.4	2.7
	Q2	2.3	4.7	3.7	1.4	4.7	3.1
	Q3	2.7	4.7	3.5	1.6	4.1	3.2
	Q4	2.9	4.0	2.2	2.1	2.8	2.9
1986	Q1	3.1	3.0	1.7	2.3	2.2	2.7
	Q2	2.6	2.5	3.3	2.5	1.8	2.6

3. The improved growth in the G5 countries in the second quarter reflects a sharp increase in domestic expenditure. Exports by the G5 picked up a bit in Q2, but remain weak, having fallen by 1½ per cent over the past year. On a year-on-year basis private investment growth has been slowing down for some time now, reflecting the maturity of the business cycle in the US and the knock-on effects of lower Japanese exports.

Table 3: Growth of real expenditure in the G5 countries

		Real GNP	Private Consumption	Private Investment	Government Expenditure	Exports	Imports
				Annual percentage change			
1980		0.8	0.5	-2.5	1.4	7.1	-1.7
1981		1.5	0.9	-0.7	1.7	5.2	1.5
1982		-0.5	1.7	-4.1	1.0	-1.4	1.3
1983		3.0	3.5	4.0	0.7	0.3	3.0
1984		4.7	3.3	9.0	2.1	9.1	12.4
1985		3.0	3.0	6.0	3.4	3.6	3.6
				Change from four quarters earlier (per cent)			
1984	Q1	5.7	4.0	9.8	0.2	8.8	14.2
	Q2	4.8	3.6	10.3	2.3	8.5	14.0
	Q3	4.6	3.0	8.5	2.4	9.6	12.4
	Q4	4.0	2.6	7.5	3.7	9.4	9.3
1985	Q1	2.7	2.7	5.8	3.3	5.9	5.3
	Q2	3.1	2.5	6.1	1.7	6.4	3.6
	Q3	3.2	3.5	6.5	3.9	2.3	2.5
	Q4	2.9	3.4	5.7	4.7	-0.2	3.1
1986	Q1	2.7	3.2	5.1	3.0	-1.7	3.3
	Q2	2.6	4.0	4.2	5.5	-1.5	7.0
				Indices (1980=100)			
1984	Q1	107.9	108.7	104.7	103.5	110.5	114.8
	Q2	108.5	109.7	107.1	105.8	111.5	118.4
	Q3	109.3	110.0	108.7	106.2	114.2	121.3
	Q4	110.2	110.6	111.3	106.9	117.4	121.7
1985	Q1	110.8	111.6	110.7	106.9	117.1	120.9
	Q2	111.8	112.4	113.6	107.7	118.7	122.7
	Q3	112.9	113.8	115.8	110.3	116.8	124.2
	Q4	113.4	114.4	117.7	111.9	117.3	125.4
1986	Q1	113.8	115.2	116.3	110.2	115.2	124.9
	Q2	114.7	117.0	118.4	113.6	116.8	131.2

CHART 4: G5 EXPENDITURE GROWTH



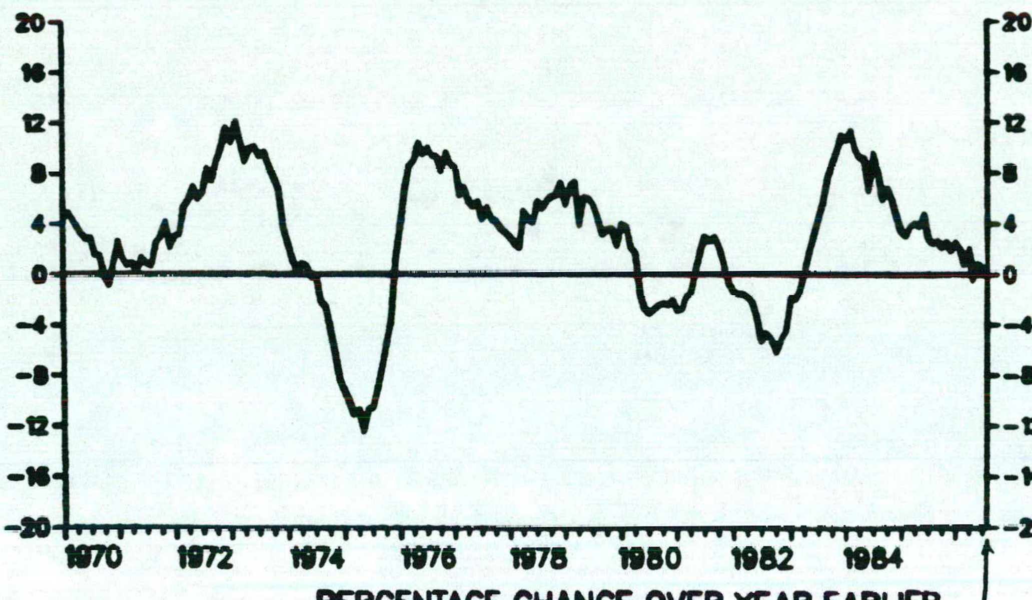
4. As Table 4 and Chart 5 show, industrial production in the G5 countries as a whole has been broadly flat over the last twelve months, though there are some indications of a pick up in recent months, especially in Germany and France. None of the G5 avoided a pause in output growth earlier in the year.

Table 4: Industrial production and employment in the Industrial Production G5 countries*

		Industrial production			Employment
		Index (1980 = 100)	Change on a year earlier (per cent)	Change on 6 months earlier, per cent, a.r.)	Change on a year earlier (per cent)
1980		100.0	-0.7		0.5
1981		100.3	0.3		0.2
1982		96.7	-3.5		-0.6
1983		100.5	3.8		0.7
1984		108.6	8.1		2.1
1985		111.9	3.1		1.3
1985	Q1	110.6	3.4	1.8	1.8
	Q2	111.8	4.1	2.8	1.1
	Q3	112.5	2.6	3.5	1.1
	Q4	112.7	2.2	1.5	1.1
1986	Q1	112.6	1.8	0.1	1.3
	Q2	112.7	0.8	0.1	
1986	Jan	112.9	2.5	0.1	
	Feb	112.9	2.0	0.8	
	Mar	111.9	0.8	-0.5	
	Apr	113.6	1.9	1.9	
	May	111.9	-0.3	-2.5	
	June	112.7	0.8	1.0	
	July	113.4	0.5	0.9	
	Aug	113.0	0.5	0.1	

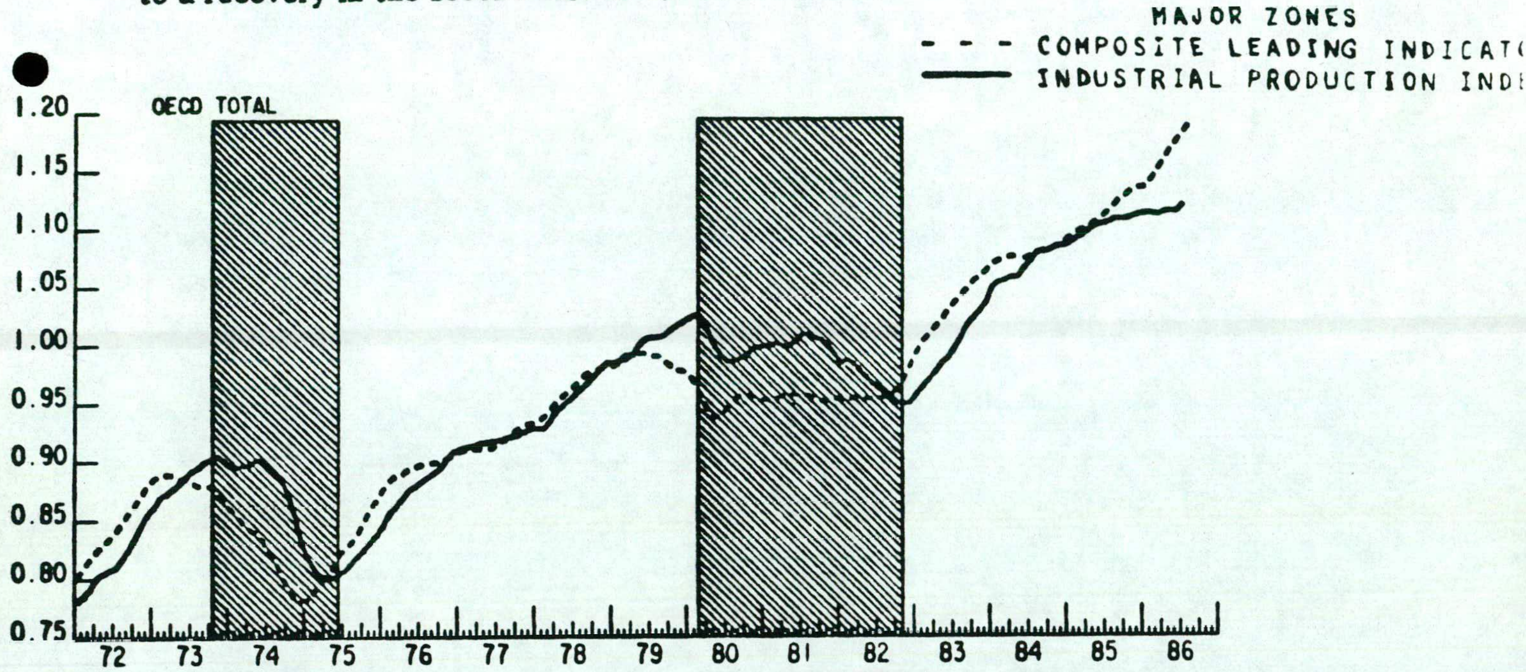
* Weights derived from 1980 gross domestic product originating in industry converted at average exchange rates for 1980.

CHART 5: G5 INDUSTRIAL PRODUCTION



PERCENTAGE CHANGE OVER YEAR EARLIER

5. The OECD's leading indicators, which are shown in the chart below, still point to a recovery in the second half of 1986 and in 1987.

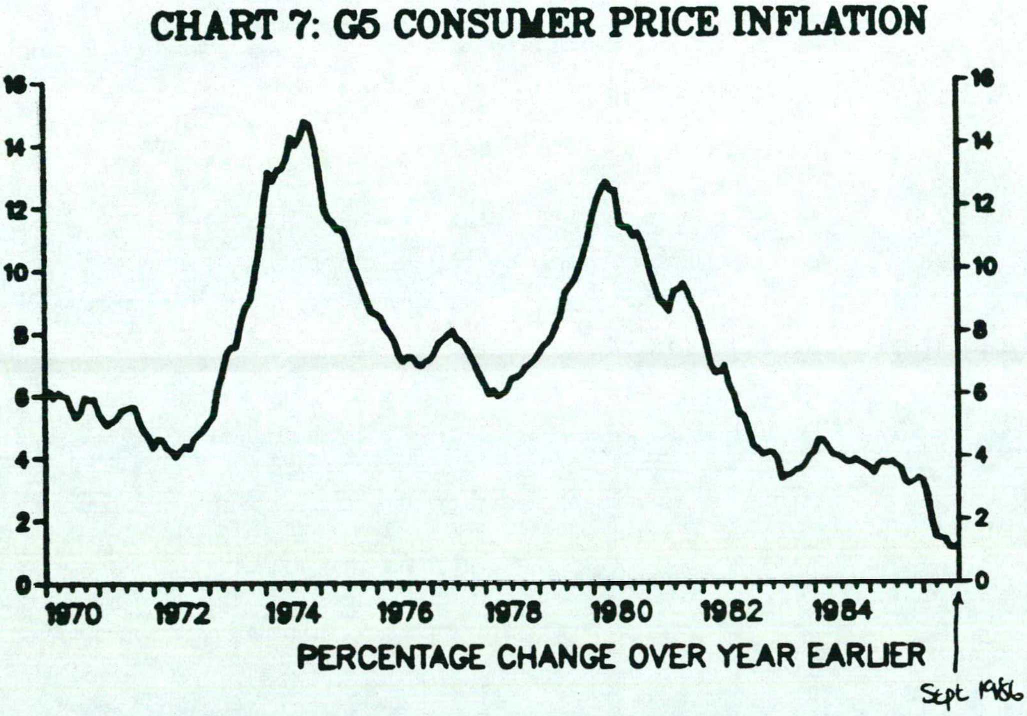


6. Unemployment has been little changed in most of the G5 countries since the middle of 1984 but in the United States it has fallen by around ½ per cent.

Table 5: OECD Standardized Unemployment rates (per cent of labour force)

		US	Japan	Germany	France	UK	G5
1980		7.0	2.0	3.0	6.3	6.6	5.4
1981		7.5	2.2	4.4	8.1	9.9	6.3
1982		9.5	2.4	6.1	8.3	11.4	7.7
1983		9.5	2.6	8.0	8.3	12.6	8.1
1984		7.4	2.7	8.5	9.7	13.0	7.4
1985		7.1	2.6	8.6	10.1	13.2	7.3
1986	H1	7.1	2.7	8.4	10.2	13.2	7.3
	Aug	6.7	2.9 (Jul)	8.3	10.5	13.3 (May)	7.3

SECTION B: PRICES AND WAGES



7. G5 consumer price inflation remains at its lowest level for over 20 years. In Germany prices are now lower than a year earlier.

Table 6: Consumer prices (percentage change on a year earlier)

	US	Japan	Germany	France	UK	G5
1980	13.5	8.1	5.6	13.5	18.0	11.7
1983	3.3	1.9	3.3	9.5	4.6	3.9
1984	4.3	2.3	2.4	7.7	4.9	4.1
1985	3.5	2.0	2.2	5.8	6.1	3.7
1986 Sept	1.8	0.1	-0.4	2.3	3.0	1.3

8. Table 7 shows that unit labour costs (not cyclically adjusted) are rising much faster in the UK than in other G5 countries, reflecting strong earnings growth.

Table 7: Unit Labour costs (manufacturing, percentage change on year earlier)

	US	Japan	Germany	France	UK	G5
1983	-2.5	-2.2	-0.4	7.6	0.2	-0.9
1984	-0.6	-4.2	-0.8	3.5	3.6	-0.8
1985	0.6	0.6	0.1	2.1	6.0	1.7
1985 Q1	1.1	-0.9	-1.8	4.5	5.1	1.5
Q2	0.0	-0.6	-0.4	1.5	5.7	1.1
Q3	0.8	0.8	1.5	1.9	7.2	2.2
Q4	0.5	3.3	1.3	0.6	6.3	2.1
1986 Q1	0.3	2.1	2.9	-0.8	7.9	1.7
Q2	1.4	3.1	3.0	-0.4	7.4	2.3

Source: IMF

9. Spot oil prices have been fairly stable since the beginning of September trading at $14-$15 pb compared with $29pb a year ago. This was in response to the announcement of an OPEC agreement to restrict production in September and October that has now been extended to December.

10. The UN commodity price figures shown in Table 8 and 9 are unit value indices. They are preferable to spot price indices, such as the Economist index, because they are based on more quotes and they incorporate producer prices. This should mean that the UN indices are more representative of long-term contracts and are less volatile.

11. However, the Economist non-oil index does provides an indication of more recent commodity price movements. On 28 October the SDR index was 1½ per cent higher, than a month earlier, but 6 per cent lower than a year ago. In the past month food prices have been risen by 3½ per cent but industrial materials prices have been largely unchanged (both in SDR terms).

Table 8: Commodity Prices (in nominal SDRs, (1980 = 100)

		Food	Agricultural Non-Food	Non-Ferrous Metals	Metal Ores	Oil
1980		100.0	100.0	100.0	100.0	100.0
1981		97.8	102.3	97.6	99.1	123.6
1982		91.3	96.3	91.6	101.1	126.7
1983		94.1	104.5	95.5	103.2	116.2
1984		93.2	114.2	97.0	102.8	117.5
1985		85.5	98.6	91.3	101.0	113.5
1984	Q1	95.6	115.4	99.5	103.0	115.7
	Q2	95.8	119.5	98.6	103.7	116.0
	Q3	92.6	110.6	95.4	103.0	118.6
	Q4	89.0	111.3	94.5	101.6	119.5
1985	Q1	87.5	106.3	95.8	106.0	121.1
	Q2	85.3	103.6	94.7	106.0	116.7
	Q3	83.6	95.0	90.2	98.2	109.4
	Q4	85.7	89.3	84.7	93.8	107.0
1986	Q1	90.2	86.8	84.7	90.6	80.4
	Q2	90.6	87.1	81.3	87.7	47.6
	Q3 est*	86.2	85.9	81.6	92.7	47.1

Source: United Nations
* By Bank of England

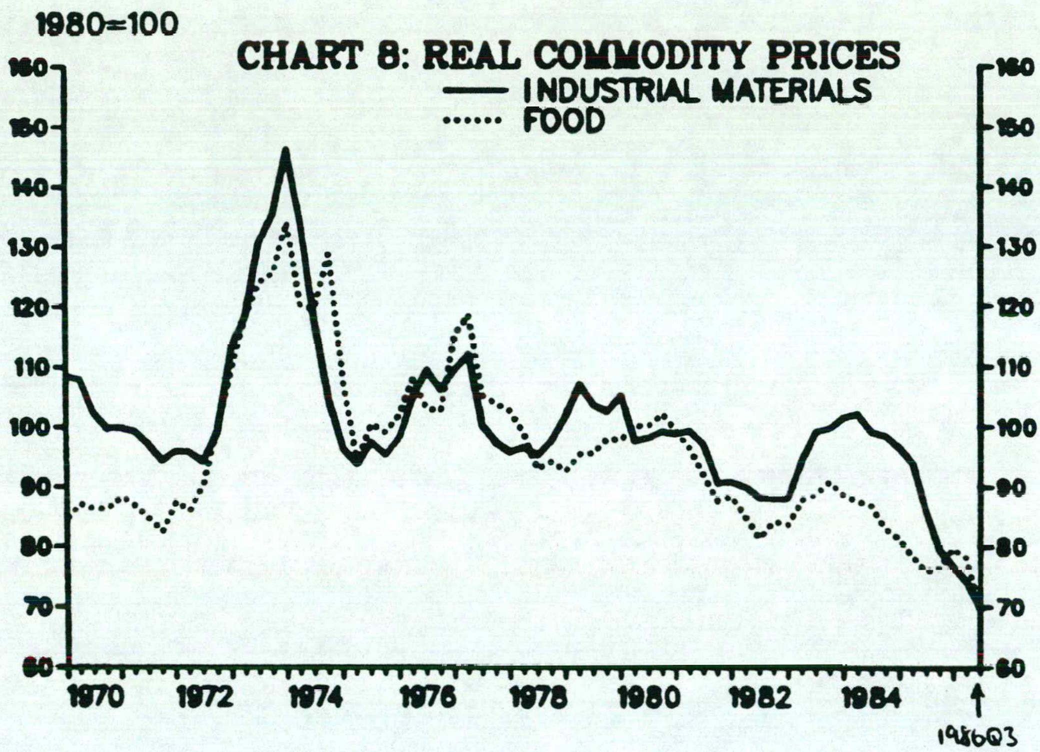


Table 9: Commodity Prices (in dollars, 1980 = 100)

		Nominal Dollars			Real Dollars*		
		Food	Industrial materials**	Oil	Food	Industrial materials**	Oil
1980		100.0	100.0	100.0	100.0	100.0	100.0
1981		88.8	91.2	111.9	93.7	96.4	118.4
1982		77.5	81.6	107.4	84.7	89.2	117.5
1983		77.3	84.0	95.5	87.6	95.2	108.2
1984		73.5	85.3	92.5	86.4	100.3	108.9
1985		66.8	75.9	88.5	77.9	88.9	103.5
1984	Q1	77.0	88.3	93.3	88.5	101.4	107.2
	Q2	77.0	89.9	93.3	87.5	102.1	106.0
	Q3	72.0	82.3	92.3	86.7	99.1	111.2
	Q4	68.0	80.8	91.3	82.9	98.5	111.3
1985	Q1	65.0	77.2	90.0	81.3	96.5	112.5
	Q2	65.0	77.9	89.0	78.3	93.8	107.2
	Q3	66.0	74.6	86.3	75.9	85.8	99.2
	Q4	71.0	73.9	88.6	76.3	79.4	95.3
1986	Q1	78.0	75.2	70.2	79.6	76.8	70.9
	Q2	78.0	74.1	41.0	78.1	74.2	41.0
	Q3 est	72.0	72.4	39.5	69.7	70.1	38.2

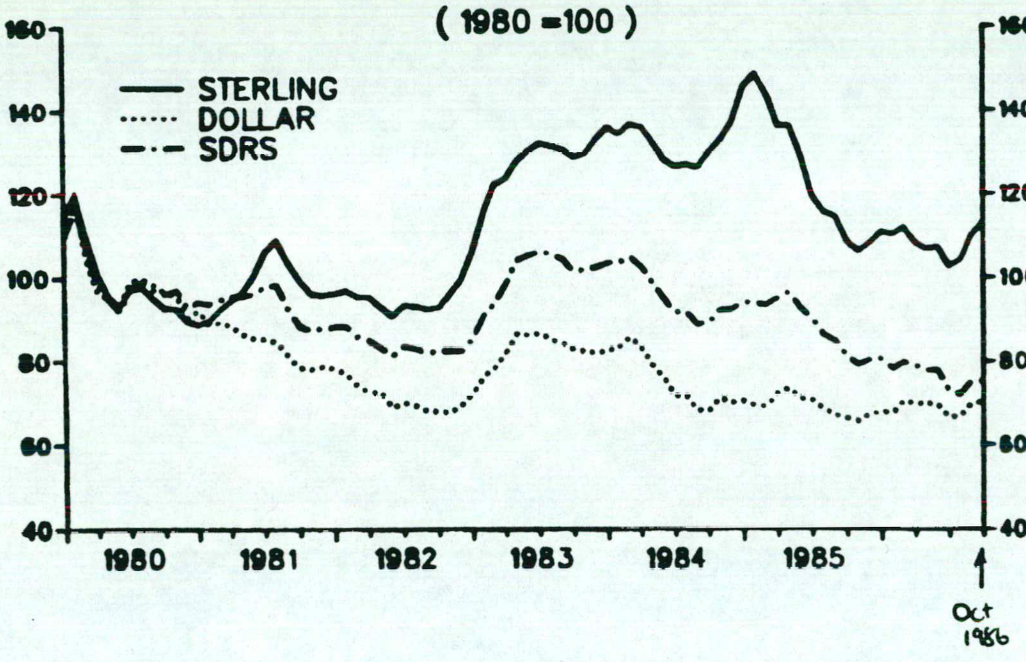
* deflated by the manufactures' unit value index.

** comprises agricultural non-food, non-ferrous metals and metal ores as shown in Table 8.

Source: United Nations

CHART 9: ECONOMIST COMMODITY PRICE INDICES

(1980 =100)



SECTION C: TRADE AND CURRENT BALANCES

12. G5 export volumes to various trade blocks are shown in Table 10. The figures are calculated by taking the value of exports from each of the G5 countries to the three trade groups and deflating this by the total export unit value index to produce estimates of exports at 1980 prices. (Export UVIs are not available for separate trade blocks.) The G5 export volumes index is derived by summing the five individual countries exports (and setting 1980 equal to 100). The volumes thus include intra-G5 trade. The table shows that between 1983 and 1985 exports to OECD countries grew strongly but allowing for seasonal variations appear to have been flat, or even fallen slightly, since the beginning of 1985. Between the first half of 1985 and the first half of 1986 exports to OPEC countries fell by 16 per cent and exports to other non-OECD countries fell by 8 per cent.

Table 10: G5 Export Volumes (1980 = 100, not seasonally adjusted)

		Total	to OECD	to non-OECD	of which: OPEC	non-OPEC
1980		100	100	100	100	100
1981		103	101	107	118	103
1982		100	99	101	119	95
1983		101	103	95	100	94
1984		109	115	97	85	101
1985		113	122	95	76	101
1984	Q1	106	112	93	91	94
	Q2	108	114	96	84	100
	Q3	106	111	95	78	101
	Q4	118	124	104	87	109
1985	Q1	112	120	95	79	100
	Q2	115	123	97	77	103
	Q3	108	117	91	72	97
	Q4	117	127	97	74	104
1986	Q1	108	120	85	65	91
	Q2	114	126	89	66	96
1986	January	103	114	81	63	87
	February	108	120	83	62	89
	March	114	125	91	70	98
	April	119	132	93	76	99
	May	108	119	87	63	94
	June	113	126	86	59	94

13. The US trade deficit in September was $12½ billion, down from $14 billion in August but these figures are subject to substantial revisions, so it is still too early to say that the trade deficit is firmly established on a downward trend. Both Japan and Germany registered record dollar trade surpluses in September, of $10 billion and $5 billion respectively, but these surpluses are not growing as fast as earlier in 1986.

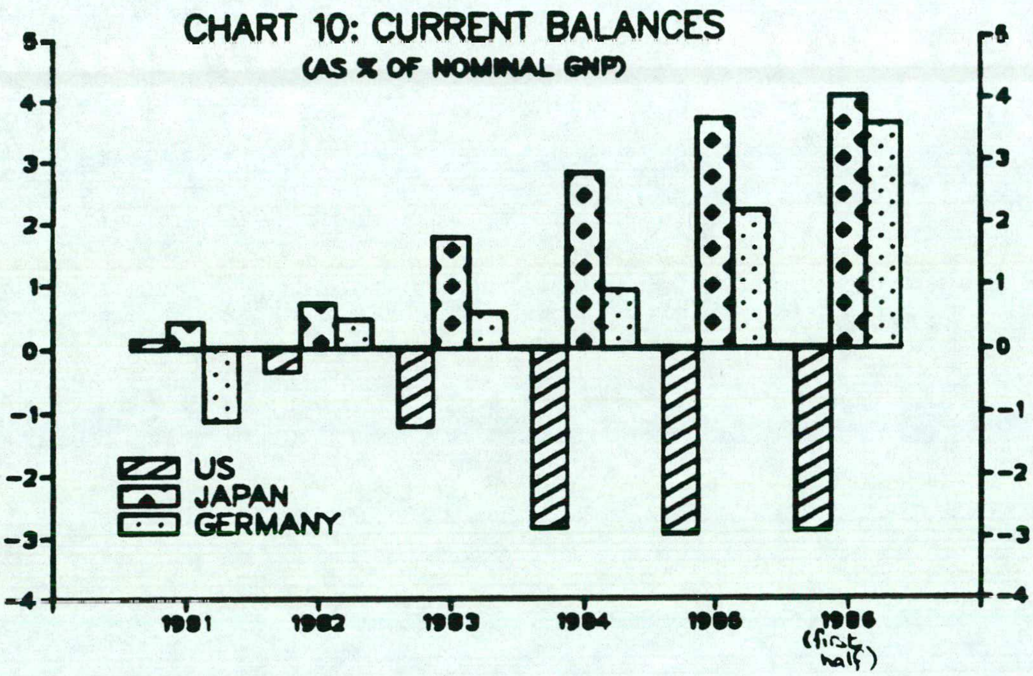


Table 11: Current balance ($bn)

	US	Japan	Germany	France	UK	G5
1982	-11	8	3	-12	7	-6
1983	-42	21	9	-4	5	-16
1984	-107	35	6	0	2	-64
1985	-118	49	14	0	5	-50
latest 12 months	-132 (June)	78 (Sept)	28 (Sep)	3 (Aug)	2 (Aug)	-21

Visible Trade balance

	US	Japan	Germany	France	UK	G5
1982	-36	8	21	-20	-3	-30
1983	-61	20	16	-9	-8	-42
1984	-114	34	19	-3	-11	-73
1985	-124	47	26	-3	-8	-63
latest 12 months	-165 (Sep)	84 (Sep)	47 (Sep)	-1 (Sep)	-8 (Aug)	-43

SECTION D: INTEREST RATES, MONEY SUPPLY AND EXCHANGE RATES

14. On 31 October the Bank of Japan announced that it was cutting its discount rate by ½ per cent to 3 per cent. At the beginning of the year the discount rate was 5 per cent. Base rates in the UK have risen by 1 per cent to 11 per cent.

Table 12: Interest rates in the G5 countries

		United States	Japan	Germany	France	United Kingdom	G5 average
Three-month interest rates							
1984	Q1	9½	6¾	6	12½	9¼	8¾
	Q2	11	6¼	6	12½	9¼	9½
	Q3	11½	6¼	6	11½	11	9¾
	Q4	9½	6¾	6	10¾	10¼	8½
1985	Q1	8¾	6¼	6¼	10½	13	8½
	Q2	8	6¼	5¾	10¼	12¾	8
	Q3	8	6¼	5	9¾	11¾	7¾
	Q4	7¾	7	4¾	9	11¾	7¾
1986	Q1	7¾	6¼	4½	8¾	12½	7½
	Q2	6¾	4¾	4½	7½	10¼	6½
	Q3	6	4¾	4½	7¼	10	6
4 Nov		5¾	4½	4¾	7½	11	6
Long-term government bond yields							
1984	Q1	12	7¼	8¼	13	10¾	10½
	Q2	13¼	7¼	8¼	13	11¾	11¼
	Q3	13	7½	8	12½	11¾	11
	Q4	11¾	6¾	7	11¼	11	10
1985	Q1	11½	6¾	7½	11¼	11½	10
	Q2	11¼	6¼	7¼	11	11¼	9¾
	Q3	10¼	6¼	6¾	10¾	10¼	9
	Q4	9¾	6	6¾	10½	10¾	8¾
1986	Q1	8¾	5½	6½	9¾	10¼	8
	Q2	7½	4¾	6¼	8	9	7
	Q3	7¼	4¾	6¼	7¼	9¾	7
4 Nov		7¼	5	6½	8¼	10¼	7¼

15. Monetary growth in the G5 countries has accelerated since the beginning of 1986. Most countries now have one of more measures of money supply growing above their target ranges.

Table 13: Narrow money growth (M1, percentage change on a year earlier)

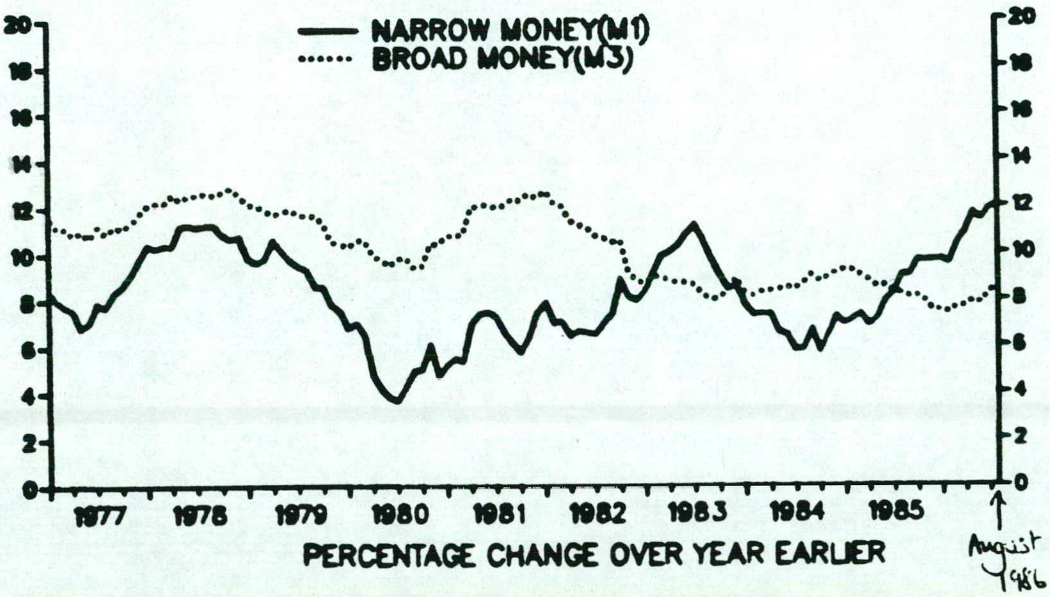
		US	Japan	Germany	France	UK	G5*	Germany CBM**	UK MO
1980		6.2	2.6	2.4	8.8	4.1	5.1	4.8	8.5
1981		7.1	3.3	1.1	11.6	11.7	6.4	4.4	4.6
1982		6.6	5.8	3.6	11.9	14.6	7.3	4.9	0.9
1983		11.2	3.7	10.2	9.8	13.0	9.6	7.3	5.7
1984		7.0	2.8	3.3	10.5	14.5	6.7	4.8	5.6
1985		9.1	5.1	4.3	8.7	16.7	8.2	4.6	4.6
1985	Aug	10.5	5.1	4.2	8.2	18.7	9.0	4.3	4.5
	Sep	11.0	4.5	5.4	6.6	17.3	9.0	4.3	4.2
	Oct	11.8	4.4	6.4	7.2	18.3	9.6	4.5	3.4
	Nov	11.9	4.4	5.6	8.1	17.4	9.6	4.6	3.4
	Dec	12.2	4.7	5.6	6.1	18.1	9.6	4.2	2.4
1986	Jan	11.4	4.1	5.7	9.3	19.6	9.7	5.2	4.5
	Feb	10.8	4.2	6.7	8.6	20.2	9.5	5.2	3.5
	Mar	11.6	4.0	9.1	9.6	20.9	10.3	5.1	3.6
	Apr	12.2	6.3	9.7	7.4	20.0	10.8	6.0	3.2
	May	13.1	6.8	9.2	9.3	22.3	11.7	5.8	3.4
	June	12.8	7.3	10.4	8.0	18.8	11.4	5.9	3.1
	July	13.4	6.9	10.1	8.0	22.5	11.9	6.5	3.0
	Aug	13.7	7.1	10.5	8.0	21.1	12.0	6.7	4.1
	Sep	13.8						7.0	4.5
1986	target	3-8						3½-5½	2-6
	latest over target base	14.3						7.4	4.5ø

* weighted average of five M1 series shown using 1980 GNP weights

** CBM is a constructed monetary aggregate not a true measure of narrow money. It comprises 100 per cent of currency in circulation plus 16.6 per cent of sight deposits plus 12.4 per cent of time deposits plus 8.1 per cent of savings deposits.

ø percentage change on year earlier.

CHART 11: G5 MONEY SUPPLY



PERCENTAGE CHANGE OVER YEAR EARLIER

Table 14: Broad money growth (percentage change on a year earlier)

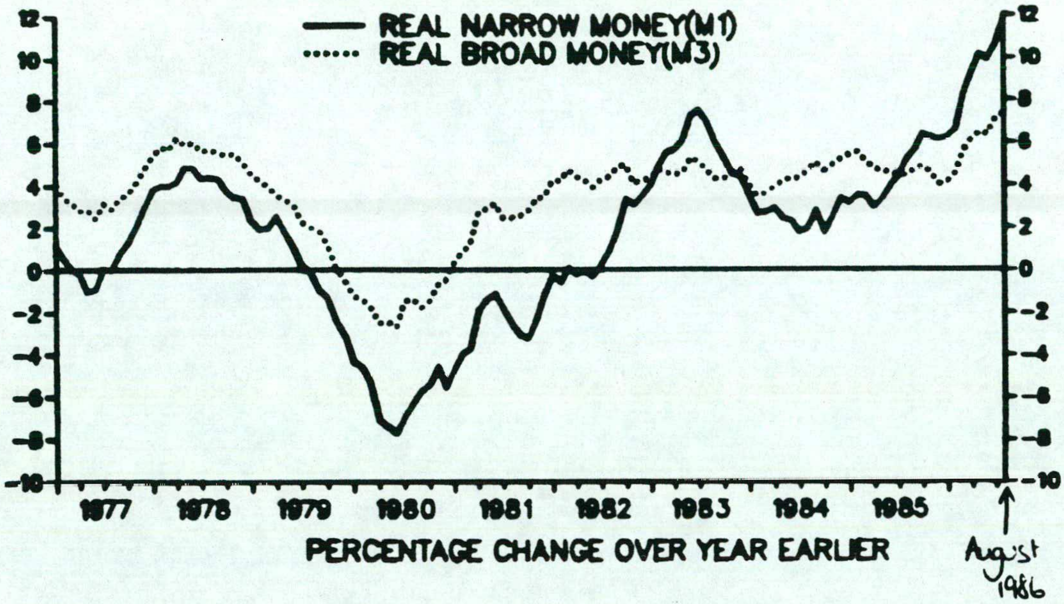
		US M3	Japan M2+CDs	Germany M2	France M3	UK £M3	G5*
1980		9.3	9.2	9.4	11.2	15.0	9.9
1981		11.9	8.9	10.4	12.1	19.7	11.7
1982		10.9	9.2	6.8	11.5	20.1	10.8
1983		10.0	7.4	2.9	10.0	10.6	8.5
1984		10.0	7.8	3.4	9.8	9.1	8.6
1985		9.0	8.4	4.3	8.0	12.9	8.4
1985	Aug	8.7	8.3	3.9	7.1	14.0	8.2
	Sep	8.6	8.2	3.2	6.9	14.7	8.0
	Oct	8.2	8.7	3.6	7.4	15.1	8.1
	Nov	7.6	9.0	3.4	7.5	14.8	7.8
	Dec	7.2	9.2	3.4	5.5	15.1	7.6
1986	Jan	7.0	9.0	4.3	6.3	14.0	7.6
	Feb	6.8	9.0	3.7	6.2	14.7	7.5
	Mar	7.1	9.0	4.0	6.1	16.3	7.8
	Apr	7.9	8.4	3.0	4.7	16.6	7.8
	May	7.9	8.4	2.5	5.2	19.4	8.0
	June	7.7	8.5	3.0	5.1	18.2	7.9
	July	8.3	8.7	3.6	4.9	19.2	8.4
	Aug	8.6	8.9	4.6	5.8	18.4	8.4
	Sep	8.9	8.9			18.3	
1986	target	6-9	8-9**		3-5	11-15	
	latest	9.2	8.9ø		6.0	18.3ø	
	over target base						

* weighted average of the series shown using 1980 GNP weights.

** projection

ø percentage change on year earlier

CHART 12: G5 REAL MONEY SUPPLY



17. The dollar effective exchange rate (IMF measure) averaged around 111 throughout August, September and October, though it has since risen slightly to 112.5. The yen reached a record level of 153.2 = $1 on 21 August, but has since fallen back and closed at 164=$1 on 4 November.

18. Latest OECD estimates (unpublished) show that only the US among the G5 countries has a larger general government deficit (expressed as a percentange of nominal GNP/GDP) than the UK, though the French deficit is roughly equivalent to that of the UK.

Table 15: General government financial balances in the G5 countries

		United States	Japan	Germany	France	United Kingdom	G5
	1983	-3.8	-3.7	-2.5	-3.1	-3.6	-3.5
	1984	-2.7	-2.2	-1.9	-2.9	-3.9	-2.6
	1985	-3.4	-1.4	-1.1	-2.6	-2.6	-2.5
OECD forecast	1986	-3.4	-1.5	-1.0	-2.9	-2.8	-2.6
	1987	-2.3	-1.4	-0.9	-2.7	-2.9	-2.0

CHART 13: REAL AND NOMINAL EFFECTIVE EXCHANGE RATES

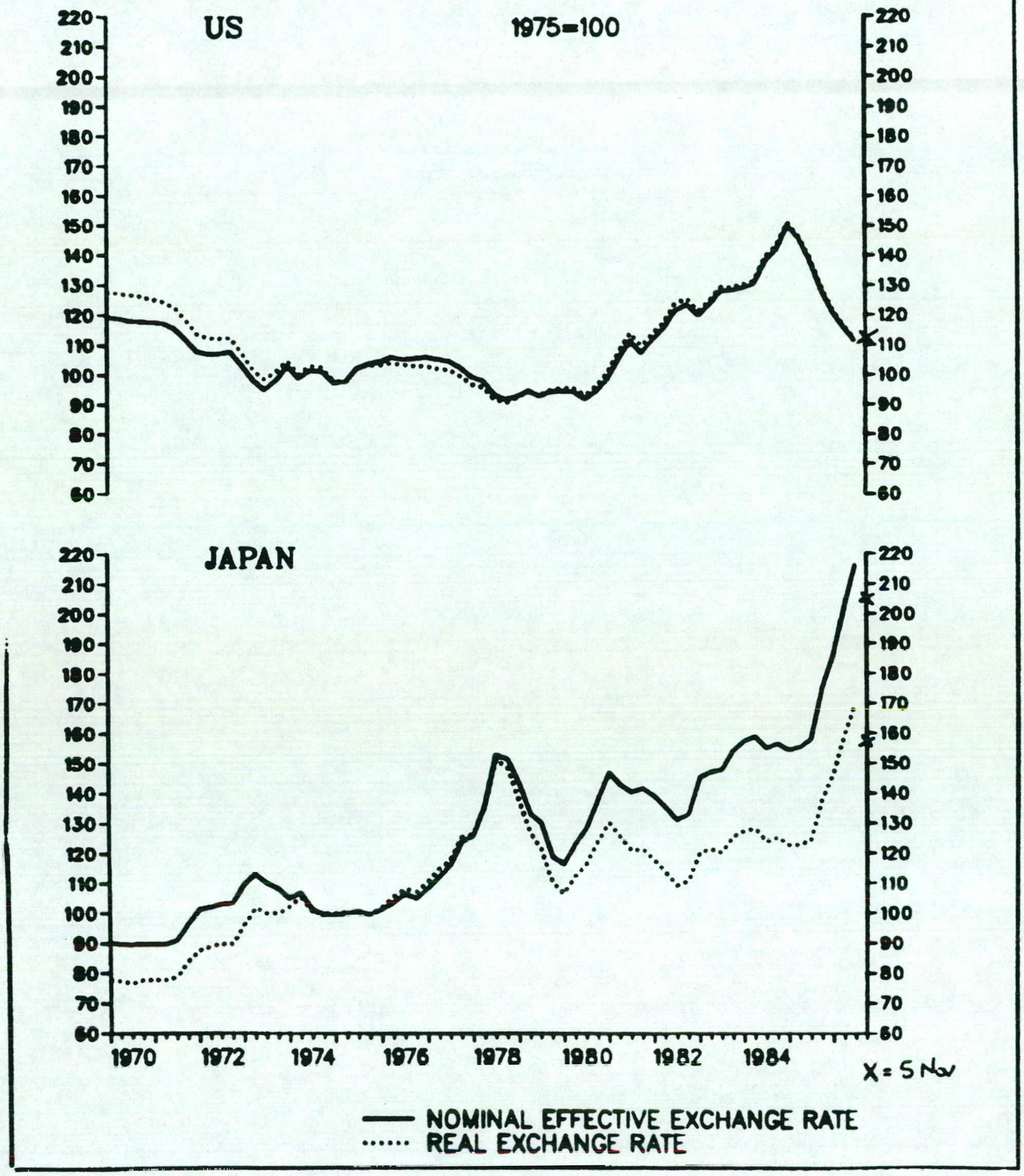
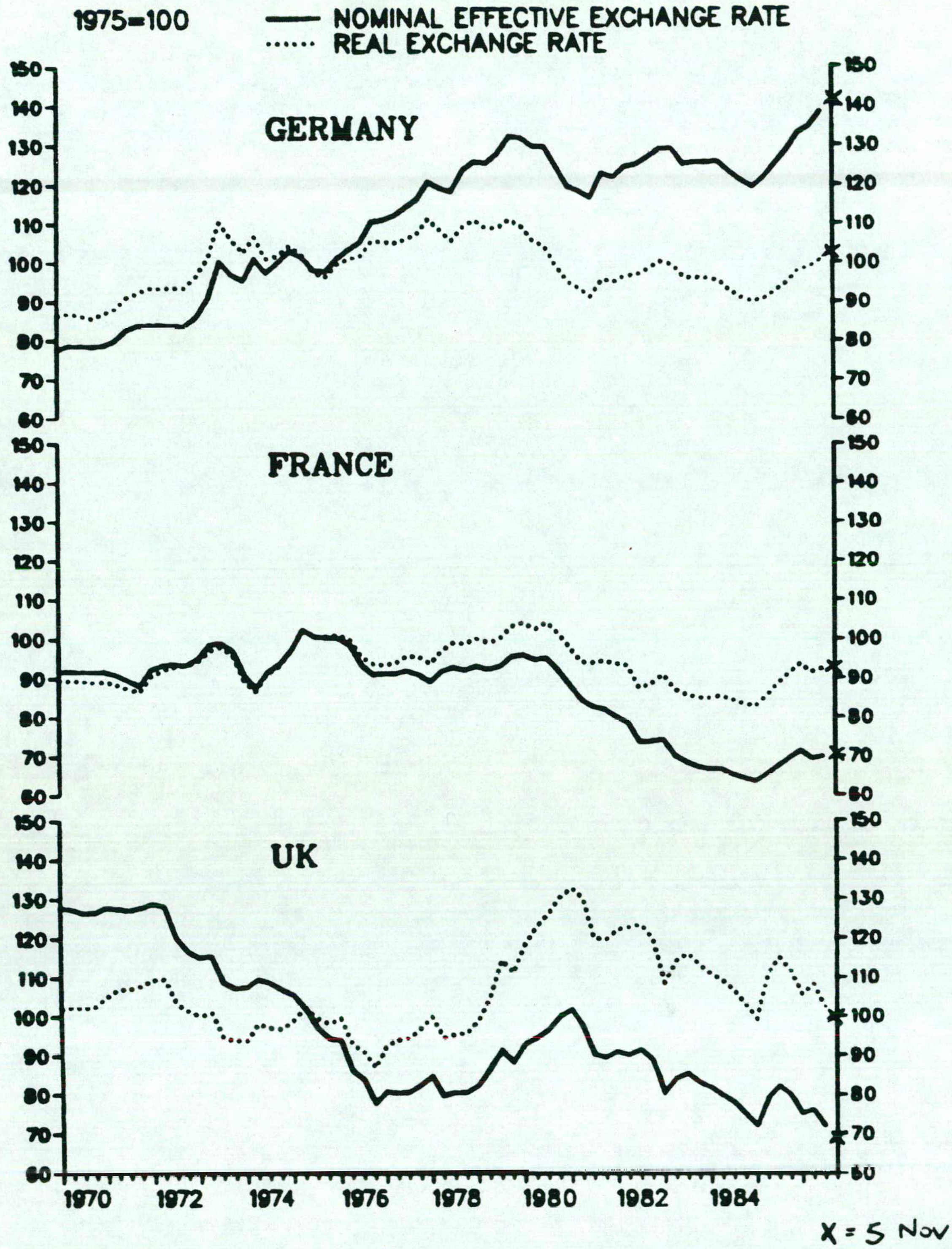


CHART 14:REAL AND NOMINAL EFFECTIVE EXCHANGE RATES



SECTION E: POLICY ANNOUNCEMENTS

US

19. The Office of Management and Budget announced that the federal deficit in FY 1986 (which ended 30 September) was a record $221 billion. This compares with a Gramm-Rudman target of $172 billion.

20. The President signed an omnibus appropriation bill for the 1987 budget on 18 October. The $576 billion bill cuts the President's proposed defence programme by $28 billion and includes $3.5 billion for the Strategic Defence Initiative (compared with the President's original request of $5.3 billion). Foreign aid has also been cut but most domestic programmes have been held constant in real terms. A reconciliation bill has also been signed that is intended to reduce the deficit in FY1987 by a further $12 billion. Extra revenue will come from privatisation and the imposition of a 0.22 per cent duty on imported goods. The Director of the Congressional Budget Office (CBO) has forecast a deficit for FY1987 of $153 billion. Most private forecasters expect a deficit of $180-190 billion well above the Gramm-Rudman target of $144 billion.

21. The President has signed a tax reform bill that will reduce tax rates on individuals and corporations whilst removing or scaling down many deductions. The income tax rate structure has been simplified so that there will only be two rates (of 28 and 15 per cent). This compares to a top rate of 70 per cent at the start of the Reagan administration. The Congressional Tax Office predicts that corporations will pay an additional $130 billion in taxes over the next five years, despite a cut in the top corporation tax rate from 46 to 34 per cent, since the Investment Tax credit has been withdrawn and other depreciation allowances will become less generous. The measure is designed to be revenue - neutral in the long run but is expected to provide $17 billion of extra revenue in FY1987.

Japan

22. A supplementary budget for FY1986 was announced on 28 October. It incorporates the central government share of the 3.6 trillion yen public works package announced in September. The expansionary effects of the construction schemes are offset by expenditure reductions from lower interest rates and savings on Government procurements (resulting from the appreciation of the yen). The central government deficit is expected to widen slightly to almost 3¼ per cent of GNP (compared to earlier Government forecasts for FY1986 of 3.2 per cent) but will still be lower than in 1985.

23 A Government tax commission has presented draft recommendations to the Prime Minister. Its report proposes a reduction in income tax rates (including a lowering of the top rate from 70 to 50 per cent - excluding local taxes) and falls in the effective corporate tax rate. In order to maintain revenue-neutrality these tax reductions would be paid for by limiting the exemption of interest receipts on small savings from tax and introducing a broad-based indirect tax.

24 On 31 October the Finance Minister, Mr Miyazawa, and US Treasury Secretary Baker announced an agreement to stimulate growth and reduce trade imbalances. Both parties agreed that the present value of the dollar against the yen reflected economic fundamentals. The Japanese government cut its discount rate by ½ per cent (to 3 per cent) and the US Government repeated its determination to resist protectionist pressures. The exact form that co-operative action to stabilise exchange rates might take was not revealed.

Germany

25. The five leading economic research institutes called, in their regular Autumn report, for the Government to bring forward its tax reform programme. Tax cuts of DM 10 billion are, at present, scheduled for introduction in January 1988. The earlier implementation of these cuts, the institutes argue, would help maintain growth in the second half of 1987 in the face of a weakening export demand.

France

26. The Government has announced more details of its privatisation programme which is expected to raise FFr 27 billion in 1987. The programme began at the end of September with the sale of part of the Government's holding in Elf-Aquitaine (though the state remains the majority shareholder). The glass manfuacturer St Gobain will be the first of the fully nationalised enterprises to be transferred to the private sector, by February 1987, and its sale is expected to raise FFr15 billion.

CONFIDENTIAL

PSM

FROM: C J RILEY
DATE: 8 JANUARY 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr F E R Butler
Sir G Littler
Sir T Burns
Mr Cassell
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Allan
Mr Cropper
Mr Ross Goobey
Mr Tyrie

Mr Battishill - IR
Sir A Fraser - C&E

POLICY BACKGROUND TO THE 1987 BUDGET

You raised some specific points on Sir Terence Burns' paper for Chevening (Cathy Ryding's minute of 2 and 7 January).

Paragraph 70

2. An international comparison of public sector financial deficits is given in table J2 of Annex J. It shows that all the major countries currently have larger deficits than in the late 1960s.

Annex B

3. A quarterly version of Chart B1 from 1980 to the present is attached.

Annex C

4. The model used for the simulations was essentially the 1986 published version of the model, released in January last year. Results were reported for the four years 1986-1989. Generally the model was estimated using data for the last 15 years or so, but the determination of the exchange rate, and hence interest rates and other variables, is dominated by the experience of the 1980s.

Annex D, paragraph 2

5. The difference between the January 1986 internal forecast of money GDP growth and the path in the MTFS is shown below, alongside the corresponding figures for the October forecast. Although the January forecast was based on an oil price of $20/ barrel, this would have had a relatively small effect on money GDP growth over the period as a whole.

Money GDP growth (% per annum)

	1986-87	1987-88	1988-89
MTFS	6.8	6.4	6.0
January forecast	6.7	6.8	7.0
October forecast	5.5	7.3	8.0

6. In comparing the January forecast and the MTFS it is difficult to disentangle changes of judgement by the forecasters and adjustments required to achieve the assumed paths for money GDP, output and inflation. The main adjustments were to earnings, interest rates, expenditure and trade. But quite a lot of work would be required to obtain an estimate of their scale because the assumed paths are imposed on the projections after the first year of the MTFS (in this case 1986-87), and as the budget approaches the distinction between judgement and adjustment becomes increasingly blurred.

7. The differences in the money GDP paths suggest <u>prima facie</u> that adjustments to the January forecast may have been quite large in relation to the change between the MTFS and the October forecast - perhaps around a half. Allowing for the change in the oil price assumption between January and March, which would probably have depressed money GDP growth in 1986-87 and raised it in 1988-89, would reduce the difference between the January and October forecasts.

Annex G, paragraph 4

8. The adjustments made for essentially capital transactions - known as "Riley adjustments" in some quarters, hence the footnote - were first set out in the paper "Public Expenditure and the Fiscal Stance" which I submitted to you on 21 December 1984. This is attached (top copy only) for ease of reference; the adjustments are described in paragraphs 13-16 and annex B. Details of the present figures are set out in the attached table; they are probably not fully consistent with the PEWP, though the differences should be small.

Table J3

9. The figures in this table were taken from an OECD working paper published in May 1986.* As far as we are aware the figures for France are correct given the definitions employed; the OECD may subsequently have updated them, but we do not have any further information on this. Corresponding figures for gross debt are shown below.

General Government Gross Debt
(per cent of GDP/GNP at market prices)

	1974	1979	1984	1985
US	40.1	37.8	44.4	46.6
Japan	17.9	47.0	67.4	67.2
Germany	19.6	30.7	41.8	41.9
France	24.7	26.2	31.8	33.4
UK	69.6	55.7	55.6	54.4
Italy	57.7	70.4	91.1	95.9
Canada	44.4	46.9	63.4	67.3

pp. C J RILEY

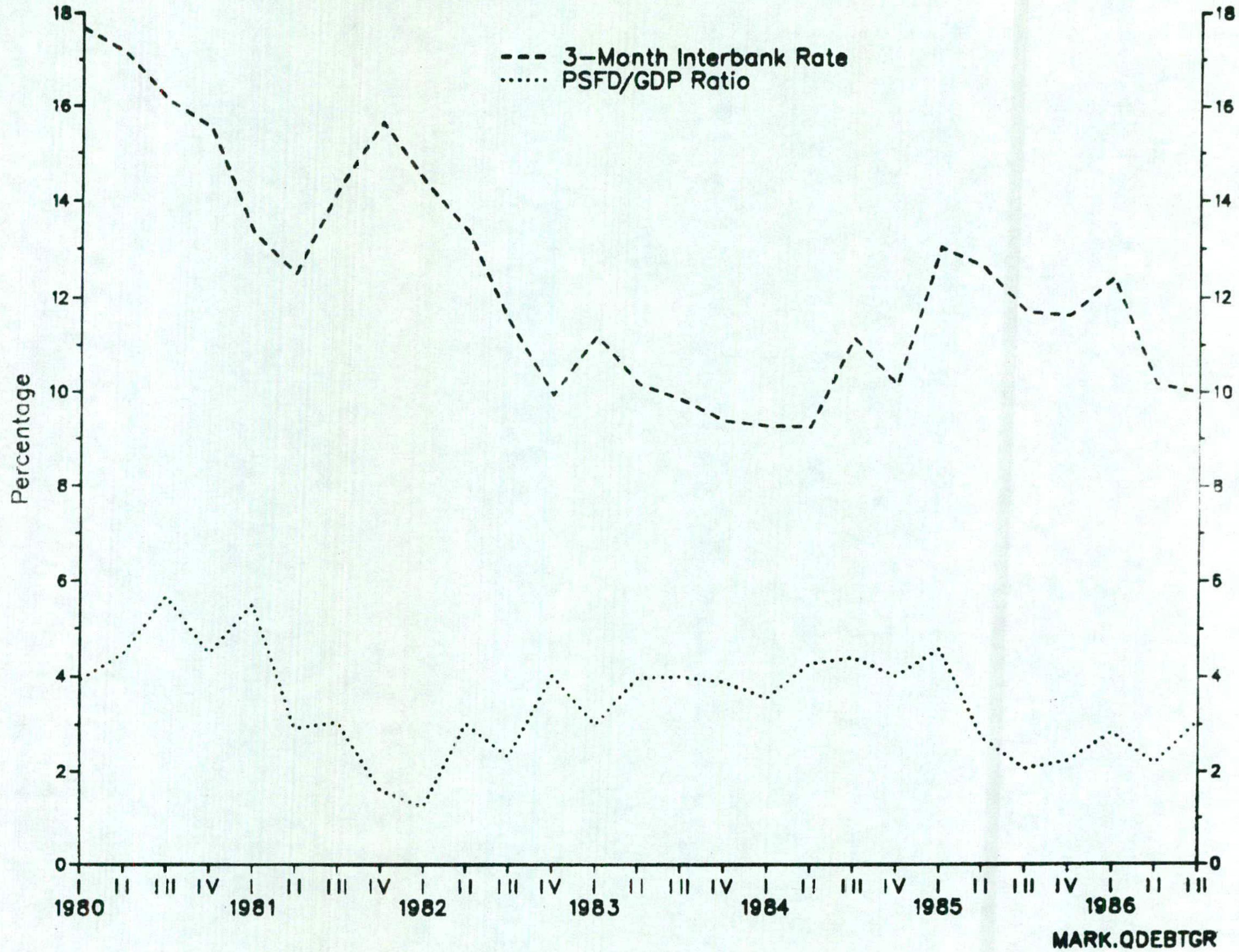
* "Public Debt in a Medium-Term Context and its implications for Fiscal Policy" by Chouraqui, Jones and Montador.

ESSENTIALLY CAPITAL TRANSACTIONS

£m cash	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90
Privatisation proceeds	370	405	494	488	1142	2132	2702	4750	5000	5000	5000
Sales of vehicles plant and machinery	1	3	3	4	7	15	17	23	17	20	20
Sales of land and buildings (net)	402	845	1735	2345	2001	1978	2022	1897	1678	1550	1570
Net lending to private sector:											
- Home shipbuilding refinance	30	31	48	23	47	25	76	-	-	-	-
- LA mortgages and other housing	-390	-274	-419	-230	269	387	338	308	280	230	230
- Other	-113	-287	-351	-358	136	72	57	-89	-74	-50	-50
Net lending to overseas											
- Export credit refinance	407	629	467	293	144	1	70	-	-	-	-
TOTAL	707	1352	1976	2566	3746	4610	5281	6889	6901	6750	6770

6 January 1987

Chart B1


3-Month Interbank Rate
PSFD/GDP Ratio
Percentage
18
16
14
12
10
8
6
4
2
0
I II III IV I II III IV I II III IV I II III IV I II III IV I II III IV I II III
1980
1981
1982
1983
1984
1985
1986
MARK.QDEBTGR

CONFIDENTIAL

FROM: C J RILEY
DATE: 8 JANUARY 1987

RILEY to CH/EX 8/1

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr F E R Butler
Sir G Littler
Sir T Burns
Mr Cassell
Mr Odling-Smee
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pp. C J RILEY

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6 January 1987

Chart B1

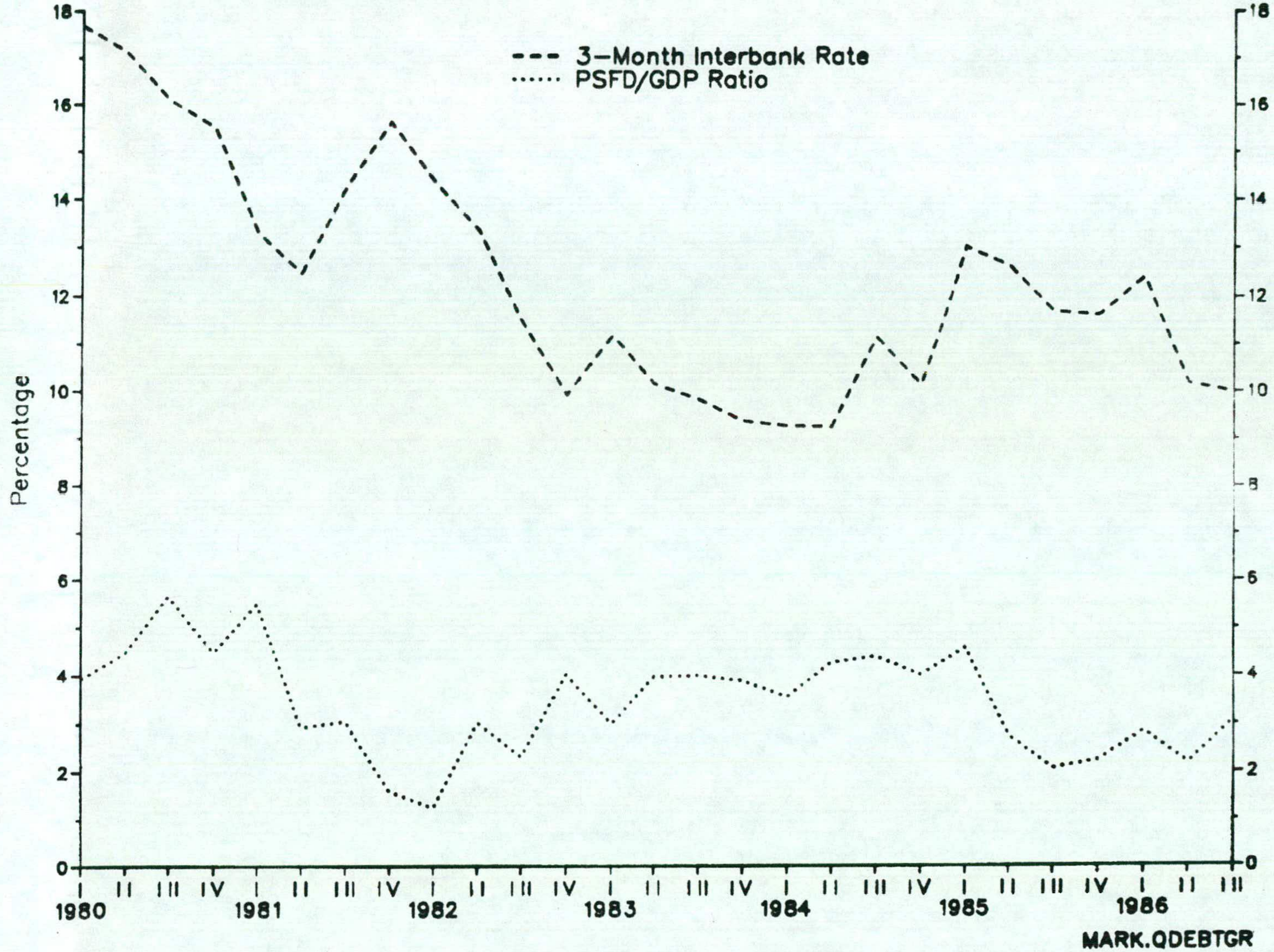

CHART B.1 · QUARTERLY.

CONFIDENTIAL

1. **SIR PETER MIDDLETON**

Copies attached for:
Chief Secretary
Financial Secretary
Minister of State
Economic Secretary

2. **CHANCELLOR**

FROM: C J RILEY
DATE: 21 December 1984

cc Mr Bailey
Sir Terence Burns
Mr A Wilson
Mr Anson
Mr Byatt
Mr Cassell
Mr Monck
Mr Battishill
Mr Monger
Mr Scholar
Mr Cropper
Mr Lord

RILEY to CH/EX 21/12/84

PUBLIC EXPENDITURE AND THE FISCAL STANCE

I attach a paper which discusses the treatment of asset sales and other essentially capital transactions in the context of public expenditure control. It is the paper described in paragraph 8(b) of Sir Peter Middleton's minute of 20 December on Christmas Reading.

2. In addition to discussing the general issues in this area and two specific cases currently under consideration, the paper presents figures for the planning total after adjustment for items which make little or no contribution to the government's interest rate and tax objectives. These figures, which have been prepared with the help of GEP, are in line with the current state of play on the Public Expenditure White Paper.

3. One issue not covered by the paper is the extent to which the success this year in hitting the planning total for 1985-86 agreed last year has been due to this type of transaction. In practice we estimate that, within the unchanged planning total, gross spending has risen by about

£1 billion and been offset by an equal increase in capital receipts - mainly special sales of assets (£500 million) and local authority housing (£400 million). This implies a change in the composition of the PSBR as a result of the Public Expenditure Survey round.

CJR

C J RILEY

Ref: 128421

CONFIDENTIAL

PUBLIC EXPENDITURE AND THE FISCAL STANCE

Introduction

1. A central plank of the government's economic policy is its aim to reverse the growth of public expenditure as a share of GDP, and thereby create room within the Medium Term Financial Strategy for lower taxation. Reducing public expenditure as a share of GDP also has a separate political purpose: to reduce the role of the State and enhance the responsibility of the individual. The public expenditure magnitude on which attention is focussed for control purposes is the planning total. The Treasury's objective in successive public expenditure roundis is to hold the planning total at levels agreed earlier, and the composition of expenditure within the planning total and programme totals is a matter for negotiation between spending Departments and the Treasury. However, the planning total is designed as a control mechanism, not as an indicator of the impact of public expenditure on the economy. The implications of any given planning total for the stance of fiscal policy depends on the composition of expenditure, and this has to be taken into account in setting the PSBR.

2. Of particular importance in recent years has been the increase in transactions in existing assets. Sales of assets of various types - including council houses, privatisation and refinancing deals - have together played an important role in restraining the growth of the planning total. Although these sales generally reflect clear policy objectives in micro-economic and political terms, there is also a natural temptation to use the receipts obtained as a means of reconciling upward pressure on other forms of spending with the declared objective of public expenditure restraint. Departments have an incentive to devise schemes which enable higher gross spending to be financed by asset sales and other capital transactions without breaching programme totals.

3. There is considerable scope for further increases in essentially financial transactions of this sort. The Secretary of State for the Environment has recently suggested that local authorities might be

encouraged to sell off their mortgage books as a way of raising finance for their repair and renovation programmes. The Secretary of State for Education has announced that student loans are to be considered in a detailed review of student support. It is important that the Treasury is clear about the implications of these financial transactions. Though they help to achieve objectives for the planning total in a way which is consistent with some of the Government's micro-economic and political objectives, at the same time if the planning total is not reduced by the same amount they impede other objectives - notably lower taxes and interest rates - and also tend to push up the cost of debt servicing, a component of public expenditure lying outside the planning total.

Macroeconomic Implications of Financial Transactions

4. Asset sales are an important part of the Government strategy, but their primary justification is micro-economic and political. We have always recognised that essentially financial transactions will have significantly different macro-economic effects from conventional tax and expenditure measures. Since they have relatively little impact on money demand, activity or prices, a lower PSBR achieved by higher asset sales will do little to reduce the interest rates needed to meet targets for broad money. Conversely, higher gross spending, financed by higher asset sales, will put upward pressure on interest rates, for any given rate of monetary growth, even though the PSBR is unchanged.

5. Outside commentators are well aware that the composition of the PSBR is relevant, as well as its level, and judge the Government's plans accordingly. Pressure for us to redefine the PSBR to exclude asset sales has been resisted; we have argued that it would be undesirable to open up the whole question of the statistical conventions underlying the PSBR. But the level of assets is taken into account in setting the PSBR -and we have acknowledged this publicly. Higher asset sales point to a lower PSBR, to achieve the fiscal stance thought to be consistent with the Government's monetary objectives.

6. The macro-economic arguments about asset sales are fairly self-evident in the case of share sales, especially where the asset on offer is likely to be a close substitute for gilt edged stock. In this

case, asset sales reduce the demand for gilts, at given interest rates; so a reduction in the supply of gilts, to match the lower PSBR, does little or nothing to ease the pressure on interest rates. Refinancing of existing public sector loans, such as LA mortgages or export credit, is likely to be offset almost entirely by increased private sector financing, especially bank and building society lending. Again this would do little to reduce money demand and hence interest rates. Sales of real assets, such as land or council houses, are rather different, and involve the private sector in raising new finance. But the general point is still valid. Since they do little to reduce money demand, they cannot be used to finance higher spending, without damage to other objectives for interest rates or fiscal policy.

7. Since higher gross spending unambiguously raises money demand, using higher asset sales to finance higher gross spending will ease the fiscal stance accompanying the announced targets for monetary growth, and for that reason will put upward pressure on interest rates. An unchanged fiscal stance would require a reduction in the PSBR, so that any given total of public expenditure would be consistent with a smaller fiscal adjustment. To the extent that this happens, the effect of higher spending financed by asset sales would be to pre-empt some of the room available for tax cuts.

Implications for the Bill Mountain

8. Higher gross spending, financed by asset sales, will typically lead to an increase in the level of gilt sales needed to stay within the monetary targets. With an unchanged PSBR, the Government's overall need for finance will remain the same, but the proportion of the PSBR that is funded (ie financed by sales of gilts to non banks) has to rise to the extent that bank lending is increased. The effect of "overfunding" is to drain cash from the banking system, putting upward pressure on short term money market rates. As part of its normal money market operations, the Bank would relieve these pressures by buying commercial bills from the monetary sector. This avoids a rise in money market rates, but adds to the already large stock of bills held by the Bank of England ("the bill mountain").

9. Asset sales that do not add directly or indirectly to bank lending are unlikely to lead to significant money market problems. For example, sales of shares that are close substitutes for gilts reduce the PSBR and the demand for gilts by roughly the same amount. So at unchanged interest rates there is no effect on either broad money or overfunding. But in general there will be a tendency for bank lending to increase. This is particularly likely in the case of refinancing of existing public sector loans (eg refinancing of fixed rate export credit) or sales of real assets (eg land and council houses). But even in the case of sales of financial assets, such as shares in BP or BT, it is likely that some of the finance will be provided by the banks. Since higher gross spending is itself likely to add to bank lending, there is therefore a strong presumption that higher gross spending financed by asset sales will exacerbate the problems which the authorities already face in the money markets.

Current Arrangements for Controlling Public Expenditure

10. Capital receipts of general government are recorded as negative public expenditure in both the national accounts and in the planning total. There is a symmetry here: purchase of assets is defined as public expenditure, and their sale reduces it. Special sales of assets are identified separately in the planning total, but other capital receipts are netted off departmental programmes. The same treatment applies in effect to capital receipts of List I public corporations because of their impact on EFLs. In the case of leasing by nationalised industries, the capital value of the lease generally scores against EFLs and gross spending is not allowed to rise: but there are some exceptions, in particular short-term sale and leaseback of property.

11. In the PES round there is an incentive for departments to increase gross spending by means of higher receipts. As well as the general pressures on departments in the Survey to use receipts to reconcile the demands for higher gross expenditure with the net PES requirement, there is specific pressure on departments to dispose of surplus assets, reflecting the objective of reducing the role of the public sector. There is considerable scope and incentive for increasing the scale of capital receipts beyond the figures envisaged in the current Survey. And

ture for aligning the treatment of receipts in PES and Estimates may make departments more conscious of the scope for increasing gross spending by a more active disposal policy.

12. The pressures are particularly acute in the local authority area; and it is here that additional receipts were offered in the last days before the publication of the Autumn Statement, to reconcile Housing Ministers' aims for gross spending with Ministers' collective commitments to published expenditure totals. In addition, increased special sales of assets have in effect enabled higher gross spending to be financed within existing totals. Planned special asset sales in 1985-86 have been increased by £500 million in the current Survey; following increases of £400 million for 1984-85 agreed in the last Survey, and £500 million for 1983-84 in the July 1983 package. Other examples relating to the current Survey are set out in Annex A.

Restraint of Public Expenditure in Recent Years

13. In the early years of the present government, public expenditure rose rapidly in both cost terms and as a share of GDP, in contrast to declared objectives. Partly this reflected the impact of the recession, particularly on the Social Security programme, but there were also many other pressures tending to increase expenditure. Since 1982-83, however, the planning total has fallen very slightly each year as a share of GDP, though it has continued rising in cost terms. But to some extent this turnaround reflects the growth of asset sales and capital transactions. We have examined the data to see how far the picture would be changed if the planning total were to be adjusted for such transactions, as we believe it should be when assessing its macroeconomic and monetary implications.

14. In arriving at an adjusted series for the planning total we have excluded the following types of transaction:

(i) Special sales of assets: mainly company securities

(ii) Net sales of physical assets: council houses and, existing buildings, plant, machinery and vehicles

(iii) Net financial transactions relating to existing assets: including company securities, local authority mortgages, refinancing of export and shipbuilding credits.

15. The criterion we have adopted is that the transactions concerned should relate to existing assets or to expenditure which would take place in any event, not to new real expenditure. It is difficult to draw the line precisely, because many transactions which appear to be entirely financial - such as sales of land - may have some effect on current spending. But it does mean that such items as lending for industrial support are not included in the adjustments.

16. The precise definitions adopted, and the data for the period since 1979-80, are set out in Annex B. The figures are from the PES database and should be consistent with the latest state of play on the PEWP. Table 1 below gives a summary of the contribution of asset sales and capital transactions to the planning total.

Table 1: Contributions to the Planning Total (£billion)

	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86
Special Sales of Assets	-1.0	-0.4	+0.1	-0.5	-1.1	-1.9	-2.5
Net Sales of Physical Assets	-0.4	-0.8	-1.7	-2.3	-2.1	-2.0	-2.2
Net Transactions in Financial Assets	+0.1	-0.2	+0.3	+0.3	-0.5	-0.2	-0.1
Total	-1.3	-1.3	-1.4	-2.5	-3.8	-4.1	-4.7

17. These figures show that asset sales and capital transactions have made a negative contribution to the planning total throughout the last six years. After remaining essentially flat in cash terms until 1981-82, they have since risen in successive years. By 1985-86, they are expected to

amount to $3\frac{1}{2}$% of the planning total, equivalent to over $1\frac{1}{4}$% of GDP. In the earlier years, some decline in special sales of assets was offset by rising net sales of physical assets, especially council houses. But since 1981-82 the main feature has been rising special sales of assets. The net contribution of transactions in financial assets has been small throughout the period.

18. Table 2, below, sets out figures for the planning total after excluding the transactions listed in Table 1. These figures are illustrative. They do not purport to show what would actually have happened to the planning total if asset sales and financial transactions had not been allowed as offsets. Other factors would then also almost certainly have been different, and this would have affected not only the numbers in each year but also the shape of the progression. But they do illustrate the scale of the contribution of these transactions to the public expenditure figures in recent years.

Table 2: Adjusted Public Expenditure

	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85*	1985-86
Cash Terms (£billion)							
Planning Total	76.9	92.7	104.7	113.4	120.3	128.1	132.1
Adjusted Planning Total	78.2	94.2	106.1	115.9	124.1	132.2	136.8
Cost terms (1979-80=100)							
Planning Total	100	101.6	104.3	106.0	107.9	109.7	108.3
Adjusted Planning Total	100	101.5	103.9	106.5	109.4	111.3	110.3
Share of GDP (%)							
Planning Total	37.1	39.3	40.3	39.9	39.3	39.2	37.4
Adjusted Planning Total	37.8	39.9	40.9	40.8	40.5	40.4	38.8

* Assumes the coal strike finishes at the end of the calendar year 1984.

19. On an adjusted basis, the planning total will have grown by $6\frac{1}{4}\%$ in cost terms between 1981-82 and 1985-86 if current plans are achieved, compared with $3\frac{3}{4}\%$ on an unadjusted basis. The planning total has fallen as a share of GDP in each year since 1981-82, and even after adjustment there has been some fall. But the fall on this basis is even less pronounced. By 1984-85, the adjusted fall is currently projected to be a mere $\frac{1}{2}\%$ of GDP, compared with over 1% using the unadjusted figures. Even by 1985-86 the fall will be only 2 points rather than 3 on the basis of current plans. Thus although the figures show clearly the progress that has been made in restraining public expenditure, they also show the extent to which this reflects transactions which contribute little if anything to the monetary and financial objectives set out in the MTFS.

Implications for Public Expenditure Planning

20. The government's policy of reducing the growth of public expenditure and bringing it down as a share of GDP reflects both financial policy objectives and a desire to reduce the role of the public sector in the economy. The financial policy objective is expressed in terms of the need to control public sector borrowing and mnetary growth, with a view to controlling money GDP and ultimately inflation. The objective of reducing the role of thepublic sector has a number of dimensions, including:

- transferring certain activities from the public to the private sector (eg privatisation), essentially for efficiency reasons

- transferring assets currently owned by the public sector to the private sector (eg council house sales)

- reducing the burden of taxation on the private sector in order to increase incentives

21. These different dimensions of policy have different implications for public expenditure. Cutting the PSBR by means of asset sales or capital transactons makes little contribution to financial policy or the scope for cutting taxation. They help the government achieve its stated plans for

public expenditure, and so have a presentational role, though only so long as the sales continue. However they do contribute to the other objectives of public expenditure policy - transferring activities and assets to the private sector. Because of these other objectives, it will sometimes be appropriate in particular circumstances for the Treasury to agree to schemes for restraining the planning total which make little or no contribution to financial policy or the objective of reducing taxation.

22. Nevertheless, it is important to be aware of all the various dimensions of public expenditure policy, and not lose sight of the macro-economic and fiscal aspects. Achieving any given planning total by means of higher asset sales or capital transactions in practice implies a relaxation of the fiscal stance. Maintaining an unchanged stance would require a lower PSBR and hence a reduction in the scope for tax cuts within the overall framework of the MTFS. In conducting public expenditure discussions it is therefore vital to take into account the implications for taxation and interest rates of accepting suggestions by Departments to finance higher gross spending by means of asset sales or capital transactions, as well as their merits in terms of other objectives.

23. In certain instances, the Government wishes to provide Departments, or Local Authorities, with an incentive to achieve higher asset sales. The current exercise designed to stimulate Departments and other public sector bodies to dispose of unused land and empty housing is a case in point. But in these cases it is important to frame the incentives in a way which does not undermine financial policies. Ideally, this suggests revising down the net spending baseline so that there is no overall addition to gross spending. But in practice this may well be difficult to achieve in full; and of course it is important to ensure that sufficient incentives are actually provided.

Relevance to Issues currently arising on Public Expenditure

24. The arguments above have implications across the whole field of public expenditure. We cannot consider in this paper all issues of current interest. But it is worth discussing briefly two areas of considerable importance in the present context.

(i) Sales of LA mortgages

25. Local authorities' capital spending is defined after netting off receipts. Under present arrangements, they are permitted to spend in any one year:

- their capital allocations, which equal the Survey provision plus estimated in-year receipts, and

- a prescribed proportion, currently about 50%, of receipts accumulated in earlier years.

The precise details of these arrangements are currently being changed following discussion in Cabinet on 13 December. But the essence of them, which allows the use of some proportion of receipts to finance increases in gross spending, will remain essentially unaltered.

26. An important source of receipts is sales of council houses, though only to the extent that they are not financed by local authority mortgages. Refinancing of existing mortgages is an option which local authorities can pursue, within certain limits, to increase receipts. In recent discussions for the current financial year, Treasury Ministers agreed that LAs should refinance up to £200 million of existing mortgages to reduce projected capital overspend. The planning total agreed for 1985-86 allows for total in-year receipts on the Housing and Other Environmental Services programmes of £1.6 billion, some of which may result from mortgage refinancing. But in a speech to the Building Societies Association on 8 November, the Secretary of State for the Environment went much further than this. He said:

> "We also have at the present time some £4 billion of public investment resources tied up in local authority mortgages. This is too much public money tied up where there should be an alternative - money which is badly needed where alternative private funding is not available. I want to see a start on refinancing some of that debt; of course we must work

to remove the practical obstacles. But, for local authorities 'selling the mortgage book' could be one way of raising money to finance their own repair and renovation programmes."

27. If the LAs were to follow the suggestion of the Secretary of State and finance higher gross spending by selling off existing mortgages, this would clearly imply a relaxation of fiscal stance for given levels of the planning total and the PSBR. And the numbers involved could be quite large. Higher gross spending would add to economic activity and the demand for money, both broad and narrow. Sales of mortgages would have no effect on narrow money or activity: they would be offset by higher mortgage lending by banks and, mainly, building societies, and so would have little effect on broad money either. The net effect would therefore be some overall increase in the demand for money, with PSL2 - which includes the bulk of biulding society deposits - rising relative to £M3. Unless there was a compensating reduction in the PSBR this would result in upward pressure on interest rates.

28. The macro-economic arguments in this paper would point to resisting Mr Jenkin's plans to encourage additional receipts, particularly from transactions of a purely financial character (like mortgage refinancing). However, decisions taken in the Survey constrain the Treasury's ability to argue in this way.

29. The cash limit derived from the Survey decisions assumed a given level of receipts, and Treasury Ministers would not be in a tenable position if they appeared to resist efforts to raise receipts up to that level. Receipts at that level, but no more, combined with agreed levels of gross spending might be seen as the ideal outcome. But the decisions taken in Cabinet on 13 December about allocatons and prescribed proportions for 1985-86 leave a significant risk of overspending of the cash limit, perhaps by up to £500 million. Mr Jenkin has admitted that his estimated receipts could easily fall short if sales of council houses and other assets slow down; this adds to the risk of over-shooting the cash limit.

30. Treasury Ministers therefore face a conflict of objectives. It would be difficult for them to resist Mr Jenkin's efforts to encourage receipts

if he claims that such action is necessary to deliver the cash limit figures. But they presumably do not want to give further encouragement to actions that would hinder their objectives to reduce taxes and interest rates. Better understanding of the nature of this conflict would be helpful. It would be desirable for Treasury Ministers to explain to DOE Ministers the dangers of relying on use of receipts to contain public expenditure. This might be done in reply to Mr Gow's letter of 21 November about sale and leaseback proposals by the water industry. But one practical difficulty in this area is that it is impossible to fine tune efforts to increase receipts to deliver a particular figure.

(ii) Student Loans

31. Following the decision announced on 5 December to modify the original proposed cut in student grants, the Secretary of State has announced a wide ranging review of student support. One possibility which will be examined in detail is the replacement of student grants by loans.

32. Insofar as student grants are merely replaced by loans, there would be no effect on public expenditure. The loans would score as public expenditure and be included in the planning total, and they would contribute to the PSBR. In practice, the total cost of student support might rise in the short term, as it seems likely that acceptance of a loan scheme would have to be "bought" by some improvement in other aspects of student support, eg the loan facilitity might not be means-tested as grants currently are. On the other hand, introduction of a loans scheme might tend to lead to some reduction in demand for higher education and thus to offsetting savings. But in the longer term when the loans start to be repaid, valuable public expenditure savings would build up. In any event, it would be legitimate to treat the effects of such a switch on public expenditure and the PSBR as quite genuine from the point of view of both macro-economic policy and public expenditure control.

33. An alternative approach would be for the government to guarantee loans to students made by the private sector - presumably banks - rather than make the loans themselves. Such loans would not be included in the planning total, in spite of the government guarantee, and nor would they contribute to the PSBR. This is because the flows of cash involved would

be between two private sector parties and would not cross the boundary of the public sector at any point. Only in the case of default, when the government would be required to pay money to the banks, or if the government were to make payments to the banks for some other reason, eg to subsidise the interest rates, would there be any effect on public expenditure and the PSBR.

34. Thus a switch to government guaranteed student loans could yield significant public expenditure savings: student grants in 1985-86 are put at about £3_4 billion in the plans recently agreed. But such savings would be essentially cosmetic from a macro-economic point of view. They would be entirely offset by increased private sector lending, leaving economic activity and the demand for money unchanged. If they were used to finance higher spending on other programmes, or cuts in taxation, this would lead unambiguously to increased activity and demand for money, and hence upward pressure on interest rates. If the government wished to maintain the same overall stance of fiscal policy it would be necessary to reduce the PSBR to the extent that private loans had been increased. And the reduction in public expenditure would not mark a very significant reduction in the public sector's role in the economy, given the extension of the government guarantee.

35. The Treasury therefore has an interest in ensuring either that the loans are made by the public sector, scoring as public expenditure and yielding essentially longer term savings, or that compensating adjustments are made to fiscal policy and the PSBR if the loans are granted by the private sector under government guarantee.

Conclusion

36. This paper has considered the use of asset sales and other capital transactions to restrain public expenditure. They have made a significant contribution in recent years, and reflect clear political and micro-economic objectives. But, for a given value of the planning total, they impede the government's objectives for taxation and interest rates. It is vital to take this into account in planning public expenditure, and in discussions relating to the current Survey.

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ANNEX A

FINANCING OF HIGHER GROSS SPENDING BY MEANS OF HIGHER CAPITAL RECEIPTS IN THE CURRENT PES

In the current Survey there are a number of cases in which increased capital receipts have been allowed to finance higher gross spending. In addition there are a number of cases currently under discussion which would have essentially the same effect. The following list, which is not exhaustive, sets out the main instances. The first two items are by far the most significant in quantitative terms at present.

(i) Special sales of assets: increased by £500 million in 1985-86.

(ii) LA housing, where additional receipts of £400 million from council house sales and refinancing of existing mortgages were necessary in order to secure agreement on the Survey figures, given higher gross spending which was likely to occur in any event. This was the one major outstanding issue at the time of the 8 November Cabinet.

(iii) Sale and short term leaseback of property by Water Authorities not counted in capitalised form against the EFL. A general case for the use of sale and leaseback arrangements to increase gross spending has been made by Mr Ian Gow in his letter of 21 November to the Chief Secretary.

(iv) Deferred payment arrangements for local authorities. This is fairly small at present, but may become more of an issue if it takes place on a large scale in the future.

(v) The proposed asset recycling scheme encouraging the FCO to dispose of assets overseas and thereby increase gross spending. Schemes allowing retention of capital receipts already operate for MOD, the universities, the regional health authorities and the PSA.

(vi) Ministers have agreed with proposals of the Financial Secretary aimed at speeding up disposals of public sector unused land and empty housing. Departments will normally be allowed to spend any excess of receipts over the target agreed in the Survey. Substantial receipts might also be generated from this source by regional health authorities, nationalised industries and local authorities.

ANNEX B

DERIVATION OF THE CAPITAL TRANSACTIONS ADJUSTMENT TO THE PLANNING TOTAL

1. The total adjustment is built up from three components:

   a) special sales of assets;

   b) net sales of public sector physical assets, including land;

   c) net reduction in public sector financial assets.

2. Special sales of assets cover a variety of transactions. But by far the largest item in most years is public sector disposals of company securities. As noted in the main text, however, such sales - whilst reducing the planning total - have little macroeconomic significance. They are therefore included in the adjustment.

3. Similarly those public sector sales of physical assets which count towards reducing the planning total will have little real effect on the economy. These items are also therefore included in the adjustment. They include net sales of vehicles, plant and machinery and of land and buildings. Council house sales are included in this last category.

4. Public sector transactions in financial assets - other than those covered by special asset sales - are more problematic. Some government lending clearly does have macroeconomic significance in the sense that the finance would not otherwise be provided by the private sector in the absence of the government. Other government lending, were it to be withdrawn, would be replaced from private sector sources so that the macroeconomic impact would be small or non-existent. Only reductions in the planning total occasioned by transactions of the second kind - those without macroeconomic effect - should be included in the adjustment.

5. These considerations suggest that changes in public sector lending should only be included in the adjustment if:

a) the lending is made at or near to market rates of interest; and,

b) the lending is not made in circumstances where credit risk would preclude the private sector from advancing the finance itself.

6. There are over 130 public expenditure subprogrammes representing public sector net lending transactions. But the vast majority of these represent credit which is clearly extended on special or preferential terms. These items are thus excluded fromm the adjustment. The main items which are included are:

(i) refinancing of home shipbuilding lending;
(ii) refinancing of export credit;
(iii) net lending for house purchase by local authorities;
(iv) net lending for house purchase by the Housing Corporation and its regional counterparts.

7. On this basis, the total adjustment is as shown in the attached table.

Ref: 128415

ADJUSTMENTS TO THE PLANNING TOTAL FOR CAPITAL TRANSACTIONS

	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86
Special sales of assets (1)	999	356	- 79	488	1142	1900	2500
Sales of vehicles, plant and machinery (2)	2	3	3	4	6	5	14
Sales of land and buildings (net) (3)	400	822	1718	2337	2117	2040	2145
Net lending to the private sector (4)							
- Home shipbuilding refinance	- 30	- 31	- 48	- 23	- 31	- 23	- 20
- Local authority mortgage and other housing finance	395	177	420	231	-262	- 74	- 90
- Other*	114	287	354	373	- 103	- 70	- 41
Net lending to the overseas sector (5)							
- Export credit refinance	- 407	- 629	- 467	- 293	- 144	2	70
TOTAL ADJUSTMENT [= (1) + (2) + (3) - (4) - (5)]	1329	1277	1383	2541	3805	4110	4740

*Mainly lending by the Housing Corporation and its regional counterparts.

CIGARETTE PRICES AND THE BUDGET

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Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

FROM: B H KNOX

DATE: 9 January 1987

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Ross Goobey

KNOX to CH/EX 9/1

CIGARETTE PRICES AND THE BUDGET

In the run-up to Christmas Imperial Tobacco and Philip Morris announced cuts in the prices of certain brands (eg 5p off John Player Special and Marlboro). This note considers the possible implications for Budget decisions.

2. The Tobacco Advisory Council has made much recently of the need to counter the threat to jobs from low-priced imports. We think it unlikely that this is the real immediate target of the price reductions; cutting JPS to 145p a packet will do little directly to curb the import and sale of own-brand cigarettes selling at around 121p. It is more probable that Imperial are fighting to increase market share generally. Their rivals, Gallahers, have done well in recent years, while Imperial have done badly; the former's market share has increased since 1984 from 32 per cent to 37 per cent, while the latter's has fallen from 43 per cent to 39 per cent.

/3. These moves

Internal distribution:

CPS Mr Jefferson Smith Mr McGuigan Mr Bone Mrs Hamill

3. These moves make little sense for the companies in the Budget context. Traditionally, manufacturers increase their prices in the New Year, not least to reduce your scope (as they see it) for putting up duty rates. A cut has the opposite effect; indeed, the health lobby might be expected to complain if you did not take up the slack provided by a fall in prices. (DHSS has already made this point to us at official level.) Moreover, 5p off JPS has the effect of increasing the proportion of the tax which is comprised by the specific duty element, and it now stands at 55.4 per cent, just over the maximum permitted under EC law (55 per cent). If the new price is maintained, any Budget increase is likely to require an increase in the ad valorem rate of duty, a development which the UK industry - devotees of high specific taxation - would regard as encouragement to low cost imports.

4. Revalorising the tobacco products duties would yield some £85 million in 1987-88 (assuming an inflation factor of 3.25 per cent). A duty change equivalent to a price rise of 5p a packet would bring in £150 million. The RPI impact effect of revalorisation is 0.09 per cent; that, plus a further 5p (ie if the 5p were in addition to revalorisation), would add some 0.24 per cent to the index.

5. The brands affected by price cuts account for less than 10 per cent of the market, so it would be an exaggeration as yet to speak of a price war. Much depends on the reactions of competitors, especially Gallahers, who are now on the point of competing with a new brand, to be launched at 140p, 5p lower than originally intended. It seems likely that the others will show their hands soon, in time for full account to be taken in framing your Budget excise package.

6. The annex to this note adds a little more detail to the facts and figures quoted above.

Bryce Knox

B H KNOX

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ANNEX

1. Currently John Player Specials account for 5.0% of the UK market - lying fifth to the market leader, Gallahers' Benson and Hedges King Size. Marlboro lies seventeenth with 1.7% of the market.

2. The market leader, Benson and Hedges King Size, currently retails for 152p. But "own brands" are typically sold at around 121p. So while the price reductions may affect the relative market shares at the top of the market, it is difficult to see that they will increase competitiveness in relation to the "own brands". If all the brands were reduced by 5p, then the volume of sales would rise by about one-and-a-half per cent.

3. While the reduction of 5p could be seen as a drastic measure, there does seem to have been a steady rise in the real value of the factor cost of typical cigarettes in recent years. This is shown in the attached graph, which also shows - the horizontal line - the factor cost after the latest reductions. In real terms the price reductions have put the clock back a year or so.

4. If Gallahers follow suit and reduce the price of Benson and Hedges by 5p, then we will be faced with a pre-Budget typical price of 145p instead of the 150p or more that we were expecting. Any duty increase would necessitate increasing the ad valorem duty. If the ad valorem rate were increased to 22%, then the specific duty could be raised by 8.8%, raising the price by 10.5p for 20, before EC rules were breached. An increase of this magnitude would yield about £300 million in 1987-88. The following table shows the increases permissible under different scenarios:

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Maximum increases in price permissible without breaking the 55% rule:

Pre-Budget price	Ad valorem rate 21%	22%
145p	Rule already breached	10.5p
150p	4.8p	
151p	6.6p	
152p	8.3p	

Note: revalorisation at 3.25% would increase the price by 3.0p.

Typical factor cost, 20KS (86–7 prices)