PO-CH/NL/0322 PTA

Part. A -

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Begins: 1/5/87.
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PO -CH /NL/0322

PART A

PO -CH /NL/0322
PART A

Chancellor's (Lawson) Papers:

THE ORGANISATION FOR
ECONOMIC COOPERATION AND
DEVELOPMENT SURVEY OF
THE UNITED KINGDOM

DD's: 25 Years

27/10/95.

CONFIDENTIAL

Many thanks. An outrageous & polemical / inaccurate draft chapter. I trust all your points have been fully taken on board. I should like to see the ~~[illegible]~~ redraft as soon as it is available, since I may need to make representations to Paye myself.

FROM: SIR T BURNS
DATE: 1 MAY 1987

CHANCELLOR

cc Sir P Middleton
Mr Sedgwick (or)
Mr Davies
Mr S Matthews

**OECD ECONOMIC OUTLOOK: COUNTRY NOTE ON UK**

P.S. Is X (para 2 of present draft – GGD as % of GDP in 1986) correct?

In Paris I had lunch with two members of the Secretariat (Andersen and Klau). I explained our concerns about the draft section on the UK:

- that we thought their forecasts for inflation and the current account were too pessimistic and needed revising in the light of more recent data;

- that their remarks about exchange rate policy were wide of the mark and in conflict with your statements;

- that they had misinterpreted the stance and role of fiscal policy;

- that our revenue forecasts were very cautious and we were very puzzled by their suggestions that the outcome may be worse.

2. I handed them a note prepared by Mr Sedgwick and my own suggested redrafting of their note (both attached).

3. Andersen (Head of Country Studies Group) is clearly very puzzled about the good performance of the UK economy relative to other major countries. During the EPC meeting he noted the difference between their interpretation and our own. He suggested that they saw bigger effects from fiscal policy and the gain to competitiveness, both of which could be transitory. I pointed out the signs of better supply performance; productivity; industrial relations, export share of world trade etc. We have to live with the fact that Andersen is very much a creature of the old school but he recognised the weakness of his position.

4. Klau (the Division chief with responsibility for the UK) was much more ready to acknowledge that the note needed redrafting and the forecasts needed revising. He mentioned that the forecasts had been made in February when the exchange rate was lower. The note itself had been written before their trip to London and their perceptions had changed in a number of ways.

5. He promised to let us see a redraft of the section when it was complete - around the middle of May. I am reasonably confident that the next version will be a substantial improvement.

6. On a separate occasion Sir Peter Middleton had some stern words with David Henderson.

Sk

PP T BURNS

ENCS

**COMMENTS ON THE OECD FORECAST AND POLICY APPRAISAL FOR THE UNITED KINGDOM**

There are substantial problems with the forecasts for <u>inflation</u>, the <u>current account</u>, and the <u>fiscal position</u> in the Secretariat documents, and with the conclusions on the stance of policy drawn from these. The OECD Secretariat forecasts are

| | **1987** | **1988** |
|---|---|---|
| Consumer prices | 4½ | 5 |
| GDP deflator | 4¾ | 5¾ |
| Current account ($b.) | -6½ | -7¾ |
| General Government Financial Deficit ((£b.) | 12 | 12½ |

2. In recent months <u>inflation</u> has been running, if anything, below the Treasury's expectations at the time of the FSBR. The Treasury's forecast of a 3¾ per cent rise in both the CED and the GDP deflator are as high as it is realistic to go in 1987 in the light of the information now available; and given the fall in private sector pay settlements since last year there is certainly not a strong case for forecasting a pick up in inflation next year.

3. The OECD'S <u>current account</u> forecast is well out of line not only with the Treasury's published forecast, but also with the consensus of outside UK forecasters , which is for £2½-£2¾ billion deficits in both 1987 and 1988. The current account figures for January and February of this year show a small surplus.

4. The OECD projections for the <u>General Government Financial Deficit</u> show a rise over the next two years rather than the fall that the FSBR implies. The suggestion (especially in paragraph 12 of the notes on the UK) that prudence would dictate less favourable projections for government revenues than set out in the FSBR seems very wide of the mark, given the deliberately cautious nature of the projections for revenue in the FSBR. We have no reason to doubt that the borrowing figures in the MTFS can be achieved. Public expenditure is likely to continue falling as a share of GDP, as it has done since 1982-83; and

even if it were not to do so this would limit the scope for tax cuts rather than jeopardise the PSBR objectives.

5. The conclusions on policy drawn from the Secretariat's interpretation of recent performance and its view of prospects are that the macroeconomic policy stance is excessively expansionary, that this is the cause of the UK'S relatively fast growth rate, and that serious problems with inflation and the current account are imminent. It is very difficult indeed to square these conclusions with a detailed assessment of recent trends and prospects. It is not a balanced view of the current position of the UK economy or of the government's approach to macroeconomic policy.

6. Policy is designed to deliver growth of money GDP in line with the medium term path set out in table 2.1 of the MTFS. The assessment notes that the projections of money GDP growth in the MTFS this year are higher than those in the 1986 MTFS. It should also recognise that:

- the growth of money GDP over the two years 1986-87 and 1987-88 is much as envisaged in 1986, though there is a difference of timing;

- the difference in the projections of money GDP in the later years (½ per cent per annum) is very small indeed in relation to the normal variability of money GDP growth rates, the errors in the money GDP data, and especially the differences in money GDP observed over time in the UK and also between countries.

7. More detailed comments on the text for the UK are attached.

## DETAILED COMMENTS ON THE COUNTRY NOTE FOR THE UK

**PARAGRAPH 1**, **first sentence**. Insert "steady" before " expansion".

**second sentence**. Redraft the opening as "Oil production, representing about 6 per cent of total output, levelled off in 1986, but...."

**Third sentence.** There has been only a marginal fall in the saving ratio, and the reference to a "sharp increase in borrowing....to finance spending" is misleading. As throughout the 1980s, the rise in personal debt has been accompanied by a similar rise in assets.

**Fourth sentence**. It is not clear what the first part of this sentence means? The government continued to take the behaviour of sterling into account in setting interest rates, and indeed real interest rates were at relatively high levels in 1986. While the government was certainly content to accept a lower level of sterling than it otherwise would have done because of the fall in oil prices, this is far from "discontinuing support" for sterling.

**PARAGRAPH 2** **First sentence**: Refer to a "small" overshooting of public spending targets.

**Second sentence**; "partly because of" rather than "reflecting", because the fall in the PSBR in 1986-87 (as now published) exceeded the rise in public asset sales.

**Fourth sentence**; This sentence implies that higher expenditure than set out in the MTFS would lead to a larger PSBR or "fiscal boost". This is not the logic of the MTFS: rather, the scale of tax cuts is dependent on the success in controlling public expenditure.

**Sixth sentence**; The GDP deflator - which is under discussion here -, shows no "recent reacceleration of inflation".

**Final sentence**; This does not accurately reflect monetary policy as described in the MTFS and elsewhere. Monetary policy is not simply aimed at the "stabilisation of the exchange rate".

**PARAGRAPH 3**, **Third sentence**: Replace "unemployment is projected to drop somewhat" with "unemployment is likely to fall further, continuing the downward trend seen since late 1986".

**Fourth sentence**: Replace "largely" with "partly".

**Final sentence**: This raises substantive questions on the forecasts for inflation and the current account, and gives a very misleading impression of the prospects for the economy. It should be redrafted in the light of the comments on the forecast numbers made at the recent meeting of short term forecasters.

**PARAGRAPH 4**; **First sentence**: this needs to be redrafted to reflect a realistic projection of inflation in the next two years.

**Fourth sentence**: This should be replaced by something like "the rise in unit labour cost which have decelerated markedly recently, may pick up again to the extent that any cyclical...." Note that for much of 1986 the cycle was having an adverse effect on labour cost growth - part of the recent improvement is due to the elimination of this earlier adverse cyclical impact.

**Penultimate sentence**: The logic of this sentence is wrong. The fastest period of growth in consumption and the associated rise in imports is in the past, not the future.

**Final sentence**: "Rising import penetration" is typical of most OECD countries. It does not necessarily reflect "supply weaknesses".

**PARAGRAPH 5**, **First two sentences**: It is not at all clear what the first two sentences are arguing. Growth in M0 has been close to the centre of its target range, and the exchange rate has been rising on balance since the autumn, interest rates are high by international standards, and, in real terms, the PSBR has been falling. On broad money "the authorities have made it quite clear" that its message is very difficult to interpret because of financial innovation, etc. Nevertheless, as the Chancellor made clear in the Mansion House speech (16 October 1986), there is every sign that people are holding increased amounts of money quite willingly. So long as this remains the case, its growth is not inflationary.

**PARAGRAPH 6**, **Final sentence:** This needs to be revised in the light of the very latest figures for manufacturing output.

**PARAGRAPH 7**, **Third sentence**: The volume of public consumption actually rose by ½ per cent in 1985 and by 1½ per cent in 1986. These numbers do not suggest that it "picked up markedly".

**PARAGRAPH 8**, **Third sentence**: This needs updating in the light of recent import figures. We suggest "considerably earlier" rather than "considerably more"; and add at end of sentence "in the middle of 1986, although this was reversed towards the end of 1986 and early in 1987".

**PARAGRAPH 9**, **First sentence**: Begin "Retail price inflation", delete "significantly"; add after "months" "in large part reflecting the movement of interest rates on housing loans, but also...."

**PARAGRAPH 10**: In general this needs updating in the light of the provisional outturn for the PSBR in financial year 1986-87.

**First sentence**: Insert "provisional" before "outturn": redraft rest of sentence to read "...£3.3 b. (¾-1 per cent of GDP), some £3½ b. less than predicted....."

**PARAGRAPH 11** **Sixth sentence**: This tells only part of the story on stamp duties. Rising prices of securities and houses are also important. The sentence could read "The sharp rise in stamp duties is attributable to rapidly expanding securities turnover and rising securities and house prices".

**Seventh sentence**: Insert "there was" before "considerable". Replace "education" with "local authority current spending" and delete from "among others" to the end of the sentence.

**Penultimate sentence**: Add after this a new sentence as follows "After allowing for drawings from the Reserve the planning total appears to have been overshot by no more than ½ per cent".

**Final sentence**: Should begin "An improvement in the financial position of public corporations...." The existing draft may give a misleading impression of the effect of financial transactions by public corporations on the PSBR.

**PARAGRAPH 12** **Sixth sentence**: Add at the beginning "Although falling unemployment may lessen pressure on social security spending".

**Seventh and eighth sentences**: Redraft as follows: "In particular public sector pay could grow more than implied by the Budget and it could prove difficult to contain this within existing cash limits. Some overshoot of the planning total may again occur though not such as to reverse the downward trend in public spending as a proportion of GDP."

<u>Ninth sentence</u>: Detailed examination of the strong rise in government revenues recorded for financial year 1986-87 does not show this strong rise to be the result of "special factors" that will weaken. Most outside commentators share this view.

<u>Tenth sentence</u>: This is not drafted with precision. It uses the term "financial deficit" when it really means some measure of borrowing. The financial deficit is not affected by asset sales.

**<u>PARAGRAPH 13</u>** <u>First sentence</u>: It is wrong to see any major change in emphasis within the MTFS framework. Successive versions of the MTFS have underlined the important role of the exchange rate in assessing monetary conditions. The aim remains to strike a balance between the exchange rate and domestic monetary growth consistent with the government's aim for money GDP and inflation.

<u>Final sentence</u>: After "satisfactory" continue "in present circumstances and that they would aim at broad exchange rate stability for the present".

**<u>PARAGRAPH 14</u>** <u>Fourth sentence</u>, "there do not seem to us to be indications of a "steepening in the underlying trends" of bank lending for consumption". Noteworthy that the increase in private borrowing as a proportion of GDP is entirely accounted for by increased mortgage borrowing. (Between 1979-80 and 1986-87, private sector borrowing rose by 2.9 percentage points of GDP while mortgage borrowing rose by 3.4 percentage points over the same period.

**PARAGRAPH 17** **First sentence**: Insert "continue" before decline.

**Second sentence**: This will clearly need to be redrafted in the light of revisions to the Secretariat's forecasts.

**Third sentence**: To describe the rise in wages as "unabated" is not justified in the light of recent information on private sector settlements.

**COMMENTS ON THE GENERAL ASSESSMENT CPE(87)2**

## Monetary Policy

**Paragraph 1.2**: It is misleading to suggest that £M3 has long been the linchpin of the medium-term financial strategy. Throughout the aim has been, rather, to create the monetary conditions consistent with steady downward pressure on inflation. At the time of the first MTFS in 1980, the Green Paper on "Monetary Control" made it clear that the most appropriate monetary aggregates for target purposes could well change over time, as financial developments proceeded. Successive versions of the MTFS have included target ranges for monetary aggregates other than £M3. In the 1987 version of the MTFS, the Government decided that, given the rapid and pervasive changes in financial practices, it was no longer appropriate to have a formal target for broad money in 1987-88. In no sense can this be regarded as abandoning the linchpin of the strategy.

**Paragraph 1.4** A number of other factors help to explain why short term interest rates in the United Kingdom are higher than in some other countries. In particular, the rapid progress made in dismantling direct controls of the financial markets has meant that interest rates alone have had to bear the weight of a monetary policy designed to place continuous downward pressure on inflation. In addition, demand for funds for investment purposes has been heavy.

**Paragraph 1.9** In the United Kingdom at least, and probably more widely, it is not only portfolio shifts in financial markets that have affected the monetary aggregates. The clear trend towards deregulation of financial markets and the rapid pace of financial innovation have also been responsible.

## Fiscal Policy

**Paragraph 1.17** **Second sentence**: It is not the case that the fiscal stance in the UK will be expansionary in 1987. The PSBR (as a share of GDP) will be close to the 1986-87 level. The debt/GDP ratio is likely to fall further (as noted in paragraph 1.19).

Mr Mathews ✓ c. Mr Sargent Mr S Davies ✓



This is the version I handed to OECD Staff. It includes all suggested changes in Mr Sargent's minute and some suggestions of my own. They were receptive and will show us the next draft.

Sent 1/5.





UNITED KINGDOM

## Assessment

1. The United Kingdom is enjoying continued STEADY expansion, with output growth in 1987 projected to exceed that for most other Member countries. ~~While~~ Oil production, representing about 6 per cent of total output LEVELLED OFF ~~, continued to rise~~ in 1986, BUT the fall in oil prices has resulted in a switch in profitability towards energy-using companies and a substantial real income gain for consumers. Unlike many other countries, consumers INCREASED SPENDING BY SLIGHTLY MORE THAN THE GAIN IN REAL DISPOSABLE INCOMES. FOLLOWING THE FALL IN OIL PRICES STERLING WEAKENED. ~~This was not~~ RESISTED BECAUSE OF THE NEED FOR SOME REAL EXCHANGE RATE ADJUSTMENT AND ~~have not only spent all of their windfall gains from lower energy prices but have also sharply increased their borrowing to finance further spending. Sterling support through high interest rates was discontinued in 1986~~, in view of the damping effect of oil prices on inflation. In the second half of the year export growth accelerated sharply~~, as previous losses in market shares were reversed~~, assisted by the depreciation of the pound sterling since mid-1985. At the same time, domestic demand CONTINUED TO GROW STEADILY ~~was boosted by higher public expenditure on goods and services.~~

SOME DEPRECIATION WAS NOT

2. Despite A SMALL overshooting of public spending targets and sharp falls in oil revenues, the rise in the general government deficit (national accounts definition), to about 3 per cent of GDP in 1986, was relatively modest thanks to buoyant non-oil tax receipts. The FY 1986/87 Public Sector Borrowing Requirement (PSBR) dropped to about 1 per cent of GDP, PARTLY BECAUSE OF ~~reflecting~~ an increase in public asset sales corresponding to 1/2 per cent of GDP. The Medium Term Financial Strategy (MTFS), as set out in the March 1987 Budget, aims at maintaining the PSBR stable in relation to GDP. PUBLIC EXPENDITURE IS PLANNED TO DECLINE AS A PROPORTION OF GDP LEAVING ROOM FOR ~~in spite of~~ continuing reductions in taxation. Taking account of privatisation proceeds and the economic cycle, this points to a declining fiscal boost to the economy. ~~in the period ahead, provided that expenditure control can be improved~~. Economic policy continues to be set in a nominal framework with the intention of bringing down inflation by a gradual reduction in the growth of nominal GDP. THE GROWTH OF MONEY GDP OVER THE TWO YEARS 1986-7 AND 1987-8 IS MUCH AS ENVISAGED IN 1986 ~~However,~~ THE target projections for the latter are now higher than those shown in last year's MTFS. ~~reflecting the recent reacceleration of inflation.~~ While recognising that a declining path for nominal GDP growth requires firm monetary policies, the authorities have dropped the formal target for broad money, due to increasing difficulties in interpreting its development. The narrow money target range for 1987 has been maintained; target ranges for the later years are intended to be gradually lowered in line with the projected path for nominal GDP growth. THE EXCHANGE RATE CONTINUES TO BE TAKEN INTO ACCOUNT IN ASSESSING MONETARY CONDITIONS ~~There has been a further step towards an exchange rate target:~~ The 1987 MTFS refers to the G6 agreement of last February, and the authorities have indicated that they aim at a stabilisation of current exchange rates which they consider satisfactory.

3. On the basis of these policies and the technical assumptions of unchanged oil prices and exchange rates, the growth of activity is projected to decelerate in the period ahead, approaching that of potential output. In 1987, real GDP growth should exceed 3 per cent, with the revival of business investment following upon that of private consumption and exports. Unemployment is LIKELY TO FALL FURTHER, CONTINUING THE DOWNWARD TREND SEEN SINCE LATE 1986 ~~projected to drop somewhat for the first time since the beginning of the recovery in 1981~~. The fall in the unemployment rate, ~~largely~~ stemming IN PART from special employment measures so far, may increasingly reflect the sustained strength of the upturn. ~~However, the acceleration of inflation and~~

## UNITED KINGDOM

### Demand, output and prices

Percentage changes from previous period, seasonally adjusted at annual rates, volume (1980 prices)

| | 1982 current prices billion £ | 1984 | 1985 | 1986 | 1987 | 1988 | 1986 II | 1987 I | 1987 II | 1988 I | 1988 II |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Private consumption | 167.4 | 2.1 | 3.7 | 4.7 | 3¾ | 2¾ | 5.1 | 3½ | 2¾ | 2¾ | 2¾ |
| Government consumption | 60.5 | 0.7 | 0.2 | 1.2 | 1½ | 1 | 3.9 | ¾ | 1 | 1 | 1 |
| Gross fixed investment | 44.7 | 9.1 | 1.8 | 0.6 | 3 | 2¾ | 0.2 | 4 | 3¼ | 2¾ | 2 |
| Public[a] | 11.3 | 0.3 | −14.4 | 1.9 | −2½ | −1¼ | −9.5 | 1 | −1½ | −1¼ | −1¼ |
| Private residential | 6.4 | 8.9 | −3.0 | 13.2 | 5¾ | ¼ | 27.7 | −¾ | 0 | ¼ | ½ |
| Private non-residential | 27.0 | 13.4 | 10.1 | −2.6 | 4 | 4¾ | −2.2 | 6½ | 5¾ | 4¾ | 3¼ |
| Final domestic demand | 272.5 | 3.0 | 2.6 | 3.2 | 3¼ | 2¼ | 4.0 | 3 | 2½ | 2¼ | 2¼ |
| * change in stockbuilding | −1.3[b] | −0.3 | 0.3 | 0 | 0 | ¼ | −0.3 | ¼ | ¼ | ¼ | 0 |
| Total domestic demand | 271.2 | 2.7 | 2.9 | 3.2 | 3¼ | 2½ | 3.6 | 3¼ | 2¾ | 2½ | 2¼ |
| Exports of goods and services | 73.1 | 6.7 | 6.0 | 3.0 | 5¾ | 3 | 11.2 | 4½ | 3¼ | 3 | 3 |
| Imports of goods and services | 68.1 | 9.2 | 3.1 | 5.8 | 7 | 4 | 18.1 | 3½ | 4 | 4 | 4 |
| * change in foreign balance | 4.9[b] | −0.6 | 0.8 | −0.8 | −¼ | −¼ | −1.7 | ¼ | −¼ | −¼ | −¼ |
| * compromise adjustment | 0.8[b] | 0.8 | −0.2 | 0.3 | ½ | 0 | 1.6 | 0 | 0 | 0 | 0 |
| GDP at market prices[c] | 277.0 | 2.9 | 3.5 | 2.7 | 3¼ | 2¼ | 3.5 | 3½ | 2¼ | 2¼ | 2 |
| GDP implicit price deflator | – | 4.1 | 6.1 | 3.8 | 4¾ | 5¾ | 3.6 | 4½ | 5¾ | 5¾ | 5¾ |
| *Memorandum items* | | | | | | | | | | | |
| Consumer prices[d] | – | 4.8 | 5.3 | 3.7 | 4½ | 5 | 2.9 | 5¼ | 5¼ | 5 | 4¾ |
| Industrial production | – | 3.9 | 3.1 | 0.2 | 3¾ | 3 | 4.0 | 4 | 3¼ | 3¼ | 2½ |
| Unemployment rate | – | 11.5 | 11.7 | 11.8 | 11½ | 11 | 11.8 | 11½ | 11¼ | 11¼ | 11 |

* As a percentage of GDP in the previous period.
a) Including nationalized industries and public corporations.
b) Actual amount of stockbuilding, foreign balance and compromise adjustment.
c) Data for GDP in the past are based on a compromise estimate which is the average of the expenditure, output and income estimates of GDP. The compromise adjustment is the difference between compromise GDP and the expenditure estimate of GDP.
d) National accounts implicit private consumption deflator.

~~the widening external deficit are worrying features of the projections, possibly calling the sustainability of the recovery into question.~~

4. The balance between real growth and inflation has tended to deteriorate A LITTLE with inflation likely to SLIGHTLY ~~substantially~~ exceed the OECD average in the foreseeable future. So far the PICKUP ~~reacceleration~~ of inflation has mainly reflected the rise in import prices, which should slow down, under the technical assumption of constant exchange rates. Substantially more rapid wage increases than in other countries, however, are likely to remain a fundamental problem. The rise in unit labour costs, which HAVE decelerated MARKEDLY recently, ~~is very likely to~~ MAY pick up again TO THE EXTENT THAT ANY ~~when the~~ cyclical acceleration of productivity growth is reversed. ~~The~~ ANY resulting deterioration in international competitiveness ~~is bound to~~ WILL affect export performance in the medium run. ~~contributing to a continued widening of the external deficit. In the short run,~~ OVER THE PAST YEAR the current account ~~is likely to~~ HAS deteriorated due to the strong growth of imports associated with the consumer boom. ~~Rising import penetration may be indicative of supply weaknesses.~~

5. In view of CONTINUING ~~growing~~ inflationary pressures and their PROSPECTS ~~implications~~ for the external balance, A ~~the~~ question ARISES ABOUT THE STANCE OF ~~arises whether~~ policy IN ~~should support~~ an economy already in cyclical recovery. The authorities have repeatedly pointed out that rapid growth in the broad measure of money supply, and in particular in bank lending, remained a cause for concern but have allowed interest rates to fall, AS NARROW MONEY HAS BEEN WITHIN TARGET AND as the exchange rate tended to strengthen against the background of improving business confidence and rising oil prices. Another area of concern is public spending: FURTHER SUBSTANTIAL ~~given the expansionary effect of the~~ tax reductions AND a fall in the fiscal deficit consistent with a broadly neutral stance of policy ~~would~~ require tighter expenditure control than in the past.

Recent trends

6. Growth in the average measure of real GDP, which had dropped to an annual rate of 1 per cent in the final quarter of 1985, accelerated sharply in 1986, to reach an annual rate of 3 1/2 per cent by the end of the year, when the level of activity was about 17 per cent higher than at its cyclical trough in 1981. Taking 1986 as a whole, real GDP growth may have been a little more than 2 1/2 per cent (or 2 per cent if allowance is made for the direct effects of the 1985 coal dispute). Output of service industries increased by nearly 4 per cent, about the same as energy output, while output in manufacturing ~~hardly rose, despite~~ SHOWED a marked revival of production THROUGH ~~later in~~ the year.

7. Consumer spending was the main source of expenditure growth, supported by a strong rise in real incomes and a SMALL fall in the saving ratio. ~~assisted by abundant credit.~~ Expenditure on durable goods grew by 9 per cent, twice as fast as total private consumption. Public consumption, which had declined in real terms during 1985, picked A LITTLE ~~up markedly~~. Despite higher public investment and rapid growth in private residential investment, fixed capital formation SHOWED LITTLE CHANGE ~~almost stagnated~~ in 1986, the weakest performance since 1981. This unexpected weakness reflected only in part the reduction of North Sea oil investment. Non-oil business investment, too, failed to recover, despite a further improvement in company profits (while total profits fell by 7 1/2 per cent, those of non-oil companies rose by 14 per cent). To some extent, weak investment performance can be explained by changes in taxation. The 1984

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## UNITED KINGDOM

**Balance of payments**

Value, $ million

| | 1985 | 1986 | 1987 | 1988 | 1985 I | 1985 II | 1986 I | 1986 II | 1987 I | 1987 II | 1988 I | 1988 II |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ***Seasonally adjusted*** | | | | | | | | | | | | |
| Exports | 100 161 | 106 792 | 121 250 | 129 750 | 47 428 | 52 732 | 52 996 | 53 796 | 59 500 | 61 500 | 63 750 | 66 000 |
| Imports | 102 870 | 118 892 | 141 750 | 152 000 | 49 047 | 53 822 | 57 100 | 61 792 | 69 500 | 72 250 | 74 750 | 77 250 |
| Trade balance | −2 709 | −12 100 | −20 500 | −22 250 | −1 619 | −1 090 | −4 104 | −7 996 | −10 000 | −10 500 | −11 000 | −11 250 |
| Services and private transfers, net | 11 585 | 13 866 | 16 250 | 16 750 | 5 407 | 6 179 | 5 909 | 7 957 | 8 250 | 8 000 | 8 250 | 8 500 |
| Official transfers, net | −4 322 | −3 378 | −2 250 | −2 250 | −1 993 | −2 329 | − 961 | −2 417 | −1 000 | −1 000 | −1 000 | −1 000 |
| Current balance | 4 555 | −1 612 | −6 500 | −7 750 | 1 795 | 2 760 | 844 | −2 456 | −2 750 | −3 750 | −4 000 | −4 000 |
| ***Unadjusted*** | | | | | | | | | | | | |
| Current balance | 4 555 | −1 612 | | | 378 | 4 176 | − 479 | −1 132 | | | | |
| Long-term capital | −19 257 | −20 337 | | | −11 071 | −8 186 | −11 122 | −9 215 | | | | |
| Short-term capital and unrecorded | 5 928 | 12 214 | | | 5 576 | 353 | 7 074 | 5 140 | | | | |
| Balance on non-monetary transactions | −8 775 | −9 735 | | | −5 117 | −3 657 | −4 527 | −5 208 | | | | |
| Net transactions of monetary authorities[a] | 162 | 4 301 | | | 483 | − 322 | 1 492 | 2 810 | | | | |
| ***Memorandum items* (Seasonally adjusted)** | | | | | | | | | | | | |
| **Per cent changes in volume[b]** | | | | | | | | | | | | |
| Exports | 5.8 | 3.8 | 6.3 | 2.8 | 7.3 | −3.0 | 2.8 | 12.9 | 4.9 | 2.8 | 2.7 | 2.9 |
| Imports | 3.4 | 7.4 | 8.7 | 4.0 | 0.4 | 0.2 | 2.8 | 24.9 | 3.9 | 4.2 | 4.0 | 4.0 |

*Note:* Detail may not add, due to rounding.

a) Previously *Balance on official settlements.* Foreign borrowing by the public sector is included in the capital account while changes in official sterling balances are included below the line as a financing item.

b) Over previous period at annual rates, customs basis.



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corporate tax reform provided a strong inducement to accelerate investment programmes, and the recent weakness of manufacturing investment included a sharp fall in the contribution of leasing, following the abolition of first year allowances from April 1986. Stockbuilding fell in 1986 partly as a consequence of the strength of consumer demand.

8. Export growth accelerated sharply in the latter half of 1986 with export performance HELPED BY ~~reacting relatively rapidly to~~ exchange-rate-induced improvements in competitiveness. Exports of manufactures grew by 6 percentage points more than markets, largely recuperating the previous losses in market shares. Import growth ~~showed a similar time pattern but~~ accelerated ~~considerably~~ ~~more~~ EARLIER than export growth (due in part to a less marked improvement in import price competitiveness) so that the real foreign balance acted as a drag on production IN THE MIDDLE OF 1986 ALTHOUGH THIS WAS REVERSED TOWARDS THE END OF 1986 AND EARLY IN 1987. With the terms of trade deteriorating, due mainly to the oil price fall but partly also to the depreciation of the exchange rate, this led to a large swing in the current account into deficit. The non-oil external deficit changed little, however, in 1986, since the deterioration in the non-oil trade balance was largely offset by a higher invisible surplus, notably in net investment income.

9. RETAIL PRICE Inflation has picked up ~~significantly~~ in recent months, IN LARGE PART reflecting the MOVEMENT OF INTEREST RATES ON HOUSING LOANS. ~~BUT ALSO THE~~ ~~reversed fall in import prices and little change in wage trends~~. Between mid-1986 and February 1987 industry's material and fuel costs rose by more than 4 per cent and the year-on-year increase in the retail price index accelerated from 2.4 per cent to 3.9 per cent. Despite indications that wage settlements have come down somewhat, effective earnings have hardly reacted to the fall in inflation in 1986. The underlying annual rate of growth of average earnings is estimated to have remained virtually unchanged at around 7 1/2 per cent since mid-1984, resulting in an increase in real wages of 4 per cent in 1986. In response to stronger activity growth, the rise in the employed labour force reaccelerated in the second half of 1986, reflecting a further increase in service industries' employment and a slower decline in manufacturing employment. With the growth in the total labour force apparently decelerating, the upward trend in unemployment since 1980 seems to have been reversed. In the six months to February, the unemployment rate (seasonally adjusted, excluding school leavers) fell by 1/2 percentage point to about 11 per cent of the working population. Part of the drop in unemployment reflected additional special employment measures.

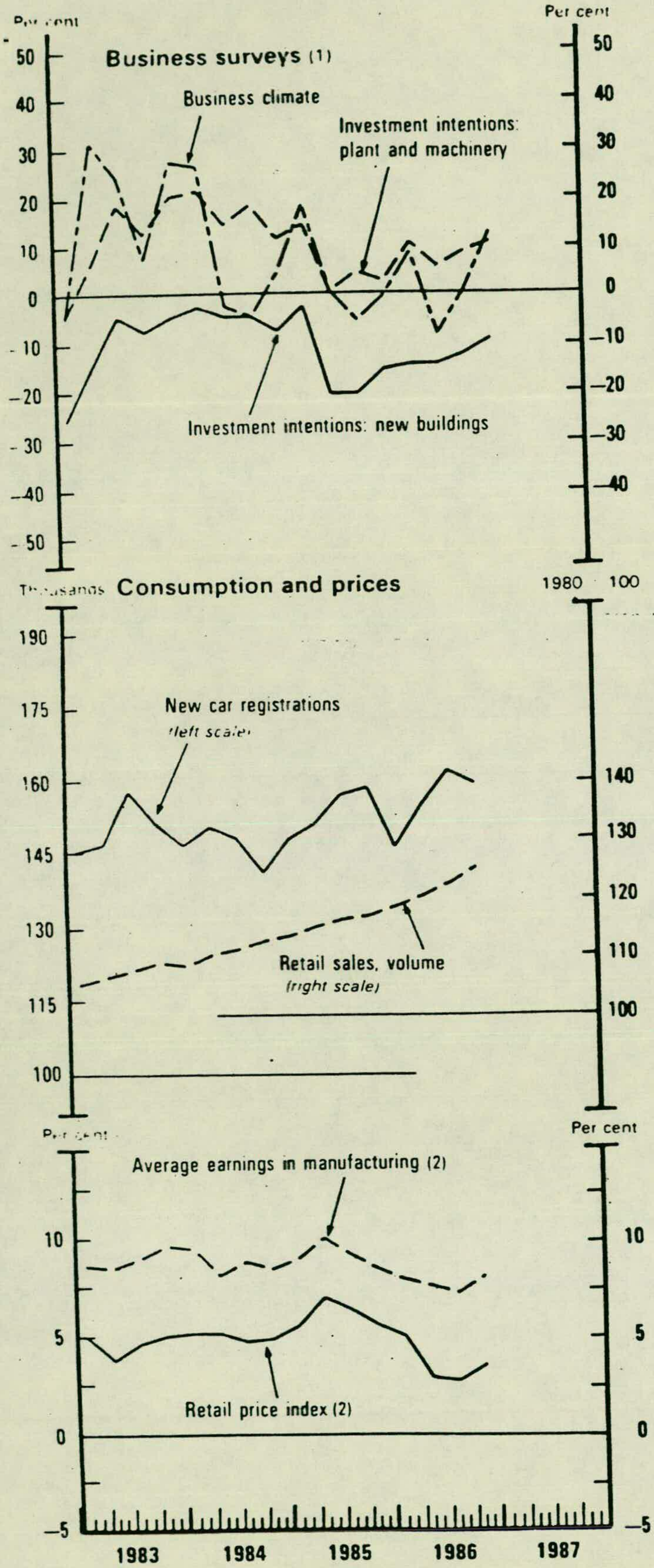
Policies

10. The PROVISIONAL outturn for the PSBR for 1986/87 is estimated to have been £~~4~~ 3.3 billion (~~about~~ LESS THAN 1 per cent of GDP), some £3 1/2 TO £4 billion less than predicted in the March 1986 Budget. This compares with an outturn of £5.8 billion or 1.6 per cent of GDP in 1985/86. Excluding privatisation proceeds, the PSBR ~~remained broadly unchanged at~~ DECLINED FROM £8 1/2 billion TO UNDER £8 BILLION. The 1986/87 PSBR (even excluding privatisation proceeds) is the lowest in relation to GDP since 1971/72. The March 1987 Budget projections are for a ~~n unchanged~~ PSBR OF 1 PER CENT OF GDP this year and next, with, however, ~~considerably~~ higher levels of both spending and revenues than envisaged in the 1986 MTFS. In the following years, the PSBR is projected to rise in nominal terms but to remain stable as a proportion of GDP.

# UNITED KINGDOM

CPE(87)3

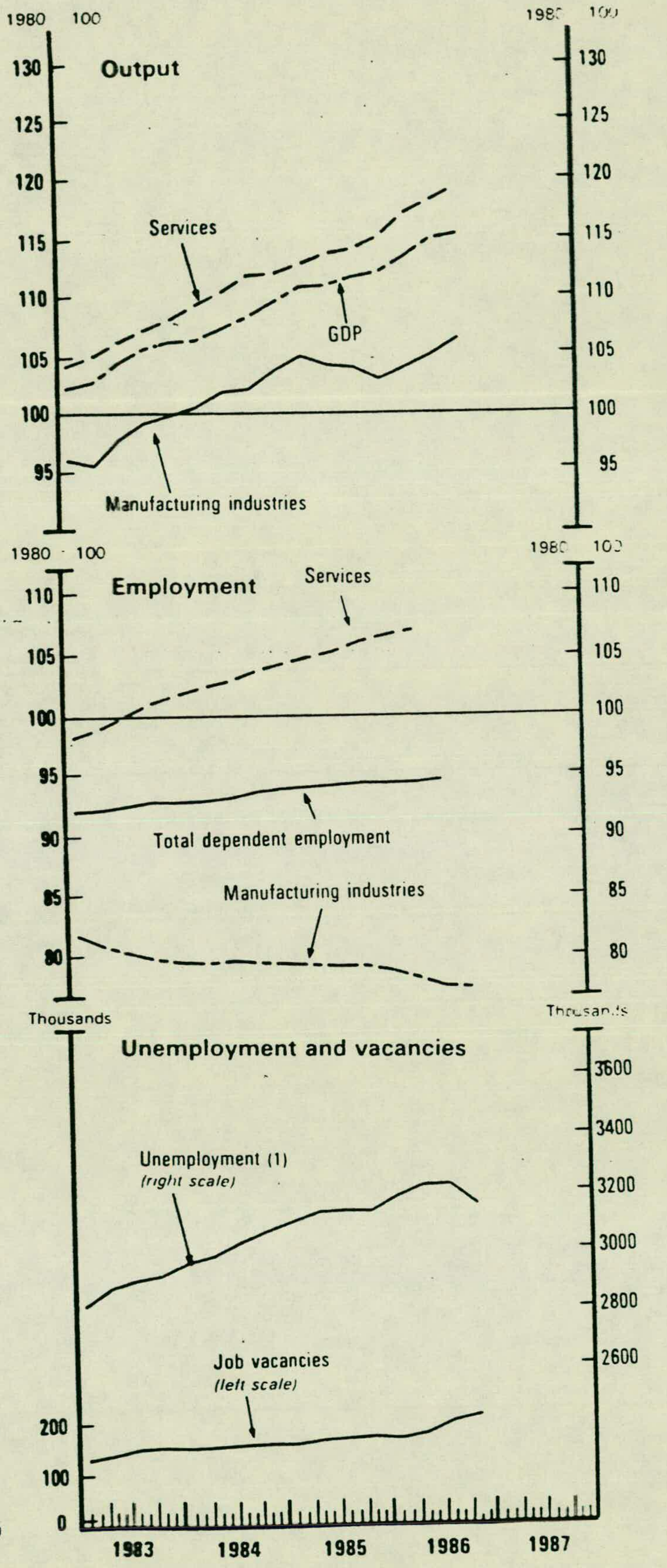
## RECENT INDICATORS




1. Balance between *positive* and *negative* answers
2. Change over 4 quarters

Sources: CBI, Economic Trends and Employment Gazette

## OUTPUT AND LABOUR MARKET




1. United Kingdom, excluding school leavers
Break in series in April 1983: recorded unemployment reduced by 160 000

Sources: Economic Trends and Employment Gazette

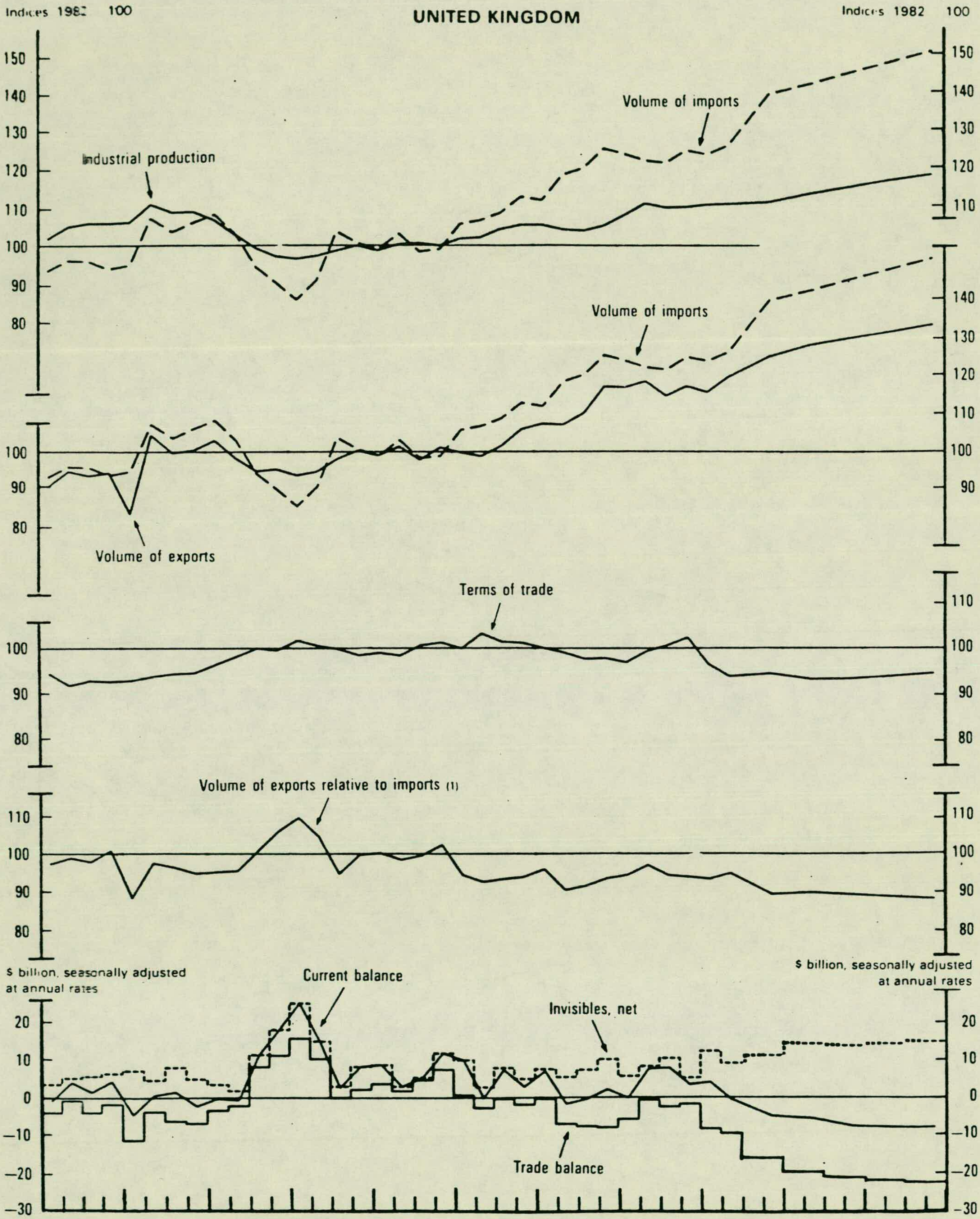
11. The favourable outturn for 1986/87 was achieved in spite of a sharper-than-expected fall in oil revenues. Other tax revenues ran much higher than the 1986 Budget forecast, with non-North Sea corporation tax accounting for the bulk of the additional receipts. The reasons for this surge in corporate taxes are not clear, as the recorded rise in profits would seem to be insufficient to explain the outcome. One possibility is that the effect of the change in investment allowances resulting from the 1984 corporate tax reform has been significantly underestimated. The greater-than-expected buoyancy of indirect taxes reflects both stronger-than-forecast consumer spending and a change in the composition of consumption towards spending on goods and services subject to VAT. The sharp rise in stamp duties is attributable to rapidly expanding securities turnover AND RISING SECURITIES AND HOUSE PRICES. On the expenditure side, THERE WAS considerable overspending in the areas of social security and ~~education, among others, was~~ LOCAL AUTHORITY CURRENT SPENDING ~~only partly offset by lower than projected debt interest payments~~. Public asset sales, which are counted as negative expenditure, appear to have almost met the projections, which were for a doubling of privatisation proceeds (to more than 1 per cent of GDP). AFTER ALLOWING FOR DRAWINGS FROM THE RESERVE THE PLANNING TOTAL APPEARS TO HAVE BEEN OVERSHOT BY NO MORE THAN 3/4 PER CENT. ~~Substantial debt repayments by~~ AN IMPROVEMENT IN THE FINANCIAL POSITION OF public corporations also reduced the PSBR in 1986/87.

12. The March 1987 Budget decision to ~~keep~~ SET public borrowing at ~~the level achieved in 1986/87~~ £4 BILLION (and below the previous target) ~~implies~~ MEANT tax adjustments limited to about the amount foreshadowed in the 1986 MTFS; higher-than-expected revenues are ~~to be used to finance~~ BALANCED BY extra expenditure. The Budget provides for tax reductions (beyond indexation) of £2 1/2 billion, mainly in the area of income tax. The basic rate of personal income tax is cut by 2 points to 27 per cent. Small companies' rate of corporation tax is reduced accordingly but the main corporate rate remains unchanged at 35 per cent. Spending plans are unchanged from those in the Autumn Statement and Public Expenditure White Paper, which raised the previous planning total by 3 per cent. ALTHOUGH FALLING UNEMPLOYMENT MAY LESSEN PRESSURE ON SOCIAL SECURITY Expenditure targets may, however, ~~soon~~ be put under pressure again, given past experience ~~with expenditure control~~. In particular, public sector pay could grow more than implied by the Budget projections and ~~inflation could be higher than assumed~~ IT COULD PROVE DIFFICULT TO CONTAIN THEM WITHIN EXISTING CASH LIMITS. Hence, the contingency reserve, which is lower than in 1986-87, ~~may soon be exhausted~~ IS EXPECTED TO BE FULLY SPENT. SOME ~~[illegible]~~ OVERSHOOT OF THE PLANNING TOTAL MAY OCCUR AGAIN BUT NOT SUCH AS TO REVERSE THE DOWNWARD TREND IN THE PUBLIC SPENDING AS A PROPORTION OF GDP AT THE SAME TIME. ~~While~~ the oil price assumption of $15 per barrel is cautious. ~~it might also be prudent to assume that the effects of the special factors which boosted revenues in FY 1986/87 will weaken. Thus, on balance, there seems to be a risk that the new PSBR targets may be overshot and that, despite rising public asset sales, the financial deficit may not decline as projected. The Secretariat estimates for the general government financial deficit (including privatisation proceeds and other financial transactions) show a stabilisation in relation to GDP, following an increase from about 2 1/2 per cent in 1985 to some 3 per cent in 1986. This implies a continued rise in the cyclically-adjusted deficit in 1987, and little change in 1988 if public expenditure growth slows down as planned.~~

13. Within the framework of the MTFS, ~~the~~ THERE HAVE BEEN ONLY SMALL SHIFTS OF emphasis ~~has shifted away from monetary targetry, as more weight is given to the exchange rate~~. As noted, the broad money target has been suspended. The target range for narrow money (MO) growth in 1987 has been kept unchanged at 2 to 6 per cent, and a gradual reduction to a range of 0 to 4 per cent by 1990 is envisaged. Underlying growth of MO significantly outside its target range would lead the authorities to change short-term interest rates, unless other indicators, including broad money and the exchange rate, suggest that monetary conditions remain satisfactory. The authorities have indicated that the present level of the

INDUSTRIAL OUTPUT, FOREIGN TRADE AND CURRENT BALANCE

UNITED KINGDOM




1. Ratio of export and import volume index multiplied by 100.

Note: OECD forecasts from 1987 I onwards exchange rate is satisfactory IN PRESENT CIRCUMSTANCES AND THAT THEY WOULD AIM AT BROAD ~~and that they would aim at~~ exchange rate stability FOR THE PRESENT, co-operating closely with the other countries represented at the Louvre meeting of last February.

14. MO growth edged up at the turn of the year but has fallen back towards the middle of its target range more recently. £M3 has displayed an opposite pattern, moderating somewhat and picking up again thereafter; expanding by almost 19 per cent in the twelve months to February, it overshot the target range for the financial year 1986/87 by a wide margin. As the effect of strong bank lending on broad money growth was damped by substantial (temporary) overfunding in the early part of this year, £M3 is probably still growing rapidly. Bank lending~~, in particular for consumption,~~ has remained high. ~~and there are indications of a steepening in its underlying trend~~. After the disturbances, which led to higher interest rates in October, financial sentiment has gradually improved, reflecting developments in the oil market and the more favourable short-term outlook for the domestic economy. As a result, sterling was hardly affected by the turbulance in the foreign exchange markets early this year and has tended to appreciate recently. GIVEN ~~As~~ the rapid growth in bank lending and the initially muted reaction of the exchange rate to the rising oil price, ~~might have suggested the need for some tightening of policy,~~ the authorities adopted a cautious approach to cuts in interest rates ~~but~~ finally allowed them to fall. In March AND APRIL banks' base rates were reduced in THREE ~~two~~ steps to 9½ ~~10~~ per cent and are now back to the pre-October level.

Prospects

15. The present forecast is based on the assumption of unchanged oil prices and exchange rates as from February. Compared with Economic Outlook 40, the sterling effective exchange rate assumption is practically the same, while the oil price assumption is now higher ($16 per barrel). Since the adoption of STET these assumptions, sterling has appreciated significantly. ~~if not reversed, this would call for a modification of the projections. In line with policies described above, the fiscal stance is assumed to be expansionary, though to a diminishing degree, and~~ Interest rates ARE ASSUMED to remain broadly unchanged, which would seem to be consistent with a gradual deceleration in monetary growth. After a marked improvement in the course of 1986, the competitive position ~~is likely to~~ MAY deteriorate A LITTLE~~, as unit labour costs in the United Kingdom are projected to increase faster than abroad~~. Hence, export market gains are likely to BE LESS RAPID ~~decrease~~. Nevertheless, export growth is projected to remain broadly unchanged in the period ahead given that the growth of markets for manufactures is expected to accelerate -- from an annual rate of 3 per cent in the first half of 1987 to 5 1/2 per cent by the end of the projection period.

16. After the rapid expansion in the last eighteen months or so, growth in domestic demand MAY ~~is likely to~~ slow A LITTLE IF ~~somewhat when~~ the projected revival of business investment and restocking no longer compensate for the deceleration in the expansion of private and public consumption. As noted above, private non-residential investment remained weak until the end of 1986. But intention surveys point to a marked pick-up early this year and into 1988. The capital/output ratio may now be relatively low, following a period of weak investment, and profitability and output expectations have further improved. However, the growth in business capital spending may decelerate towards the end of the projection period influenced by less buoyant export expectations

and lower profitability. Residential investment is projected to level off in the period ahead, given the deceleration in housing starts. Public investment should decline, according to Budget plans. Stockbuilding is expected to temporarily accelerate after the marked drop in the stock/output ratio last year. Budget plans point to slower growth in public consumption, following the rapid expansion in the recent period. Private consumption is also likely to grow at a slower pace. While rising inflation will erode personal income gains, the resulting weakening in consumer spending may be damped by some further decline in the saving ratio. Real GDP growth is projected broadly to follow the trend of domestic demand, though at a lower rate, as imports are forecast to continue to grow faster than exports.

17. Unemployment is expected to CONTINUE TO decline significantly for the first time in the 1980s, with its fall, however, likely to decelerate in the course of 1988. Inflation is projected to remain A LITTLE ABOVE THE OECD AVERAGE ~~high by international comparison~~. The inflationary effect of import price increases should diminish, while the increase in unit labour costs is projected to INCREASE FROM RECENT LOW LEVELS ~~reaccelerate, given the unabated rise in wages and~~ GIVEN the likely slowdown in productivity growth. All-in-all, some deceleration in inflation appears possible towards the end of the projection period. Given the forecast decline in real net exports, the current account deficit is expected to show a rising trend, although the turnaround in the terms-of-trade is likely to limit the extent of the deterioration in the external balance.

C23/03

UNCLASSIFIED

Ch
See also two notes below, from Roger Lavelle, + Andrew Edwards
AWK 1/5

FROM: A W KUCZYS
DATE: 1 MAY 1987

CHANCELLOR

cc Mr Allan
Mrs Lester

**ECOFIN AND OECD: 11-12 MAY 1987**

On present plans, you are going to ECOFIN in Brussels on Monday 11 May; flying to Paris that evening for a briefing meeting and dinner with the Ambassador to the OECD (Nicholas Bayne); staying that night at the Ambassador's residence; and attending the OECD Ministerial meeting on Tuesday 12 May. There are a number of points which we now need to settle.

2. First, flights. There are scheduled flights which you could use. But, after a very inconclusive COREPER yesterday, we are still unclear about when ECOFIN will start and when it will finish. The agenda is quite heavy, and there must be a risk that it will run on into the early evening. Given the need to get to Paris, and have a briefing meeting there, I think it would be well worthwhile having the extra flexibility of an RAF plane to take you first to Brussels and then on to Paris. Do you agree please? (It may be possible for you to return from Paris on Tuesday evening in the same RAF plane as Sir G Howe, who will also be there.)

Yes

3. Second, there is the question of whether Alex or I should come with you. Normally I would do ECOFIN, and Alex would cover OECD. We could arrange things so that I did the first leg of the trip, and Alex flew out to Paris where we would hand over. But this may seem rather unwieldy. The alternatives are that either Alex or I accompany you for the whole two days. Have you any preference? Ch I think easiest if Tony does the lot AA

Just Tony

4. Next, will you want Robert to accompany you both to ECOFIN and to OECD? I suspect he will want to suggest Steven Pickford.

Yes

5. The provisional agenda for ECOFIN is set out in a telegram in your box today. Apart from Robert, and either Alex or me,

Roger Lavelle and Andrew Edwards will support you. They will then go on to Luxembourg for an EIB meeting.

6. Finally, do you have any thoughts on what you would do in the event of the Prime Minister deciding, over the weekend of 9-10 May, to call an Election on 11 June? Would you still go to Brussels and Paris?

Ch
One potential problem is the Finance Bill. I have discussed this with Jill Rutter, who feels CST + other ministers should be able to cope with guillotine and standing committee without you.
AA

For the time being, assume answer "Yes". But I will have a word with the PM in due course.
L

R.3 LV

A W KUCZYS

CHANCELLOR OF THE EXCHEQUER

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MR 2/73

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FROM: A W KUCZYS
DATE: 5 May 1987

SIR G LITTLER o/r

cc: PS/EST
PS/MST
PS/Sir P Middleton
Mr Lavelle
mr A Edwards
Mr H P Evans
Mr Culpin
Mr Allan
Mrs Lester

**ECOFIN AND OECD: 11-12 MAY 1987**

The purpose of this note is to simply to record the logistic arrangements for ECOFIN and OECD next week.

**Monday 11 May**

2. The Chancellor, accompanied by Mr Lavelle, Mr Edwards, Mr Culpin and myself, will be attending ECOFIN in Brussels. Because of the uncertainty as to what time ECOFIN will finish, and the need to get to Paris for a briefing session and working dinner with the Ambassador ahead of the OECD Ministerial, we will use an RAF jet, which gives us much greater flexibility. We are having a meeting with the Minister of State, Mr Lavelle and Mr Edwards tomorrow (Wednesday) to discuss the ECOFIN agenda.

3. After ECOFIN, the Chancellor, Mr Culpin and I will fly on to Paris, where we will meet up with you and Mr Evans. We are having a briefing session at No.11 on Thursday, and the Ambassador (Mr Bayne) is providing a working dinner on our arrival in Paris. Four of us will be able to stay at the Ambassador's residence; the UK delegation in Paris have booked Mr Evans into a nearby hotel.

CHANCELLOR OF THE EXCHEQUER

**Tuesday 12 May**

4. After the OECD Ministerial meeting, the Chancellor, Mr Culpin and I are booked to return to London on the 7.30 pm British Airways flight from CDG to Heathrow.

AWK

A W KUCZYS

RT8.91 CONFIDENTIAL

b/f 6/5
(for OECD mtg)

FROM: A W KUCZYS
DATE: 5 May 1987

SIR T BURNS

cc Sir P Middleton
Mr Sedgwick
Mr Davies
Mr S Matthews

**OECD ECONOMIC OUTLOOK: COUNTRY NOTE ON UK**

The Chancellor was most grateful for your minute of 1 May, with your comments on the current draft of the OECD note on the UK economy. He has commented: "An outrageous and palpably inaccurate draft chapter". He trusts all your points have been fully taken on board? He would also like to see the redraft as soon as it is available, since he may need to make representations to Monsieur Paye himself.

2. Is the first sentence of paragraph 2 of the present draft - which refers to a rise in the general Government deficit to about 3 per cent of GDP in 1986 - correct?

AWK

A W KUCZYS

Janet

Thanks

FROM: **S J DAVIES**
DATE: 6 MAY 1987

**CHANCELLOR**

cc Sir P Middleton
Sir T Burns
Mr Odling-Smee
Mr Sedgwick o/r
Mr Matthews
Mr Mowl

**OECD ECONOMIC OUTLOOK : COUNTRY NOTE ON UK**

You asked (Mr Kuczys' minute to Sir T Burns of 5 May) whether the OECD's figure of 3 per cent for the general government deficit as a proportion of GDP in 1986 is correct.

2. The OECD's figure is in line with the current published estimate for the general government deficit of £11.2 billion - 3.0 per cent of nominal GDP at market prices. The FSBR gave (in Table 6.7) an estimate of £11.3 billion for the general government financial deficit for financial year 1986-87.

3. The £11.2 billion general government financial deficit in calendar year 1986 compares with a general government borrowing requirement of £3.3 billion and a £2.2 billion public sector borrowing requirement in the same period. The main elements of the gap between the GGBR and GGFD are privatisation proceeds (about £3½ billion) and a £3 billion excess of cash receipts of taxes over estimated tax accruals. Cash receipts count toward reducing the borrowing requirement, but it is accruals that affect the financial deficit: the excess of receipts over accruals in 1986 reflects in part the "Keith" measures to speed up VAT payments but mainly advances in the timing of composite tax payments by building societies. It is worth adding that estimates of many of the elements of the financial deficit are very provisional at this stage.

SJD

**S J DAVIES**

sw21

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T.

CONFIDENTIAL
SAVING TELEGRAM

BY BAG
CONFIDENTIAL
FM FCO
TO UKDEL OECD TELNO 1 SAVING OF 8 MAY 1987
AND SAVING TO WASHINGTON, TOKYO, BONN, PARIS, ROME, OTTAWA, BRUSSELS, UKREP BRUSSELS, CANBERRA, VIENNA, COPENHAGEN, HELSINKI, ATHENS, REYKJAVIK, DUBLIN, LUXEMBOURG, THE HAGUE, WELLINGTON, OSLO, LISBON, MADRID, STOCKHOLM, BERNE, ANKARA
UKDEL IMF

**OECD: ECONOMIC POLICY COMMITTEE, 29 - 30 APRIL 1987**

Sir Peter Middleton, Sir T Burns and Mr Flemming (Bank of England) represented the UK at this meeting, which was chaired by Dr Sprinkel. Sir Geoffrey Littler attended on the afternoon of 29 April to present his account of recent discussions in Working Party 3.

<u>Summary</u>

2. A routine discussion of the economic policies and prospects of the three largest OECD economies in which the Japanese were particularly unhelpful and reluctant to give any significant details on the composition or effects of their recently announced package. The efforts of the G7 in the Louvre Agreement and subsequently to stabilise exchange rates were generally welcomed in the round of discussion on economic policy coordination, but there were considerable doubts about whether US and Japanese policies were adequate or sufficiently credible to convince markets that a period of exchange rate stability was justified.

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The meeting also welcomed the revised version of the Synthesis Report on Structural Adjustment and approved the EPC's conclusions on "Reform of Microeconomic policies" for transmission to the Ministerial meeting.

<u>Detail</u>

3. <u>Andersen</u> reported on the meeting of the short-term economic forecasters of the previous week. He noted that the only major differences between national forecasters and the OECD Secretariat had occurred in the cases of Japan, the United States and the UK. In all cases the national forecasts were more optimistic than those of the OECD. He noted that the short-term forecasters meeting had taken a positive view of the OECD's work on medium-term scenarios. In the margins of the meeting Sir Terence Burns gave the Secretariat a full briefing on the current position and prospects for the UK, and persuaded them to modify their views.

4. <u>Sprinkel</u> defended the US Administration's forecast and assured delegates that the Gramm-Rudman targets for the Federal budget deficit would be met by public expenditure cuts as proposed by the President. He asserted that tax increases would only encourage Congress to spend more. Sir Peter Middleton and others were sceptical about this, and Sprinkel had no satisfactory answer other than to appeal to the problems presented by the division of powers in the US.

5. The <u>Japanese</u> considered that the yen was now misaligned and over-valued, but without offering any evidence that current exchange rates would achieve a significant reduction in current imbalances. Despite pressure from Sir Peter Middleton and others, they gave few details of the content or effects of the proposed 5 trillion yen package. They said that the objective of medium-term consolidation of the central government budget was not being abandoned and had no convincing replies to offer to the wide-spread scepticism about how far the measures in the package would be genuinely new and additional.

6. Molitor (Germany) stressed the importance of maintaining medium-term macroeconomic framework and continuing structural reform. He considered that the slow growth in the last couple of quarters was essentially a temporary pause, and saw growth picking up again later in the year. Other delegates welcomed the tax cuts which the German Government had announced, but wondered whether it should do more. Several countries argued that the Germans needed to respond quickly and flexibly if the period of slow growth proved more durable.

Economic policy coordination

7. Sir Geoffrey Littler reported on the work of WP3. The June 1986 meeting had explored the concept of policy unsustainability (i.e. policies leading to a situation which could only be resolved by some major and damaging discontinuity) but had reached no substantive conclusions. The Working Party had therefore decided to investigate a number of historical episodes in more detail to see what general lessons could be learnt. Sir Geoffrey then summarised the discussion at the Working Party's meetings in December and March, which had examined medium-term scenarios prepared by the Secretariat. Despite the health warnings that needed to be attached to them, these scenarios were nevertheless useful in illustrating that the reduction of current imbalances could not rely either on exchange rate changes or on domestic policy changes alone. Virtually all members of WP3 had been persuaded of the serious damage done by exchange rate instability.

8. Norway drew attention to the continuing fall of the dollar. This suggested an unsustainable situation and that we were now experiencing a "market enforced adjustment". Markets lacked confidence in the announced policies of the US, Japan and Germany, and perhaps doubted whether they would in fact be carried out.

9. Australia considered that the Secretariat had not yet written down their forecasts sufficiently and could be under-stating the problem of slow growth. This made the need to strengthen demand in Japan and Germany more urgent. Both countries were proposing to act. In the case of the US though, the commitment to reducing



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the Federal budget deficit was unconvincing. The Netherlands made the same criticism of the US and stressed that international cooperation needed to be based on sound policies.

10. Milleron (France) was similarly critical of the US failure to make significant cuts in the budget deficit and noted that their commitments to make future reductions lacked credibility. He regarded the Japanese evasiveness about the effects of their forthcoming package as quite intolerable. He wondered whether the scope for action on monetary policy was as limited as some were claiming, in view of continuing high real interest rates at a time of low inflation and slow growth.

11. Dobson (Canada) feared that impatience with the rate of adjustments of current account imbalances could encourage protectionism and exchange rate over-shooting. She welcomed the policy announcements of the US, Japan and Germany, but thought that the OECD forecasts suggested that the German measures were insufficient. Italy as usual, was strongly critical of German policy.

12. Switzerland considered that the problems of imbalances and exchange rate instability stemmed from lack of policy convergence. Germany picked up this point and argued that there should be no major conflict between the policies needed or domestic and international stability.

13. Frenkel (IMF) considered that the cooperative strategy agreed by the G7 would help, but it would take time to reduce imbalances. He thought that the Louvre agreement indicated that policy makers in the major countries were looking for a more stable world. Markets, however, were telling them that they had not yet done sufficient to achieve this. He agreed with Sir Geoffrey Littler that fiscal, monetary and structural policy changes were all needed, and that all the major countries needed to act. Promises of action though needed to be credible, and in this respect he implicitly criticised Japan and the US.

14. Turning to monetary policy, he argued that it was impossible to have both stable exchange rates and sovereign monetary policy. It was generally agreed that intervention, in order to be effective, should be unsterilised and this implied a loss of domestic sovereignty. This raised the question of who should intervene. If only appreciating countries intervened then there was a risk of an excessive money supply boost, if only depreciating countries intervened then interest rates might be pushed up unduly. Coordination was therefore needed to control the world money supply.

15. After interventions by Denmark and Sweden, Sir Terence Burns gave his assessment of the discussion. The text of his remarks is annexed.

Structural adjustment

16. The Synthesis Report of the Secretary-General's study on Structural Adjustment was widely praised and the meeting approved the draft of the EPC's conclusions on "The Reform of Microeconomic Policies" endorsing the Report.

17. Sir Peter Middleton argued that governments' economic strategies needed to have both macro and micro aspects. Both needed to be pursued consistently over the medium-term. The difficulty with microeconomic policy though was that the costs of a change in policy tended to be immediate, while the gains occurred in the medium-term and were more widely spread. It was difficult for governments to appear to be confiscating "property rights" from some groups for a vague general national (or worse, international) good. Microeconomic policy reform thus tended to get delayed.

18. A similar situation occurred in international economic discussions where micro policy often got crowded out. It was essential to continue to pursue sound medium-term financial policies, but microeconomic policy reform to tackle the root causes of poor growth was also needed. There was an important international dimension to structural adjustment policies and he

considered that EPC should spend half its time on such issues. Both EPC and WP1 should follow up the Secretary-General's report in their future work programmes.

19. Switzerland considered that the Structural Adjustment report was excellent, but was concerned about the adequacy of the surveillance procedures being suggested in the EPC's conclusions on it. They thought that the EDRC might not be sufficiently well equipped to undertake the tasks suggested. They wondered whether it might be possible to set objectives, timetables etc as was done in the OECD codes for capital movements and invisible transactions. It was also important to look at structural adjustment in a wider international context, and this was a matter for EPC rather than the EDRC.

20. Casse (US) also stressed the need for the Secretariat to pursue their work on structural issues. Henderson (OECD) considered that it would be impossible for the Secretariat to reduce the amount of macro material prepared for the EPC, but thought that more use could be made of the work on structural issues being done by WP1. This work could be drawn on to facilitate a fuller and more systematic discussion of these issues in EPC.

21. Maldague considered that WP1 was more research based than EPC, but thought that they could try to generate more operational conclusions and could perhaps submit their future programme of work to EPC for its views. Sprinkel and the Canadians welcomed these ideas. Casse (US) wondered whether WP1 could help develop suitable methodologies for the EDRC to apply in its analysis of structural questions for the country surveys. These surveys could then provide the basis for a synthesis paper and discussion by EPC.

22. Finally, the Chairman read out his proposed report to the Ministerial meeting. No comments were offered by delegates. It was provisionally agreed that the next EPC meeting should be on November 16 - 17.

HOWE

MONETARY
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ANNEX.


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**REMARKS TO EPC 30 APRIL 1987**

**Chairman**

1. It has been a moderately depressing discussion. A lot of hand-wringing; a lot of frustration; a lot of anxiety, and a lot of puzzlement - as one delegate remarked "the world refuses to work in the way members of EPC think it should".

2. In my own mind I have tried to separate the worries. Although clearly interrelated there seem to be four strands of concern:

(i) overall performance of the major industrial economies has been disappointing in 1986 and is forecast to remain so over the next two years. This is despite the fall in oil prices and the dollar - both events which it was hoped would help sustain the recovery;

(ii) the persistence of current account imbalances and projections that they will continue into the medium term. This is combined with a fear that the three largest countries are not prepared to take the necessary policy actions to reduce those imbalances;

(iii) the fear that governments will do foolish things. The most obvious threat is increased protection. But there are also fears that the pressures of financial markets might provoke policy responses that could threaten recovery;

(iv) the fear that financial markets will do foolish things. We have seen huge movements in foreign exchange markets. Many of those who could never understand why the dollar rose to such dizzy heights fear we might see equally excessive dollar depreciation. Many worry that such an undershoot could cause inflation problems for the US and industrial problems for Germany and Japan.

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3. Like to comment on each of these worries.

**Disappointing Overall Performance**

4. Is there a problem with overall performance? A year ago many forecasters were looking to 3 per cent growth for the OECD in 1986 followed by 3 per cent plus in 1987. Now we are looking at 2½ per cent forecasts in 1986 to 1988. But whilst this may be disappointing it cannot be described as alarming; it would be a mistake to exaggerate the differences.

5. Of course, performance seems worse when we consider that fall in oil prices and correction of dollar were, if anything, expected to help. My own view is that, if anything, macro economic policy in aggregate in the main industrialised countries has remained a little on the tight side. As a result more of the gains have been taken in lower inflation, and less in the form of activity. And by contrast with some of the views expressed here I would point to monetary policy rather than fiscal policy. Despite the growth of monetary aggregates real interest rates have remained high; and commodity prices, having fallen sharply during 1986, have shown little recovery.

6. Even so I would not put much emphasis on the aggregate macro-stance for disappointing growth. The bulk of the problem seems to be the difficulties of adjusting to the large real price changes; oil prices, commodity prices, and currencies. In time these transitional problems should sort themselves out and I resist suggestions that we should respond by efforts to fine tune a policy response. The main lesson seems to be that large real price changes are damaging - in either direction, up or down.

7. So in aggregate I doubt if we need a major change to the overall approach; steadily disinflationary policy combined with policies to improve supply performance orientated towards the medium term remain the best combination on offer.

**Disappointing Current Account Imbalances**

8. Persistent current account imbalances and differences in performance between countries are more of a problem; largely because no-one seems to like them, markets, politicians, or voters.

9. I have argued here before that correction will take time. The imbalances built up over many years. During the five years or so of the dollar rise US domestic demand grew by 1 per cent per annum more than GDP. In Germany and Japan we had the mirror image. It will take time to unwind that process - several years of cumulative significant differences between domestic demand and GDP growth. Meanwhile we live with the familiar and predictable problems of the J-curve.

10. I think I am more optimistic than many that we will see some correction over the medium-term if we persist with present policies. The effects of exchange rate changes will build up to substantial effects.

11. But credibility will be helped if countries concerned are seen to be taking effective action. Many of the worries expressed here reflect a worry that despite all promises the US is not taking enough action on the budget. And each time we hear of a fudge on the arithmetic; a projection that is not delivered; and an explanation of why the twin deficits are unrelated, confidence is damaged.

12. There is also a worry that Japan and Germany are not sufficiently ambitious about the growth of domestic demand; and in the case of Japan that they are not prepared to open markets fast enough. I hope delegates will forgive me if I say that the Q and A sessions we had yesterday have not removed those worries. Personally I accept assurances that action is now being taken. It needs to be sustained.

13. I have an additional observation. Several comments have been made that recent exchange rate changes are taking longer than

expected to show results. Our own experience over the past 20 years has been that when exchange rate changes seem to be slow in having their effect on current account balances it is usually because other policies are not being sufficiently supportive of the exchange rate adjustment.

## Worry that countries will do foolish things

14. Undoubtedly much of the worry is not with the unchanged policy, unchanged exchange rate projections presented by the Secretariat. But the fear of the implications of policy adjustments and exchange rate changes. There is considerable alarm about protectionist threats to the US.

15. There is also a lot of resentment. In many people's view the current account imbalances are primarily the responsibility of the US. They pursued fiscal policy that was quite the opposite of the consensus. They not only watched the dollar rise but encouraged and applauded it. This dollar appreciation put pressures on other countries whose economies became more export orientated. Germany and Japan took advantage of these circumstances to reduce budget deficits, further encouraged by the high interest rates they faced.

16. It is now not good enough for the US to throw all the blame on the surplus countries. At the same time surplus countries need to recognise that they have experienced very low domestic demand growth in the first half of the 1980s. They have a lot of ground to make up. They adjusted policy in the face of the rising dollar and must now respond to the dollar fall.

## Worries that markets will do the wrong things?

17. Finally there is a lot of worry that markets will do the wrong things. They worry that we now face the serious danger of exchange rates overshooting in the other direction.

18. I feel we have to face the reality that the international monetary system has great difficulty in dealing with significant differences in the policy stance of member countries. The swings in exchange rates have been much bigger than many of us expected when the world embarked on floating exchange rates. These unpredictable swings in real exchange rates in turn have damaged performance of industrial countries.

19. One lesson is that we need greater policy compatibility. There is much truth in this. But it is difficult to be optimistic. Significant differences between countries in the framework being used have been revealed during these meetings. And even small differences can be quickly amplified by exchange rate movements.

20. The desire for greater exchange rate stability has been clearly shown in the Louvre agreement and the Washington discussions. But we have also seen that achieving it is far from simple.

21. If we will the ends we must will the means. Some countries, like the UK, have been trying for many years to take exchange rates into account in assessing monetary conditions. If we are to have greater exchange rate stability even the largest countries have to give an explicit weight to exchange rates in decisions about monetary policy. This also means giving less weight to domestic indicators. If we want to have greater exchange rate stability it has to be turned into suitable action. It won't be easy but minds have to be focussed on this challenge. Some of the unease round the table and in financial markets relates to worries that although the G3 say they want greater exchange rate stability there is some doubt about whether they are willing to take the necessary action.

22. Of course if industrial countries are to give greater weight to exchange rates then we must ensure that does not lead to an inflationary or deflationary bias for the G7 as a whole. This requires concentration upon behaviour of G7 in aggregate and a continuing assessment of their position in aggregate. It means

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monitoring global monetary behaviour, aggregate activity and inflation and aggregate monetary conditions generally. For example, only then can we tell whether differential movements of interest rates should be brought about by some rates rising or some falling or some combination of both.

23. We have reached the stage where there is increasing agreement about objectives; the next step is to be prepared to take the necessary action.

PPS 12/2 RD

DOMINIC HARROD - INTERVIEW ON OECD MEETING IN PARIS

Transcript from: BBC Radio 4, Today, 12 May 1987

INTERVIEWER: (..... .....) .... the OECD are meeting in Paris at the present moment and they're hoping to agree by Wednesday a communique on how to reduce world agricultural surpluses. But it seems that there's a row in the Club of 24, the 24 richest nations some people say, that compares the level of farm support in different countries. Some feel that they are being unfairly compared and will resist efforts to cut back too far. Well our economics editor, Dominic Harrod, is in Paris for the meeting - he's on the line now. Dominic, who feels most aggrieved?

HARROD: Well I think that this is a long running debate about who should put their house in order. And those who feel most aggrieved are those who are most out of line. And principally that's Germany, where the farmers of southern Germany receive very high subsidies per capita and per acre and however you measure it. They are one of the principal beneficiaries of the Common Agricultural Policy in the European Community and they don't want drastic change. What they particularly don't want are real price cuts in the products that they produce. And so they're against major reform. The other people who are against precipited (?) are the Japanese. And it's interesting to see in work that's been done by the OECD secretariate here that the Japanese have the largest support per hectare and per worker and so on than anybody outside the Common Market. They actually put an awful lot of money into Japanese agriculture. And indeed, something like half the total value of Japanese agricultural production is subsidy.

INTERVIEWER: But in a sense isn't Japanese agriculture somewhat, how shall I put it, idiosyncratic in that Japanese food tastes are rather different from the rest of the world's?

HARROD: Well their food tastes may be different but that doesn't say that they couldn't eat the rice that's produced all round them in Asia - as it is rice in Japan costs 6 or 7 times as much to the consumer as (sic) if they participated in the world market. That is to protect the Japanese rice farmer at perhaps the expense of the Asian rice farmer next door.

INTERVIEWER: How far will this spat over agriculture spill into other discussions on say trade, particularly the looming trade war that everybody's talking about?

HARROD: Well I think that they're slightly distinct. In a sense the agriculture problem has been one that's been worrying people like Sir Geoffrey Howe, who's coming out here later in the day for the British Government and who's been an enthusiastic proponent of reform in agriculture. We shall be interested to see how sharp his enthusiasm is for reduced subsidies in the run up to an election. But never mind that. But I think that the trade thing is something perhaps that's cropped up more recently than the worries about agriculture, particularly obviously over the US and Japanese confrontation over micro chips. And then yet another one popped up yesterday when the Ministers were talking about energy matters. We the British are very concerned lest the Americans start putting duties on imported oil, oil imported into the United States because we from the North Sea supply quite a lot of that oil. The American Government says of course it wouldn't dream of doing such a thing but it doesn't have the control of the Congress at the moment. So when we're talking about trade wars and the potential for trade deterioration we're not just looking at the policies of Governments who are of course in favour of motherhood, apple pie and free trade but we're looking beyond them to Parliaments and protectionist movements in countries which may be looming at the moment.

INTERVIEWER: Sounds as if you're in for a lively time, or as lively a time as 24 nations talking about economics can ever be.

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C2/003

UNCLASSIFIED

FROM: MISS J L CAMP
DATE: 12 MAY 1987

CP

MRS J DAVIES

**OECD ECONOMIC OUTLOOK: COUNTRY NOTE ON UK**

The Chancellor has seen and was gratefulf or your minute of 6 May.

Janet Camp
MISS J L CAMP

X Lack of commitment from Baker's pos.n for some time, but he has run up against Presidential veto. ([illegible] suggestion [illegible] PM [illegible] N Lawson [illegible] with Reagan himself).

1. Copy to - Mr Bone w/Tom - Mr Gillmore
2. Mr Crompton Mr Hipson

13/5/87.

Copy
PS/Chancellor
Sir G. Littler
Mr Evans
Mr H. Walsh
(all Treasury)
13.5. PS/Sir R. Armstrong
Mr Broadbent

Mr Fowler, NAD

## Secretary of State's Meeting with Mr Baker

The Secretary of State had a brief informal word with Mr Baker in the margins of the OECD Ministerial Conference yesterday.

### Sub-Saharan Africa

The Secretary of State said that he had heard from the Chancellor that Mr Baker had told him that he would not stand in the way of the Chancellor's initiative on Sub-Saharan Africa. He believed that Paris Club interest rates concessions might be the best way forward. Several Sub-Saharan countries were virtually insolvent, and without concessions overall debt would continue to mount dramatically. Cutting interest rates was only a matter of accepting reality. Since this required no major institutional changes it ought to be possible to reach an agreement relatively quickly through the Paris Club.

However US support for the scheme would be essential to ensure equitable burden sharing and to persuade other creditors such as Germany and Japan to join in. African expectations were now raised, and we hoped that the Americans could reconsider their position so that the Summit could take the matter forward.

Mr Baker replied that he was worried by the push the French were currently giving to their own scheme, which he thought was much more wide-ranging than ours and too open-ended. The US was prepared to consider going along with our scheme vis a vis the poorest Sub-Saharan countries through the Paris Club. He wanted to keep closely in touch with the Chancellor on this.

/ G5/G7

G5/G7

The Secretary of State also mentioned the prospect of a G5/7 meeting at the Venice Summit. Mr Baker agreed that it would be quite inappropriate to hold one: he had sent a message to Goria, who had been anxious to hold a dinner. There was simply no time to prepare for this.

OECD Budget

The Secretary of State raised the question of the OECD budget. Baker and Alan Wallace, who was also present, shuffled their feet somewhat, seemed to disagree on whether it was State Department or Treasury money, and put the blame squarely on Congress. They confirmed that George Shultz was anxious that the money should be available for OECD, which they regarded as the best international organisation. But they said they could not offer any guarantee.

Bankers Trust

The Secretary of State raised this subject, stressing our interest in securing the future of the Eurodollar market. Mr Baker agreed that our interests were very close, and that experts should discuss the problem. The US had been looking for an expert witness: was there no help that we could give in this respect? They were only looking for a witness to give evidence on extremely narrow issues not on the broad position: this ought to be compatible with both our positions. The Secretary of State said that we were not standing in the way, but did not think we could give any positive help. He derived the impression from Mr Baker that the Americans might now have an expert witness lined up.

Structural Adjustment

Wallace said that he was plotting to get the President to raise the question of Structural Adjustment at Venice. If the President agreed to do so, he hoped that the Prime Minister would support him.

/US Budget Deficit

US Budget Deficit

The Secretary of State stressed the importance of cutting the budget deficit. Mr Baker said that it looked as if things might turn out better in Congress than had at one time seemed likely. The problem was that most of the pressure would fall on the overseas element of the budget. His own view was that an increase in taxation was likely to be inevitable. He mentioned the case for a gasoline tax. In general he spoke more positively about the case for increased taxation than the Secretary of State can recall any other senior US official doing.

X

(A C Galsworthy)

13 May 1987

cc: PS/Mrs Chalker
PS/Mr Patten
Mr Braithwaite
Mr Maud
Mr Munro
NENAD
ERD

ps3/39K

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CP

FROM: A W KUCZYS
DATE: 18 May 1987

SIR G LITTLER

cc Mr H P Evans
Mr Walsh

PS/Foreign Secretary
(Mr Galsworthy)

The Chancellor has seen Tony Galsworthy's note of the Foreign Secretary's meeting with Secretary Baker in the margins of OECD last week. In particular he has noted Secretary Baker's view that an increase in taxation was necessary.

2. The Chancellor has commented that this has been Baker's position for some time, but he has run up against a Presidential veto. (Hence the suggestion that the Prime Minister might have a word with Reagan herself.)

AWK

A W KUCZYS

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FROM: **P N SEDGWICK**
DATE: 27 MAY 1987[

**CHANCELLOR**

Ch
This is probably as good as we'd get, though not as good as we'd have liked.
The worry about pressing further is that unsympathetic people in OECD might run "Treasury leans on OECD" stories.
AA

cc Sir P Middleton
Sir T Burns
Mr Evans
Mr Turnbull
Mr Bottrill
Mr Culpin
Mr Davies
Mr Mowl
Miss O'Mara
Mr Matthews
Mr Allum

Thanks. {per para 3 (+ X: growth IFIs + mortgage, and inc.)

**OECD ECONOMIC OUTLOOK : COUNTRY NOTE ON UK**

In his minute to Sir T Burns of May (copy attached) Mr Kuczys recorded your wish to see the redrafted version of the country note on the UK to be published in the Economic Outlook on June 19. You will recall that Sir T Burns handed over to the Secretariat a version of the chapter with extensive suggested changes to the draft together with a separate note by us containing critical comment on the analysis, numbers, and drafting of the OECD document.

2. We have now received the revised version (copy attached). The OECD Secretariat have on the whole taken a good deal of account of comments on the tone of the text, particularly when dealing with the policy stance. On the other hand the forecast numbers have not changed much, other than for the current account. The summary table attached illustrates this point. (The technique of the OECD - and others belonging to the pessimistic school of forecasters, such as the NIESR in their Review to be published ~~tomorrow~~ tonight - in the face of fairly encouraging economic news appears to be to put~~t~~ off adverse developments until the following year.)

3. I have spoken to Sir T Burns about the handling of the OECD Secretariat redraft. Our view is that little would be gained by putting more pressure on the Secretariat to change the aspects of the material on the UK's policy stance and on prospects with which we disagree. There are, however, a few errors of fact that the Secretariat would probably correct. (There are errors in paragraphs 1 and 7 on changes in public expenditure in real terms in 1985 and 1986 and in paragraph 14 on housing starts.) We propose to let them have a (short) list of these.

+ para 12 on bank lending for consumption? X

P.N.S
P N SEDGWICK

## OECD ECONOMIC OUTLOOK FORECASTS

(i) GDP (constant market prices.) (percentage change on year earlier)

| | December 86 Outlook | April 87 draft | May 87 draft |
|---|---|---|---|
| 1987 | 2¾ | 3¼ | 3¼ |
| 1988(H1) | 2 | 2¼ | 2¼ |
| 1988 | not published | 2¼ | 2¼ |

(ii) Inflation (market price GDP deflator, percentage change on year earlier)

| | December 86 Outlook | April 87 draft | May 87 draft |
|---|---|---|---|
| 1987 | 4¼ | 4¾ | 4½ |
| 1988(H1) | 5¼ | 5¾ | 5½ |
| 1988 | not published | 5¾ | 5½ |

(iii) Current Balance ($ billion)

| | December 86 Outlook | April 87 draft | May 87 draft |
|---|---|---|---|
| 1987 | -4¾ | -6½ | -2½ |
| 1988(H1)* | -8½ | -8 | -5 |
| 1988 | not published | -7¾ | -6 |

*at an annual rate

5/2/2/3

**UNITED KINGDOM**

**Key features**

1. The United Kingdom is enjoying continued expansion, with output growth in 1987 projected to exceed that for most other Member countries. Oil production, representing about 6 per cent of total output, levelled off in 1986, but the fall in oil prices has resulted in a switch in profitability towards energy-using companies and a substantial real income gain for consumers. In addition, consumers reduced their saving rate despite the windfall gains from lower energy prices. In view of the damping effect of oil prices on inflation and the need for some real exchange rate adjustment, the exchange rate was allowed to fall further. In the second half of 1986, export growth accelerated sharply, assisted by the depreciation of sterling since mid-1985. At the same time, domestic demand was supported by higher public expenditure on goods and services, reversing the decline in real terms in 1985.

2. Despite some overshooting of public spending targets and sharp falls in oil revenues, the rise in the general government deficit (on a national accounts definition), to about 3 per cent of GDP in 1986, was relatively modest thanks to buoyant non-oil tax receipts. The FY 1986/87 Public Sector Borrowing Requirement (PSBR) dropped to about 1 per cent of GDP, partly because of an increase in public asset sales corresponding to 1/2 per cent of GDP. The Medium Term Financial Strategy (MTFS), as set out in the March 1987 Budget, aims at maintaining the PSBR stable in relation to GDP. Public expenditure is planned to decline as a proportion of GDP, leaving room for further reductions in taxation. Taking account of privatisation proceeds and the economic cycle, this points to a declining fiscal boost to the economy. Economic policy continues to be set in a nominal income framework with the intention of bringing down inflation by a gradual reduction in the growth of nominal GDP. The target projections for the latter are now a little higher than those shown in last year's MTFS. While recognising that a declining path for nominal GDP growth requires firm monetary policies, the authorities have dropped the formal target for broad money, due to increasing difficulties in interpreting its development. The narrow money target range for 1987 has been maintained; target ranges for the later years are intended to be gradually lowered in line with the projected path for nominal GDP growth. The exchange rate continues to be taken into account in assessing monetary conditions. The 1987 MTFS refers to the G6 agreement of last February, and the authorities have indicated that they aim at a stabilisation of exchange rates at current levels which they consider satisfactory.

G7, now!

3. On the basis of these policies and the technical assumptions of unchanged oil prices and exchange rates, the growth of activity is projected to decelerate in the period ahead. In 1987, however, real GDP growth should exceed 3 per cent, with the revival of business investment following upon that of private consumption and exports. Unemployment is likely to fall somewhat, continuing the downward trend since mid-1986. The fall in the unemployment

rate, stemming in part from special employment measures so far, may increasingly reflect the sustained strength of the upturn. Inflation is projected to accelerate somewhat. The external balance is likely to turn again into deficit, following the improvement in recent months.

4. The balance between real growth and inflation has tended to deteriorate with inflation likely to slightly exceed the OECD average over the next eighteen months. So far the pick-up in inflation has mainly reflected the rise in import prices, which should slow down, under the technical assumption of constant exchange rates. Substantially more rapid wage increases than in other countries, however, are likely to remain a fundamental problem. The rise in unit labour costs, which has decelerated markedly in recent months, is likely to pick up again, in particular if the cyclical acceleration of productivity growth is reversed. Any resulting deterioration in competitiveness is bound to affect export performance over the medium run.

Recent trends

5. Growth in the average measure of real GDP, which had dropped to an annual rate of 1 per cent in the final quarter of 1985, accelerated sharply in 1986, to reach an annual rate of 3 1/2 per cent by the end of the year, when the level of activity was about 17 per cent higher than at its cyclical trough in 1981. Taking 1986 as a whole, real GDP growth may have been a little more than 2 1/2 per cent (or 2 per cent if allowance is made for the direct effects of the 1984/85 coal dispute). Output of service industries increased by nearly 4 per cent, about the same as energy output, while output in manufacturing rose little in 1986 on average but showed a marked revival through the year. Subsequent to a weather-induced setback in early 1987, manufacturing production has again picked up markedly. //

6. Consumer spending was the main source of expenditure growth in 1986, supported by a strong rise in real incomes and a further fall in the saving ratio. Expenditure on durable goods grew by 9 per cent, twice as fast as total private consumption. In the latter part of 1986 and into 1987, growth of real consumer demand appears to have paused. Public consumption, which had declined in real terms during 1985, picked up through 1986. Despite higher public investment and rapid growth in private residential investment, fixed capital formation showed little change in 1986, the poorest performance since 1981. This unexpected weakness reflected only in part the reduction of North Sea oil investment. Non-oil business investment, too, failed to recover, despite a further improvement in company profits (while total profits fell by 7 1/2 per cent, those of non-oil companies rose by 14 per cent). To some extent, weak investment performance can be explained by changes in taxation. The 1984 corporate tax reform provided a strong inducement to accelerate investment programmes, and the recent weakness of manufacturing investment included a sharp fall in the contribution of leasing, following the abolition of first year allowances from April 1986. Stockbuilding fell in 1986; this was partly a consequence of the strength of consumer demand, but also in line with the falling trend of the stock/output ratio in recent years.

7. Export growth accelerated sharply in the latter half of 1986 with export performance helped by exchange-rate-induced improvements in competitiveness. Exports of manufactures grew by 6 percentage points more than markets, largely recuperating the losses in market shares over the preceeding year. Import

growth accelerated earlier and considerably more than export growth (due possibly to a less marked improvement in price competitiveness on internal markets) so that the real foreign balance acted as a drag on production. Negative net exports coupled with deteriorating terms of trade, due mainly to the oil price fall but partly also to the depreciation of sterling, led to a large swing in the current account into deficit. However, the non-oil external deficit changed little in 1986, since the deterioration in the non-oil trade balance was largely offset by a higher invisibles surplus, notably in net investment income. In the first quarter of 1987, merchandise imports dropped markedly while exports almost remained at previous high levels; together with a reversal in terms-of-trade trends, this is estimated to have resulted in a swing of the current balance back into surplus.

8. Inflation has picked up again in recent months, reflecting the rise in import prices. Between mid-1986 and March 1987 industry's material and fuel costs rose by 4 1/2 per cent and the year-on-year increase in the retail price index accelerated from 2.4 per cent to 4 per cent (excluding mortgage interest rates and seasonal food prices from 3 to 3 3/4 per cent). Despite indications that wage settlements have come down somewhat, earnings have hardly reacted to the fall in inflation in 1986. The underlying annual rate of growth of average earnings is estimated to have remained virtually unchanged at around 7 1/2 per cent since mid-1984, resulting in an increase in real wages of 4 per cent in 1986. In response to stronger activity growth, the rise in the employed labour force reaccelerated in the second half of 1986, reflecting a further increase in service industries' employment and a slower decline in manufacturing employment. With the growth in the total labour force apparently decelerating, the upward trend in unemployment since 1980 seems to have been reversed. From mid-1986 to March 1987, the unemployment rate (seasonally adjusted, excluding school leavers) fell by 3/4 percentage points to about 11 per cent of the working population. Part of the drop in unemployment reflected additional special employment measures.

Policies

9. The outturn for the PSBR for 1986/87 is estimated to have been £3.3 billion (less than 1 per cent of GDP), some £3 1/2 billion less than predicted in the March 1986 Budget. This compares with an outturn of £5.8 billion or 1.6 per cent of GDP in 1985/86. The favourable outturn for 1986/87 was achieved in spite of a sharper-than-expected fall in oil revenues (by about £7 billion). Other tax revenues ran much higher than the 1986 Budget forecast, with non-North Sea corporation tax accounting for the bulk of the additional receipts. The reasons for this surge in corporate taxes are not clear, as the recorded rise in profits would seem to be insufficient to explain the outcome. One possibility is that the effect of the change in investment allowances resulting from the 1984 corporate tax reform has been significantly underestimated. On the expenditure side there was considerable overspending in the areas of social security and local authority current spending. Public asset sales, which are counted as negative expenditure, appear to have almost met the projections, which were for a doubling of privatisation proceeds (to more than 1 per cent of GDP). After allowing for drawings from the reserve, the public expenditure planning total seems to have been overshot by less than 1 per cent. An improvement in the financial position of public corporations also reduced the PSBR in 1986/87.

10. The March 1987 Budget projections are for a PSBR of £4 billion, significantly below the previous target. The decision to set public borrowing at about the level expected for 1986/87 at Budget time meant tax adjustments limited to about the amount foreshadowed in the 1986 MTFS; higher-than-expected revenues are balanced by extra expenditure. The Budget provides for tax reductions (beyond indexation) of £2 1/2 billion, mainly in the area of income tax. The basic rate of personal income tax is cut by 2 points to 27 per cent. Small companies' rate of corporation tax is reduced accordingly but the main corporate rate remains unchanged at 35 per cent. Spending plans are unchanged from those in the Autumn Statement and the Public Expenditure White Paper, which raised the previous planning total by 3 per cent. While the oil price assumption of £15 per barrel underlying the revenue estimates is very cautious, expenditure targets may be put under pressure again, given past experience, although falling unemployment may lessen pressure on social security spending. In particular, public sector pay could grow more than implied by the Budget projections. Hence, the contingency reserve, which is lower than in 1986/87, is expected to be fully spent, and some overshoot of the planning total may occur again but probably not such as to reverse the downward trend in public spending as a proportion of GDP. Public spending plans for 1988/89 are for a sharp deceleration in volume growth. The authorities have made it clear that further tax cuts are dependent on the success in controlling public expenditure. The PSBR is intended to be kept stable as a proportion of GDP for the rest of the decade.

11. Within the framework of the MTFS, there have been further shifts of emphasis. As noted, the broad money target has been suspended. The target range for narrow money (M0) growth in 1987 has been kept unchanged at 2 to 6 per cent, and a gradual reduction to a range of 0 to 4 per cent by 1990 is envisaged. Underlying growth of M0 significantly outside its target range would lead the authorities to change short-term interest rates, unless other indicators, including broad money and the exchange rate, suggest that monetary conditions remain satisfactory. The authorities have indicated that the current level of the exchange rate is satisfactory in present circumstances and that they would aim at broad exchange rate stability, co-operating closely with the other countries represented at the Louvre meeting of last February.

12. M0 growth edged up at the turn of the year but has fallen back towards the middle of its target range more recently. £M3 has displayed an opposite pattern, moderating somewhat and picking up again thereafter; expanding by about 19 per cent in the twelve months to March, it overshot the target range for the financial year 1986/87 by a wide margin. Bank lending, in particular for consumption, has remained high. After the disturbances which led to higher interest rates in October, financial sentiment has gradually improved, reflecting developments in the oil market and the more favourable short-term outlook for the domestic economy. As a result, sterling was hardly affected by the turbulence in the foreign exchange markets early this year and has tended to appreciate recently. Given the rapid growth in bank lending and the initially muted reaction of the exchange rate to the rising oil price, the authorities adopted a cautious approach to cuts in interest rates but finally allowed them to fall. From March to May, banks' base rates were reduced in four steps to 9 per cent and are now below the pre-October level.

?? Is this true

## Prospects

13. The present forecast is based on the assumption of unchanged oil prices and effective exchange rates as from April. Compared with Economic Outlook 40, both are now considerably higher. Some tightening of policies is assumed, with public expenditure growth decelerating and interest rates edging up somewhat in line with international developments. This would seem to be consistent with both a constant exchange rate and a gradual deceleration in monetary growth. After a marked improvement in the course of 1986, the competitive position is likely to deteriorate a little, as unit labour costs in the United Kingdom are projected to increase faster than abroad. Hence, export market gains are likely to decrease and possibly be reversed. Export growth is projected to slow down progressively, although the growth of markets for manufactures is expected to accelerate -- from an annual rate of 3 per cent in the first half of 1987 to 4 1/2 per cent by the end of the projection period.

14. Growth in domestic demand is likely to remain strong this year but to slow somewhat in 1988 when the projected revival of business investment and restocking may no longer compensate for the expected deceleration in the expansion of private and public consumption. As noted above, private non-residential investment remained weak until the end of 1986. But intention surveys point to a marked pick-up early this year and into 1988. The capital/output ratio may now be relatively low, following a period of weak investment, and profitability and output expectations have further improved. However, the growth in business capital spending may decelerate towards the end of the projection period influenced by less buoyant export expectations and lower profitability. Growth in residential investment is projected to slow down in the period ahead, given the levelling-off in housing starts. Public investment should decline, according to Budget plans. Stockbuilding is expected to temporarily accelerate after the marked drop in the stock/output ratio last year. Budget plans point to slower growth in public consumption, following the rapid expansion in the recent period. Private consumption is also likely to grow at a slower pace, as higher inflation erodes personal income gains, although the weakening in consumer spending may be damped by some further decline in the saving ratio. Real GDP growth is projected to fall short of that of domestic demand, decelerating gradually in the period ahead.

X 9 11

15. Unemployment is expected to continue to decline, with its fall, however, likely to decelerate in the course of 1988. Inflation is projected to remain above the OECD average. The inflationary effect of recent increases in import prices should diminish, while the increase in unit labour costs is projected to reaccelerate from recent low levels, as productivity growth slows down. Given the forecast decline in real net exports, the current account deficit is expected to show a rising trend, somewhat mitigated by a positive evolution of the terms-of-trade.

UNITED KINGDOM
PERCENTAGE CHANGES, SEASONALLY ADJUSTED AT ANNUAL RATES
(1980 PRICES)

| TABLE 1 | 1982 CURR.PRICES MILL £ | % GDP | 1986 | 1987 | 1988 | 1986:1 | 1986:2 | 1987:1 | 1987:2 | 1988:1 | 1988:2 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **A.DEMAND AND OUTPUT** | | | | | | | | | | | |
| PRIVATE CONSUMPTION | 167.4 | 60.4 | 4.7 | 3.9 | 3.5 | 4.4 | 5.1 | 3.1 | 4.1 | 3.4 | 3.0 |
| GOVERNMENT CONSUMPTION | 60.5 | 21.8 | 1.2 | 1.6 | 1.1 | 0.4 | 3.9 | 0.7 | 1.1 | 1.1 | 1.1 |
| GROSS FIXED INVESTMENT | 44.7 | 16.1 | 0.6 | 2.8 | 3.4 | 2.2 | 0.2 | 3.0 | 5.3 | 3.5 | 1.6 |
| FINAL DOMESTIC DEMAND | 272.5 | 98.4 | 3.2 | 3.2 | 3.0 | 3.2 | 4.0 | 2.6 | 3.7 | 3.0 | 2.4 |
| STOCKBUILDING (A) | -1.3 | -0.5 | -0.0 | 0.1 | 0.1 | 0.3 | -0.3 | 0.3 | 0.2 | 0.0 | 0.0 |
| TOTAL DOMESTIC DEMAND | 271.2 | 97.9 | 3.2 | 3.3 | 3.1 | 3.5 | 3.6 | 2.9 | 3.8 | 3.0 | 2.4 |
| EXPORTS OF GOODS&SERVICES | 73.1 | 26.4 | 3.0 | 4.5 | 1.5 | 1.2 | 11.2 | 2.7 | 1.8 | 1.5 | 1.4 |
| IMPORTS OF GOODS&SERVICES | 68.1 | 24.6 | 5.8 | 4.4 | 4.3 | 2.0 | 18.1 | -2.0 | 5.3 | 4.2 | 3.5 |
| FOREIGN BALANCE (A) | 4.9 | 1.8 | -0.8 | 0.0 | -0.8 | -0.2 | -1.7 | 1.4 | -1.0 | -0.9 | -0.6 |
| COMPROMISE ADJUSTMENT (A) | 0.9 | 0.3 | 0.3 | 0.0 | 0.0 | -0.6 | 1.7 | -0.8 | 0.0 | 0.0 | 0.0 |
| G.D.P. AT CONSTANT PRICES(B) | | | 2.7 | 3.3 | 2.2 | 2.6 | 3.5 | 3.4 | 2.8 | 2.2 | 1.9 |
| G.D.P. PRICE DEFLATOR | | | 3.7 | 4.6 | 5.4 | 2.1 | 3.7 | 4.7 | 5.4 | 5.4 | 5.3 |
| G.D.P. AT CURRENT PRICES | 277.0 | 100.0 | 6.5 | 8.0 | 7.7 | 4.8 | 7.3 | 8.2 | 8.3 | 7.7 | 7.2 |
| **B. MEMORANDUM ITEMS** | | | | | | | | | | | |
| PRIVATE CONSUMPTION DEFLATOR | | | 3.7 | 3.9 | 4.4 | 3.6 | 2.9 | 4.2 | 4.1 | 4.5 | 4.6 |
| MANUFACTURING PRODUCTION | | | 0.8 | 4.3 | 3.2 | -1.1 | 6.0 | 3.6 | 4.0 | 3.1 | 2.5 |
| BREAKDOWN OF GROSS FIXED INVESTMENT | | | | | | | | | | | |
| PUBLIC SECTOR | 11.3 | 4.1 | 1.9 | -1.8 | -0.8 | 9.0 | -9.5 | 1.9 | -0.8 | -0.8 | -0.8 |
| PRIVATE SECTOR | 33.4 | 12.1 | 0.2 | 4.2 | 4.6 | 0.4 | 3.2 | 3.3 | 7.0 | 4.6 | 2.2 |
| RESIDENTIAL | 6.4 | 2.3 | 13.2 | 8.5 | 2.0 | 10.0 | 27.7 | 3.1 | 2.9 | 1.9 | 1.6 |
| NON-RESIDENTIAL | 27.0 | 9.7 | -2.6 | 3.1 | 5.3 | -1.7 | -2.2 | 3.3 | 8.1 | 5.4 | 2.4 |
| TOTAL EMPLOYMENT | | | 0.5 | 1.1 | 0.9 | 0.3 | 0.9 | 1.2 | 1.1 | 0.9 | 0.8 |
| UNEMPLOYMENT RATE | | | 11.3 | 11.2 | 10.9 | 11.9 | 11.7 | 11.4 | 11.1 | 10.9 | 10.8 |
| STOCKBUILDING AT 1980 PRICES ACTUAL RATES(MILL £) | | | 564.0 | 790.0 | 990.0 | 393.0 | 171.0 | 340.0 | 450.0 | 490.0 | 510.0 |

A)THE YEARLY AND HALF-YEARLY RATES OF CHANGE REFER TO CHANGES EXPRESSED AS A PERCENTAGE OF GDP IN THE PREVIOUS PERIOD
B)GDP ON A COMPROMISE BASIS . AVERAGE OF THE EXPENDITURE, OUTPUT AND INCOME ESTIMATES OF GDP .

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# UNITED KINGDOM
## COSTS AND PRICES

PERCENTAGE CHANGES - ANNUAL RATE

| TABLE 5 | 1986 | 1987 | 1988 | 1986:1 | 1986:2 | 1987:1 | 1987:2 | 1988:1 | 1988:2 |
|---|---|---|---|---|---|---|---|---|---|
| WAGE RATE | 8.4 | 7.9 | 7.3 | 7.9 | 8.5 | 7.8 | 7.5 | 7.2 | 7.3 |
| TOTAL COMPENSATION PER EMPLOYEE | 7.9 | 7.4 | 7.0 | 7.2 | 7.6 | 7.4 | 7.2 | 7.0 | 7.1 |
| LABOUR PRODUCTIVITY | 2.1 | 2.2 | 1.3 | 2.3 | 2.6 | 2.2 | 1.7 | 1.2 | 1.0 |
| UNIT LABOUR COSTS | 5.1 | 4.9 | 5.6 | 5.0 | 4.0 | 5.1 | 5.4 | 5.6 | 5.9 |
| PRIVATE CONSUMPTION DEFLATOR | 3.7 | 3.9 | 4.4 | 3.6 | 2.9 | 4.2 | 4.1 | 4.5 | 4.4 |
| GOVERNMENT CONSUMPTION DEFLATOR | 6.5 | 6.0 | 6.0 | 9.4 | 3.8 | 7.0 | 6.3 | 6.0 | 5.8 |
| TOTAL FIXED INVESTMENT DEFLATOR | 6.0 | 6.1 | 6.0 | 5.5 | 6.3 | 6.0 | 5.9 | 6.1 | 5.9 |
| GOVERNMENT INVESTMENT DEFLATOR | 2.7 | 4.6 | 5.3 | 3.1 | 1.8 | 5.5 | 5.5 | 5.4 | 4.9 |
| RESIDENTIAL CONSTRUCTION DEFLATOR | 6.7 | 7.4 | 7.5 | 6.3 | 7.4 | 7.4 | 7.4 | 7.5 | 7.4 |
| BUSINESS FIXED INVESTMENT DEFLATOR | 6.4 | 5.8 | 5.7 | 6.0 | 6.2 | 5.7 | 5.5 | 5.8 | 5.7 |
| F.D.D. DEFLATOR | 4.7 | 4.7 | 5.0 | 5.1 | 3.7 | 5.1 | 4.8 | 5.0 | 4.9 |
| T.D.D. DEFLATOR | 4.8 | 4.6 | 5.0 | 4.8 | 4.3 | 4.7 | 4.9 | 5.0 | 4.9 |
| EXPORT DEFLATOR | -7.1 | 2.9 | 3.7 | -8.5 | -3.7 | 6.3 | 3.0 | 3.9 | 4.0 |
| IMPORT DEFLATOR | -3.6 | 3.1 | 2.6 | 0.9 | -1.2 | 5.9 | 1.8 | 2.8 | 2.9 |
| G.D.P. DEFLATOR | 3.7 | 4.6 | 5.4 | 2.1 | 3.7 | 4.7 | 5.4 | 5.4 | 5.3 |
| MEMORANDUM ITEMS | | | | | | | | | |
| ========== ===== | | | | | | | | | |
| HOURLY EARNING IN MANUFACTURING | 7.6 | 7.6 | 7.3 | 7.5 | 7.7 | 7.7 | 7.6 | 7.3 | 7.3 |
| UNIT LABOUR COSTS IN MANUFACTURING | 3.4 | 2.6 | 4.8 | 6.7 | 0.5 | 2.7 | 4.4 | 4.9 | 5.1 |
| REAL TOTAL COMPENSATION PER EMPLOYEE | 3.9 | 3.4 | 2.6 | 3.5 | 4.5 | 3.0 | 2.9 | 2.4 | 2.6 |
| REAL LABOUR COSTS | 3.9 | 2.7 | 1.6 | 5.0 | 3.7 | 2.6 | 1.7 | 1.5 | 1.7 |
| TERMS OF TRADE | -3.7 | -0.1 | 1.1 | -9.3 | -2.5 | 0.4 | 1.2 | 1.1 | 1.1 |

UNITED KINGDOM
APPROPRIATION ACCOUNT FOR HOUSEHOLDS

PERCENTAGE CHANGES

| TABLE 3 | 1982 BILL £ | 1986 | 1987 | 1988 |
|---|---|---|---|---|
| COMPENSATION OF EMPLOYEES | 158.4 | 7.8 | 8.4 | 8.0 |
| INCOME FROM PROPERTY AND OTHERS | 48.3 | 8.9 | 6.5 | 6.1 |
| CURRENT TRANSFERS RECEIVED | 36.5 | 7.7 | 4.9 | 5.2 |
| LESS: INTEREST ON CONSUMER DEBT | | | | |
| TOTAL INCOME | 243.2 | 8.0 | 7.5 | 7.2 |
| LESS: DIRECT TAXES | 31.5 | 8.4 | 5.8 | 4.7 |
| CURRENT TRANSFERS PAID | 19.6 | 6.6 | 6.8 | 6.8 |
| DISPOSABLE INCOME | 192.1 | 8.1 | 7.8 | 7.6 |
| CONSUMERS' EXPENDITURE | 167.4 | 8.6 | 7.9 | 8.0 |
| SAVINGS RATIO | 12.9 | 11.0 | 10.9 | 10.7 |
| REAL DISPOSABLE INCOME | | 4.3 | 3.8 | 3.1 |

# UNITED KINGDOM

## APPROPRIATION ACCOUNT FOR GENERAL GOVERNMENT

(INCLUDING SOCIAL SECURITY)

BILL./L STG.

| TABLE 4 | 1984 | 1985 | 1986 | 1987 | 1988 |
|---|---|---|---|---|---|
| **RECEIPTS:** | | | | | |
| A.DIRECT TAXES | 46.9 | 51.7 | 52.9 | 55.3 | 58.3 |
| OF WHICH ON HOUSEHOLDS | 34.9 | 38.3 | 41.5 | 43.9 | 46.0 |
| B.SOCIAL SECURITY CONTRIBUTIONS | 22.3 | 24.3 | 25.8 | 27.6 | 29.5 |
| D.INDIRECT TAXES | 52.5 | 56.8 | 61.6 | 66.6 | 71.2 |
| E.PROPERTY AND ENTREPRENEURIAL INCOME | 12.7 | 14.3 | 12.8 | 12.4 | 11.7 |
| F.CURRENT RECEIPTS/TOTAL | 134.4 | 147.0 | 153.1 | 161.9 | 171.2 |
| **DISBURSEMENTS:** | | | | | |
| G.GOVERNMENT CONSUMPTION | 69.3 | 74.1 | 79.3 | 86.0 | 92.2 |
| OF WHICH WAGES AND SALARIES | 41.3 | 43.8 | 46.6 | 50.1 | 53.7 |
| H.PROPERTY INCOME PAYABLE (INTEREST ON PUBLIC DEBT) | 15.7 | 17.5 | 17.2 | 17.4 | 18.1 |
| I.SUBSIDIES | 7.7 | 7.7 | 6.8 | 6.6 | 6.5 |
| J.SOCIAL SECURITY OUTLAYS | 42.7 | 46.4 | 49.9 | 52.4 | 55.1 |
| K.OTHER CURRENT TRANSFERS PAID | 2.2 | 3.2 | 2.0 | 2.0 | 2.0 |
| L.CURRENT DISBURSEMENTS/TOTAL | 138.2 | 148.9 | 155.7 | 164.3 | 173.8 |
| M.SAVING(F-L) | -3.7 | -1.8 | -2.6 | -2.4 | -2.6 |
| N.GROSS INVESTMENT | 6.5 | 6.6 | 7.4 | 7.7 | 8.1 |
| O.NET CAPITAL TRANSFERS RECEIVED | -2.3 | -1.3 | -0.9 | -1.0 | -1.0 |
| P.CONSUMPTION OF FIXED CAPITAL | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| R.NET LENDING(M-N+O+P) | -12.6 | -9.7 | -10.9 | -11.1 | -11.7 |

MEMORANDUM ITEM:

| | 1984 | 1985 | 1986 | 1987 | 1988 |
|---|---|---|---|---|---|
| NET LENDING AS % OF NOMINAL GDP AT MARKET PRICES | -3.9 | -2.7 | -2.9 | -2.7 | -2.7 |

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UNITED KINGDOM

FINANCIAL DATA

| TABLE 6 | 1986 | 1987 | 1988 | 1986:1 | 1986:2 | 1987:1 | 1987:2 | 1988:1 | 1988:2 |
|---|---|---|---|---|---|---|---|---|---|
| SHORT-TERM INTEREST RATE | 10.7 | 9.4 | 9.9 | 10.5 | 10.1 | 9.3 | 9.5 | 9.7 | 10.0 |
| LONG-TERM INTEREST RATE | 9.9 | 9.2 | 9.9 | 9.6 | 10.1 | 9.0 | 9.3 | 9.7 | 10.0 |
| MONEY SUPPLY:M3 (YEARLY GROWTH RATE) | 17.5 | 16.5 | 11.5 | 17.8 | 19.4 | 16.6 | 13.6 | 11.4 | 9.8 |

Economic Outlook

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## UNITED KINGDOM

**Balance of payments**

**Value, $ million**

| | 1985 | 1986 | 1987 | 1988 | 1986 II | 1987 I | 1987 II | 1988 I | 1988 II |
|---|---|---|---|---|---|---|---|---|---|
| *Seasonally adjusted* | | | | | | | | | |
| Exports | 100 238 | 106 783 | 127 000 | 135 500 | 53 792 | 61 750 | 65 250 | 67 000 | 68 500 |
| Imports | 103 033 | 118 883 | 140 500 | 152 750 | 61 788 | 68 250 | 72 500 | 75 000 | 77 750 |
| Trade balance | −2 795 | −12 100 | −13 500 | −17 500 | −7 996 | −6 250 | −7 250 | −8 000 | −9 250 |
| Services and private transfers, net | 10 918 | 13 865 | 15 750 | 15 750 | 7 955 | 8 000 | 7 750 | 8 000 | 8 000 |
| Official transfers, net | −4 343 | −3 378 | −4 750 | −4 500 | −2 419 | −2 500 | −2 500 | −2 250 | −2 000 |
| Current balance | 3 781 | −1 613 | −2 500 | −6 000 | −2 461 | − 750 | −2 000 | −2 500 | −3 500 |
| *Unadjusted* | | | | | | | | | |
| Current balance | 3 781 | −1 613 | | | −1 133 | | | | |
| Long-term capital | −19 257 | −20 337 | | | −9 215 | | | | |
| Short-term capital and unrecorded | 6 702 | 12 214 | | | 5 140 | | | | |
| Balance on non-monetary transactions | −8 775 | −9 735 | | | −5 208 | | | | |
| Net transactions of monetary authorities[a] | 162 | 4 301 | | | 2 810 | | | | |
| *Memorandum items* (Seasonally adjusted) | | | | | | | | | |
| Per cent changes in volume[b] | | | | | | | | | |
| Exports | 5.8 | 3.8 | 5½ | 1½ | 12.9 | 4 | 1¾ | 1¾ | ¾ |
| Imports | 3.4 | 7.4 | 5 | 4½ | 24.9 | −3¼ | 5 | 4½ | 4 |

*Note:* Detail may not add, due to rounding.

*a)* Previously *Balance on official settlements*. Foreign borrowing by the public sector is included in the capital account while changes in official sterling balances are included below the line as a financing item.

*b)* Over previous period at annual rates, customs basis.

## ROYAUME-UNI

**Balance des paiements**

En valeur, millions de dollars

| | 1985 | 1986 | 1987 | 1988 | 1986 II | 1987 I | 1987 II | 1988 I | 1988 II |
|---|---|---|---|---|---|---|---|---|---|
| *Chiffres corrigés des variations saisonnières* | | | | | | | | | |
| Exportations | 100 238 | 106 783 | 127 000 | 135 500 | 53 792 | 61 750 | 65 250 | 67 000 | 68 500 |
| Importations | 103 033 | 118 883 | 140 500 | 152 750 | 61 788 | 68 250 | 72 500 | 75 000 | 77 750 |
| Balance commerciale | −2 795 | −12 100 | −13 500 | −17 500 | −7 996 | −6 250 | −7 250 | −8 000 | −9 250 |
| Solde des services et transferts privés | 10 918 | 13 865 | 15 750 | 15 750 | 7 955 | 8 000 | 7 750 | 8 000 | 8 000 |
| Solde des transferts publics | −4 343 | −3 378 | −4 750 | −4 500 | −2 419 | −2 500 | −2 500 | −2 250 | −2 000 |
| Balance des opérations courantes | 3 781 | −1 613 | −2 500 | −6 000 | −2 461 | − 750 | −2 000 | −2 500 | −3 500 |

cc Sir T. Burns
PC Sedgwick
PC Bottrill
PC S. Davies

The previously missing balance of payments table from the next OECD Economic Outlook

ORGANISATION FOR ECONOMIC
CO-OPERATION AND DEVELOPMENT

CONFIDENTIAL

Paris, drafted: 27th May 1987

dist:

EDR(87)12

Or.Engl.

ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE

1986-1987 ANNUAL REVIEW

UNITED KINGDOM

DRAFT ECONOMIC SURVEY BY THE SECRETARIAT

(Note by the Secretariat of the Committee)

The attached draft Economic Survey of the United Kingdom is submitted to the Economic and Development Review Committee for CONSIDERATION.

The Annual Review of the United Kingdom by the Economic and Development Review Committee has been arranged for Wednesday, 17th June 1987. The examining countries are the Netherlands and the United States.

The tables, diagrams, annexes and statistical annex will be circulated separately.

It should be noted that the United Kingdom authorities did not have the opportunity to comment on this draft before it was circulated.

CONTENTS

## TABLES



## DIAGRAMS

## INTRODUCTION

1. The United Kingdom is enjoying continued expansion. In spite of the importance of North Sea oil, the economy has coped better with the impact of lower oil prices than many others in the OECD area. Output growth in 1987 is likely to exceed that for most other Member countries. Recent developments also compare favourably with the generally disappointing long-term performance of the United Kingdom (Part IV), characterised by a decline in per capita income relative to other industrial countries. Measured from the previous cyclical peak in 1979, performance is less impressive, with manufacturing output still lower and GDP growth broadly in line with the European Community average. This reflects output losses in the initial years of the Government's medium-term-oriented strategy, which successfully reduced inflation, though at the expense of a strong rise in unemployment. Since then the strategy has been largely maintained but implemented more flexibly. The policy approach appears to have contributed to the favourable recent performance which is reviewed in Part I.

2. After slowing down in the second half of 1985, due mainly to weaker foreign demand, activity growth reaccelerated in the course of 1986, with consumer demand boosted by strong real income gains. More recently, there has been a sharp revival in export growth, assisted by the depreciation of the pound sterling since mid-1985. Unemployment has declined since mid-1986, helped by labour market measures. Inflation dropped following the oil price fall but has picked up since then, reflecting the marked decline in the exchange rate through 1986. Wage increases have remained high but their inflationary impact has been damped by the cyclical acceleration of productivity growth. Largely as a result of the sharp drop in energy prices, the current external account has swung into deficit for the first time in the 1980s.

we also slow growth ? of export mkts

3. As discussed in Part II, fiscal policy has become less restrictive since 1985. Previous expenditure targets have been raised and personal income tax rates reduced. With unexpectedly buoyant tax receipts partly offsetting sharply lower oil revenues, the rise in the general government deficit has remained limited, however, and the public sector borrowing requirement has even dropped due mainly to accelerated asset sales. Monetary developments have been characterised by very rapid expansion of broad money and credit and by on-target growth of narrow money and high real interest rates. A more prominent role has been given to the exchange rate as an indicator of monetary conditions. Given the inflation differential, interest rates have tended to

be higher than abroad. The Government has continued to attempt and improve the output/inflation split through microeconomic policies. Recent developments in this area include major financial market reforms, the acceleration of the privatisation programme, personal income tax adjustments and additional labour market measures.

4. On the basis of these policies and the technical assumptions of unchanged oil prices and exchange rates, the growth of activity is projected to continue, albeit at diminishing rates. A revival of business fixed investment and stockbuilding is expected to partly compensate for decelerating expansion of private consumption and export demand. Unemployment should continue to decline slightly. Inflation and the external deficit are likely to rise somewhat, reflecting the stickiness of wage developments. These trends could possibly call into question the sustainability of the recovery beyond the forecast horizon, although much will depend on the progress achieved in improving supply-side conditions (Part IV).

5. Previous Surveys have examined various issues related to the supply side of the economy, the latest focusing on the labour market. The special chapter of the current Survey (Part III) deals with the financial markets. The financial system is one of the most valuable assets of the United Kingdom economy. Dynamic and highly developed, it has maintained a role in world markets far exceeding that of the economy as a whole. Nevertheless, its leading position has been eroded in some fields. In order to improve the functioning of financial markets, the Government has taken a number of liberalisation measures, commencing with the abolition of exchange controls in 1979, and has encouraged a complete reorganisation of the Stock Exchange.

## I. RECENT TRENDS

6. The United Kingdom's economic performance since the large oil price fall at the beginning of 1986 has compared favourably, and increasingly so, with that of the OECD area as a whole. At first glance, this seems rather surprising as the vast majority of OECD countries has experienced a terms-of-trade gain in real income equivalent, on average, to nearly 1 per cent of GNP while the United Kingdom has suffered a terms-of-trade related loss in real income of a similar order of magnitude. For the OECD area, the short-run net impact on activity of the shift in relative prices is estimated to have been slightly negative, because the resulting fall in oil producers' imports from OECD countries outweighed the lagged extra-domestic spending. In the case of the United Kingdom, the weakness of export markets has been felt less as the fall in the exchange rate has improved competitiveness, and business and consumer confidence have not suffered from deteriorating export expectations. The income losers -- oil companies and the Government -- have, so far, broadly maintained spending while the gainers -- households and non-oil companies -- have increased theirs. The other side of the coin has been the swing of the external account into deficit and higher inflation than abroad. The former reflects above all the oil price fall but also rising import penetration, while the latter was the result of both exchange rate developments and wage rigidity.

**Demand and output**

7. After near-stagnation towards the end of 1985, overall economic activity accelerated sharply through 1986. Real GDP (average measure) grew at an annual rate of 4 per cent in the fourth quarter, exceeding its cyclical trough in 1981 by some 17 per cent. Taking 1986 as a whole, real GDP growth may have been a little more than 2 1/2 per cent (or 2 per cent if allowance is made for the direct effects of the 1984-85 coal dispute). Output of service industries increased by nearly 4 per cent, about the same as energy output, which seems to have peaked in 1986. Manufacturing output grew by less than 1 per cent but picked up sharply through the year (Table 1). After a weather-induced set-back in early 1987, the recovery appears to have resumed. Given the very slow rise in the net capital stock in manufacturing, which contrasts with developments in the services and energy sectors, capacity utilisation appears to have surpassed its previous cyclical peak of 1979.

(Table 1. Demand and output)

8. The main contribution to growth in 1986 came from **private consumption** (Diagram 1). Consumer spending was supported by both a strong rise in real incomes and a continued fall in the saving ratio (Table 1). The acceleration in the growth of real disposable income of households reflected sustained

growth of nominal earnings and a lower rate of inflation. The fall in the saving ratio by 4 percentage points since 1980 has occurred despite relatively rapid expansion of incomes and high real interest rates, suggesting that positive wealth effects of disinflation have apparently been the overriding influence. Expenditure on durables grew by 9 per cent in 1986, twice as fast as total consumer spending. Growth of private consumption seems to have decelerated in recent months through the combined effect of slower income growth, higher inflation and a stabilising saving ratio. Even so, consumer spending in the first quarter of 1987 was running some 3 1/2 per cent above its level of a year earlier. **Public consumption,** which had declined in real terms through 1985, increasingly contributed to GDP growth in the course of 1986 (Table 1, Diagram 1).

(Diagram 1. Contributions to changes in real GDP)

9. **Fixed capital formation** increased by less than 1 per cent in 1986, representing the weakest performance since 1981 (Table 1). Residential construction has, however, experienced a marked recovery from its depressed level in 1985 when it seemed to have been damped by unexpected increases in prices and interest rates. The weakness of private non-residential investment reflected only in part the reduction of North Sea oil investment. Non-oil business investment, too, failed to recover, despite a further improvement in profits (while total profits fell by 7 1/2 per cent, those of non-oil companies rose by 14 per cent). To some extent, the sluggish investment performance can be explained by changes in taxation. The 1984 corporate tax reform provided a strong inducement to accelerate the implementation of investment programmes. Moreover, the recent weakness of manufacturing investment included a sharp fall in the contribution of leasing, following the abolition of first-year allowances from April 1986. According to provisional estimates, business investment remained depressed in the first quarter of 1987. **Stockbuilding** fell in 1986. This appears to have been a consequence of both the strength of consumer demand and the trend decline of the stock/output ratio in the past few years, probably reflecting, among other things, the high cost of holding stocks and improved technology of inventory management.

10. While the growth of total domestic demand was relatively stable through 1986, **foreign demand** remained depressed in the early part of the year, reflecting slowing export market growth and the lagged effects of the appreciation of sterling until mid-1985. Following a reversal of these trends, exports picked up sharply (Table 1). Import growth, however, accelerated even more so that the real foreign balance acted as a drag on production. In 1986 as a whole, the fall in net exports reduced GDP growth by 3/4 percentage points, after a positive growth contribution of the same size in the year before. More recently, import demand has weakened, due partly to less buoyant domestic demand, and the deterioration in the real foreign balance seems to have come to a halt.

**The labour market**

11. Following a marked decline in the early 1980s, **employment** grew rapidly in the two years to mid-1985 (Table 2). Reflecting the pattern of activity growth, its expansion came to a virtual halt in the latter part of 1985 but reaccelerated through most of 1986. The rise in self-employment, being encouraged by various schemes and tax changes, accounts for about one-half of

the more than 1 million jobs created since 1983. More recently, the number of self-employed has grown more slowly, though still faster than dependant employment. Rising demand for labour has mainly benefited part-time workers whose share in total employment is approaching one-fourth. Dependent employment in the service sector has exhibited strong buoyancy, exceeding in 1986 its previous cyclical peak of 1979 by about 7 per cent. By contrast, the decline in manufacturing employment has continued, but slowed down markedly in more recent months.

(Table 2. Labour market)

12. Reflecting both demographic factors and a substantial increase in female participation rates, the **labour force** has expanded strongly in 1984-85. Since then, its growth has decelerated markedly and appears to have stopped rising more recently (Table 2). With employment growth picking up, the rate of **unemployment** began to fall. By April 1987, the seasonally-adjusted total of adult unemployment had dropped for the ninth consecutive month, to slightly above 3 million or just under 11 per cent of the total labour force, back to its 1983-84 level. The fall from its peak in July 1986 by almost 200 000, or 3/4 per cent of the labour force, can only be partly ascribed to greater strength of activity. In fact, the major part seems to reflect the effects of specific government programmes. In July 1986, a new scheme for the long-term unemployed, the Restart Programme, was introduced on a national basis. From then to March 1987 most of the 1.3 million long-term unemployed had been interviewed. By early January, about 165 000 of them had ceased registering, though only in part as a direct result of Restart; about 70 000 had joined Restart training courses, about 20 000 had been directed into the Community Programme and a similar number into various other schemes. The Community Programme, which provides jobs for long-term unemployed adults, is now covering 245 000 people, compared with 200 000 a year ago. The coverage of the Youth Training Scheme, too, has been considerably expanded (by about 170 000 from 265 000 in March 1986). These programmes have not only curbed the rise in unemployment but also substantially modified its structure: the share of young unemployed in total unemployment has continued to fall markedly, to about one-third, and the number of long-term unemployed has started to decline.

**Costs and prices**

13. The persistence of high unemployment has not yet resulted in any significant moderation in wage growth. A remarkable feature has been the stickiness of wage trends since unemployment has stopped rising, often attributed to various hypothetical causes of hysteresis in the natural rate of unemployment such as insider-outsider theories or efficiency wage theories (see the January 1986 Survey). The underlying annual rate of growth of average earnings is estimated to have remained virtually unchanged at 7 1/2 per cent since mid-1984, in spite of substantial fluctuations in inflation and output. Earnings in the manufacturing sector have shown greater variations, apparently reflecting sharper changes in output growth, but their underlying rate of growth has nonetheless remained within a narrow range. Pay settlements have reacted, with a lag, to changing inflation trends. Their median annual rate fell from 6 per cent to 5 per cent through 1986, edging up only little thereafter. Yet, this slowdown was offset by higher wagedrift in response to accelerating output growth in the latter part of 1986, so that the

rate of growth of earnings at the turn of the year was not much different from that a year before (Table 3). The apparent inertia of wage trends conceals, however, very different developments, in particular within the service sector. Average earnings in banking, finance and insurance, and in education and health services have grown at annual rates of around 10 per cent in recent months, representing a continuation of previous trends in the financial service sector and a marked steepening in important parts of the public sector.

(Table 3. Costs and prices)

14. Given fairly steady wage growth, variations in unit labour cost increases have reflected primarily changes in productivity growth (Diagram 2). Mirroring output developments, these have been particularly pronounced in manufacturing. As a result, the growth of unit labour costs in this sector accelerated to an annual rate of about 8 per cent in the two years to early 1986, and has come down sharply since then (Table 3). In contrast, raw material and fuel prices fell markedly from mid-1985 to mid-1986 but have picked up thereafter. The combined effect of these developments has been a sharp slowdown in the growth of total unit costs in 1986, with some reacceleration in the latter part of the year and into 1987. The response of manufacturing output prices to lower cost pressures has been relatively slow (Table 3), reflecting a significant improvement in profit margins. The rate of growth of the GDP deflator fell, however, much more in 1986 than that of overall unit labour costs, as a result of the oil sector's falling prices and profits. The year-on-year increase in the retail price index decelerated from 7 per cent in mid-1985 to 2 1/2 per cent in mid-1986 but had climbed up to 4 per cent by March 1987. Excluding mortgage interest rates and seasonal food, both the slowdown (from 5 1/2 per cent to 3 per cent) and the reacceleration (to 3 3/4 per cent) were much less pronounced. One area, however, where inflation has accelerated sharply is housing: the rise in house prices has doubled since 1985 and shows little sign of abating (Table 3).

(Diagram 2. Wages, productivity and unit labour costs)

**External balance**

15. Recent balance-of-payments developments have been influenced by two major events: the steep decline in the oil price during the first half of 1986, which was only partially reversed thereafter, and the sharp depreciation of sterling until the end of 1986. The oil price dropped by about one-half in dollar terms in 1986 as a whole and a little more in sterling terms. The effective exchange rate of sterling had risen sharply in the first half of 1985; its subsequent fall accelerated with the drop in the oil price. Some recovery has taken place more recently as a lagged response to the rebound of the oil price. In the eighteen months to end-1986, sterling depreciated by 18 per cent in nominal effective terms. Despite an appreciation of sterling by more than 5 per cent in recent months, and stronger cost increases than abroad up to early 1986, the United Kingdom's competitive position is still considerably better than two years ago (Table 4). The oil price and exchange rate changes have adversely affected the terms of trade, but improved competitiveness has already favourably influenced real export performance.

(Table 4. External trade and the current account)

16. Following a marked fall after mid-1985, merchandise exports (volume) picked up sharply in the course of 1986 (Table 4). In the second half of the year, exports of manufactures grew by 6 percentage points more than markets, largely recuperating the previous losses in market shares. Despite a slight volume decline in the first quarter of 1987, goods exports were 10 per cent higher than a year before. Imports picked up earlier and even more vigorously, due possibly to the less marked improvement in price competitiveness on internal markets, but declined sharply in the first quarter of 1987, reflecting subdued domestic demand. With a fall in real net exports and some terms-of-trade loss, the non-oil trade balance deteriorated in 1986 (Table 4). Two-thirds of the £6 billion increase in the trade deficit was, however, accounted for by the fall in the net oil surplus (Diagram 3). Reflecting above all the sharp decline in import volumes, but also a reversal in the deterioration in the terms of trade, the trade deficit dropped markedly in the first quarter of 1987, back to the level of a year earlier. Figures were distorted, however, by the effects of bad weather early in the year.

(Diagram 3. Current account developments)

17. The current account surplus in the first half of the 1980s was attributable to the rising oil surplus which reached a peak of £8 billion in 1985 (Diagram 3). Excluding oil, the current external balance turned into deficit in the early phase of the recovery. The rising surplus on invisibles, reflecting above all buoyant investment income and exports of financial services, has helped, however, to limit the widening of the non-oil trade deficit. In 1986, the negative swing in the current account broadly corresponded to the adverse effect of the oil price fall. The resulting current account deficit, the first since 1979, amounted to £1.1 billion, following a surplus of £2.9 billion in 1985. The favourable trends of merchandise trade recorded during the first three months of this year suggest that the current account has switched back into surplus in the first quarter of 1987.

Some missing from balance

## II. THE POLICY ENVIRONMENT

18. Previous Surveys have discussed the origins and evolution of the Government's medium-term-oriented economic strategy. Its twofold objective has been to bring down inflation -- and ultimately to achieve price stability -- through macroeconomic policies, and to improve the output responsiveness of the economy through microeconomic policies. The inflation target was to be achieved by a progressive reduction in the money stock growth, accompanied by a decline in public borrowing to avoid excessive upward pressures on interest rates. Since 1982, nominal income growth has been explicitly included in the target projections of the Medium Term Financial Strategy (MTFS), which was launched in the 1980 Budget. While considerable progress has been made in achieving ultimate objectives, it has proved difficult to meet intermediate targets (Table 5). The conduct of monetary policy has been particularly difficult, as the information content of specific monetary aggregates about conditions in the economy has been persistently blurred by the effects of deregulation and innovation in financial markets.

(Table 5. The Medium Term Financial Strategy: projections and outturns)

### Fiscal policy

19. Since its inception in 1980, the Medium Term Financial Strategy has aimed at a steady decline of the Public Sector Borrowing Requirement (PSBR) as a percentage of GDP (Table 5). The 1984 Green Paper which discussed appropriate fiscal policies over the longer term assumed that the PSBR/GDP ratio would be brought down to 1 per cent by the 1990s. Given the unexpected buoyancy of non-oil revenues and the acceleration of the privatisation programme, this objective was achieved in 1986/87. By contrast, the general government financial deficit (which excludes public corporations and financial transactions) has not changed significantly, fluctuating around 3 per cent of GDP (Diagram 4). This is close to the OECD average. The gross government debt/GDP ratio has shown some decline over the past six years or so but at about 50 per cent has remained relatively high by international comparison.

(Diagram 4. General government revenue and expenditure)

20. With public sector borrowing at a low level, the emphasis of fiscal policy has shifted to curbing public spending in order to provide scope for tax reductions. The marked rise in the tax/GDP ratio which took place in the early 1980s has so far been reversed only partially. The personal income tax burden has been reduced to the 1979 level while corporate tax receipts have risen sharply since the 1984 tax reform (see below). Total government revenue is still higher in relation to GDP than at the end of the 1970s despite recent declines in oil revenue (Diagram 4). As to government spending, developments in recent years have fallen short of plans which aimed at maintaining the expenditure planning total broadly unchanged in real terms. Nevertheless, at

an annual rate of about 2 per cent, real growth of public spending in the 1980s has been significantly lower than previously. The ratio of government expenditure to GDP has declined since 1984 (Diagram 4) and it is planned to come down to the 1979 level by 1988.

21. With North Sea revenue reduced by one-half in 1986, the authorities faced the difficult decision as to whether they should stick to previous borrowing targets. In view of the transitory nature of privatisation proceeds and of oil revenue, and given the relatively high debt/GDP ratio, any addition to public borrowing could have been regarded as undesirable. On the other hand, an unchanged borrowing requirement would have represented a tightening of policy relative to the Government's earlier intentions. In the event, the authorities decided to broadly adhere to the targets set prior to the oil price fall. In view of the better-than-expected outcome for 1985/86 (Table 6), the PSBR for 1986/87 was set at about £7 billion, less than 2 per cent of GDP and somewhat lower than indicated in the 1985 MTFS. This target was to be achieved by a combination of increased public asset sales, lower-than-planned income tax cuts, and stronger-than-projected non-oil revenues.

(Table 6. Budgetary developments)

22. According to provisional estimates, the PSBR for 1986/87 was less than half of that envisaged in the initial budget and about £2 1/2 billion below that for the year before (Table 6). In relation to GDP it was the lowest since 1971/72 (even excluding privatisation proceeds). This favourable outcome was achieved in spite of a sharper-than-expected fall in oil revenues (by almost £7 billion). Other tax revenues were much higher than forecast, with non-North Sea corporation tax accounting for the bulk of the additional receipts. The reasons for this surge in corporate taxes are not clear, as the recorded rise in profits would seem to be insufficient to explain the outcome. One possible explanation is that the effect of the change in investment allowances resulting from the 1984 corporate tax reform had been significantly underestimated. The greater-than-expected buoyancy of indirect taxes reflects both stronger-than-forecast consumer spending and a change in the composition of consumption towards spending on goods and services subject to VAT. The sharp rise in stamp duties is attributable to a rapidly expanding securities turnover and rising securities and house prices. An improvement in the financial position of public corporations also helped to bring down the PSBR in 1986/87. On the **expenditure side**, there was considerable overspending in the areas of social security and local authority current spending. Public asset sales, which are counted as negative expenditure, appear to have almost met the projections, which were for a doubling of privatisation proceeds. After allowing for drawings from the reserve, the expenditure planning total seems to have been overshot by less than 1 per cent.

23. In his 1986 Autumn Statement, the Chancellor announced an increase in the 1987/88 public expenditure planning total by £4 3/4 billion representing a rise of more than 3 per cent compared with its previous target. Privatisation proceeds were envisaged to be raised to £5 billion and the contingency reserve to be lowered to £3 1/2 billion. The PSBR target of £7 billion was confirmed. The March 1987 Budget decision to set public borrowing at about the expected favourable outturn for 1986/87 of £4 billion limited the room for tax adjustments to about the amount foreshadowed in the 1986 MTFS. The basic rate

of personal income tax has been cut by 2 points to 27 per cent following a 1 per cent cut in 1986. The corporation tax rate for small companies has been reduced accordingly while the main corporate rate remains unchanged at 35 per cent. Spending plans are unchanged from those in the Autumn Statement and Public Expenditure White Paper, which raised previous projections for local authority and social security expenditure, in particular. While the oil price assumption of $15 per barrel underlying the revenues estimates now seems very cautious, expenditure targets may be put under renewed pressure, given past experience. In particular, public sector pay is likely to grow more than allowed for in the Budget. Hence, the contingency reserve, which is lower than in 1986/87, can be expected to be fully spent and some overshooting of the planning total to occur, although the downward trend of public spending as a proportion of GDP is unlikely to be reversed. The scale of further tax cuts will be made dependent on the success in curbing public expenditure growth, which is planned to slow down markedly in 1988/89. At present, the intention is to reduce the basic rate of personal income tax to 25 per cent.

**Monetary policy**

24. Maintenance of downward pressure on inflation has remained the primary objective of monetary policy. The implementation of policies has continued to be rather pragmatic, responding flexibly to unrest in international exchange markets and changes in the private sector's liquidity and portfolio behaviour. The shift of emphasis away from broad money towards other indicators, in particular the exchange rate, has become more manifest. The target for £M3, temporarily suspended in October 1985 but reinstated in the March 1986 Budget, was dropped in the 1987 MTFS. This step was recommended by the Governor of the Bank of England in his Loughborough University speech, where he argued that the relationship between the rate of growth of broad money and that of nominal incomes had become increasingly unpredictable because of the fast pace of financial innovation and liberalisation. Targeting of M0 (cash held by the private sector and the banks) is continued. The target range for narrow money growth in 1987/88 has been kept unchanged at 2 to 6 per cent. By the end of the decade a gradual reduction to a range of 0 to 4 per cent is envisaged, in line with the projected path for nominal GDP growth. Underlying growth of M0 significantly outside its target range would prompt the authorities to change short-term interest rates, unless other indicators, including broad money and the exchange rate, advised against it. There is no target for sterling, though at Budget time, and in the context of the Louvre Accord, the authorities have indicated that they aim at a stabilisation of exchange rates and interventions in the foreign exchange market have sharply increased since then.

25. In contrast to broad money targets, those for narrow money have been met since their introduction in 1984 (Table 5). M0 accounts for about 6 per cent of the broadest aggregate PSL2, which includes private sector deposits with building societies. The relationship between M0 and nominal income has been relatively stable, with the year-to-year increases of velocity staying within a range of 0 to 6 per cent. In 1986/87, M0 grew by no more than 3.5 per cent despite some acceleration prior to the rise in interest rates in October. The most salient feature of recent monetary developments has been the sharp acceleration in the rate of growth of broad money (Table 7). Indeed, in 1986/87, £M3 expanded by almost 20 per cent, overshooting both initial and subsequently revised targets by wide margins. The decline in

velocity, which commenced in 1981 and was particularly marked in 1985 and 1986, can be related to a number of factors among which financial innovation and deregulation (see Part III) as well as disinflation appear to have been the most important ones; more recently, the end of overfunding the PSBR (Table 7) and the expansion of public sector asset sales have also contributed.

(Table 7. Formation of the money supply)

26. Given the unstable and hence unpredictable behaviour of broader monetary aggregates, other indicators have increasingly served as a guide to monetary policy. The exchange rate, in particular, has assumed a greater influence. In January and October 1986 interest rates were raised when the decline in the effective exchange rate appeared excessive (Diagram 5). Sterling was, nevertheless, allowed to fall in response to the oil price collapse, as the adverse impact on inflation was expected to be partly offset by the effects of lower oil prices. In the course of the first half of 1986, and in the context of global interest rate reductions, banks' base rates came down by 2 1/2 points to 10 per cent. Their renewed rise by 1 percentage point later in the year was preceded by strong downward pressures on sterling. The move out of sterling, which occurred in the face of recovering oil prices, appears to have reflected financial market concern about accelerating monetary expansion and deteriorating prospects for inflation and the balance of payments. With good news from the budgetary front and the balance-of-payments side, financial sentiment has improved and sterling appreciated more recently. Given the rapid growth in bank lending and the initially muted reaction of the exchange rate to the rising oil price, the authorities adopted a cautious approach to cuts in interest rates, though finally allowing them to fall. In the two months to early May 1987, banks' base rates were reduced in several steps to 9 per cent, the lowest level since 1984. Nonetheless, both nominal and real interest rates are still higher than generally elsewhere, reflecting the persistence of positive inflation differentials vis-à-vis important trading partners, and an uncertainty premium possibly related to expected greater interest and exchange rate variability.

(Diagram 5. Interest rates and the exchange rate)

**Supply-side policies**

27. The Government has continued to give attention to structural policies designed to promote the functioning and flexible operation of markets. Progress in the pursuit of supply-side policies was reviewed in the last two Surveys. The January 1986 Survey focused on measures affecting the labour market including a discussion of changes to industrial relations law. Part III of the present Survey deals with financial markets, where a wide range of legislative and other controls on activity have been abolished since 1979. Recent developments, other than in the financial field, comprise changes to income taxation, continued help for small businesses, tax relief on profit related pay, further employment and training measures, and a considerable expansion of the privatisation programme.

28. The tax and benefit system is an area where important steps have already been taken but where more fundamental reforms are still awaited. The reform of corporate taxation announced in 1984 has now been fully implemented, with a major reduction in the tax rate and a widening of the tax base by the

abolition of stock relief and advanced depreciation allowances. These changes have reduced tax distortions, making investment decisions more responsive to market signals and lessening the fiscal attraction of debt over equity financing (see Part III). A package of VAT changes to help small businesses was announced in the 1987/88 Budget. The rate of corporation tax for small companies has been reduced in line with the basic rate of personal income tax.

29. More ambitious measures of tax reform designed to lower the tax burden on individuals are dependent on the progress achieved in containing the growth of public expenditure. The last two budgets reduced the basic rate of personal income tax and continued to increase income tax thresholds (in real terms in 1986 and in line with inflation in 1987). A recent Green Paper outlining the Government's proposals for the future reform of personal taxation argues that the basic rate of income tax is still too high, especially in comparison with other major industrial countries, while the tax thresholds are too low in relation to earnings. The centrepiece of the Green Paper is a proposal for the introduction of a system of fully transferable allowances between spouses. This would help to remove poverty and unemployment traps but no decision has as yet been made in this respect. As from 1988, the introduction of family credit by the Social Security Act 1986 will provide extra financial aid for low income families with children and help to improve the replacement ratio (relative incomes in and out of work). The Act also establishes the general right (with effect from 1988) to join a personal pension scheme. Moreover, the 1987 Budget gives personal pensions the same favourable tax treatment as retirement annuities. These measures should be conducive to labour mobility.

30. Existing employment and training measures have been improved and expanded. The 1986 Budget introduced two new schemes, the Restart programme for long-term unemployed and the New Worker Scheme for youths (see Labour Market section in Part I). In real terms, government expenditure on employment, training and related measures has more than doubled since FY 1978/79. Following the publication of a Green Paper and discussions with employers and others, the Government announced in the 1987/88 Budget that it intended to introduce income tax relief for participants in profit related pay (PRP) schemes registered with the Inland Revenue lasting at least one year; one-half of PRP would be free of income tax up to a limit of £3 000 per year or 20 per cent of pay whichever is lower. The authorities expect that encouragement of PRP will protect jobs that may be at risk and get jobless back into work more quickly. Yet, the response of both employers and trade unions has so far been tepid. The Government has issued a Green Paper containing proposals to further strengthen the right of individual union members and improve unions' internal democracy. The authorities have also urged the abandonment of wage bargaining at the national level in favour of decentralised settlements in which local conditions would play an important role. This is expected to reduce regional differences in unemployment.

31. The Government's privatisation programme has been significantly expanded and is expected to yield proceeds of more than 1 per cent of GDP per year over the rest of the decade. No enterprise or public utility has in principle been excluded from the scope of the programme. To date, fourteen major companies and some smaller concerns have been transferred to the private sector, involving around 600 000 employees. These transactions have reduced the state-owned sector of industry by around one-third (for details see

Annex I). The most important so far have been the sales of British Telecom in 1984 and British Gas in 1986. The success of these flotations has contributed to wider share ownership (see Part III). Privatisations planned for the immediate future include the British Airports Authority, the Water Authorities, Rolls Royce and Royal Ordnance. The Government intends to privatise most of the remainder in the next Parliament. The authorities believe that the programme will increase productive efficiency and benefit consumers. There are signs of efficiency gains within both the privatised and still nationalised sector, as a result of measures taken to prepare state-owned businesses for privatisation. Competition has, however, been introduced very cautiously for the privatised large monopolies.

## III. FINANCIAL MARKETS

**Introduction and overview**

32. The United Kingdom has a long tradition as an important international financial centre. Its leading position in world financial markets is partly attributable both to its trading and imperial history and its liberal regulations on foreign trade and financial transactions. While the weight of the United Kingdom economy in world output and trade has declined and sterling's role as a trading and reserve currency has diminished, London has succeeded in maintaining its importance as an international financial centre by attracting the Eurocurrency and Eurobond markets. Nevertheless, the development of other financial centres and the trend towards greater integration of, and competition among, financial markets has tended to erode the dominant position of London in some fields.

33. Concern over the City's loss of international competitiveness and the conviction of the benefits of greater competition have led the present Government to take a series of liberalisation measures. The abolition of foreign exchange controls for residents in 1979 has accelerated the internationalisation of London as a financial market and opened up the domestic market to international competition. Further measures, such as the move towards a more market-oriented monetary policy and away from quantitative controls, were in a way the inevitable consequence of the first step. They have reduced domestic market segmentation and barriers between financial institutions, accelerating the trend towards financial conglomerates with wide-ranging functions. Financial reforms have culminated in the complete reorganisation of the Stock Exchange, aimed at establishing an open and fully competitive domestic and international equity market able to complement London's strong position in foreign currency trading, Eurobonds and international banking among others. The deregulation and growing internationalisation of financial markets have certainly increased competition but also the risk of losses and malpractices. Prudential controls have, therefore, been completed and tightened. Hence, the overall result of recent reforms represents a mixture of liberalisation and greater regulation of financial markets.

34. In order to put the financial system in a macroeconomic perspective, this Part of the Survey starts with a description of the financial sector's direct contribution to the economy, in terms of output, employment and the balance of payments, and of the pattern of financial flows between different sectors of the economy. The subsequent sections deal with London's role in world financial markets, the institutional set-up and the financial reforms of the present Government. The concluding section attempts to assess the financial system's impact on economic performance.

**The financial system in a macroeconomic perspective**

**A. The financial sector's contribution to the economy**

35. Besides their role as intermediaries between economic units and sectors wishing to borrow and lend funds, financial institutions make more tangible contributions to the economy, producing a wide range of services, generating income, creating employment opportunities and earning money from overseas through net exports of services. The output of service industries, and in particular of financial institutions, is notoriously difficult to define and measure. International comparisons are particularly hazardous, as statistics are not always available for the desirable definition and grouping. But Table 8, along with additional information for smaller countries, suggests that the United Kingdom financial sector's share in total value added is among the highest and fastest rising in the OECD area. In 1975 the total factor incomes of the financial sector represented about 5 per cent of total net value added in the economy, with banking and insurance accounting for about one-half and one-third, respectively, of the sector's contribution (Table 9). Since then the financial sector's share has risen to more than 6 per cent. Value added of non-bank financial institutions has grown particularly strongly while insurance has lost some ground.

(Table 8. Financial sector's share)

(Table 9. Gross value added in the financial sector)

36. Figures at constant prices are only available for the broader grouping of financial and business services, which includes, among other things, rapidly expanding items such as property owning and managing. Over the last decade or so real output of this sector has almost doubled while real GDP has grown by about one-fifth and manufacturing output, apart from cyclical fluctuations, has remained broadly unchanged (Diagram 6). These trends are reflected in sharply diverging employment patterns. While manufacturing employment has fallen by one-quarter, employment in financial and business services has grown by one-third and its share in total employment has risen from 6 1/2 per cent in the mid-1970s to more than 9 per cent. The corresponding figure for the financial sector in a narrower sense has increased by almost 1 percentage point to 3 1/2 per cent in 1986 (Table 10). Although the financial sector's share in total employment may appear relatively small, it is among the highest and fastest rising of Member countries. Since the mid-1970s the number of employees in the financial sector has grown by one-quarter to reach 760 000 in 1986. The share of insurance has dropped to below one-third of the total in spite of employment growth of about 2 per cent per annum in recent years. The expansion has been particularly marked in other non-bank financial institutions where the number of employees has risen by almost one-half over the last decade to reach one-sixth of total financial sector employment.

(Diagram 6. Output and employment trends)

(Table 10. Employment in the financial sector)

37. Net overseas earnings of financial institutions have made an important and growing contribution to the United Kingdom's external account balance.

They consist of receipts from net exports of services to foreign residents, interest received on net lending abroad, direct investment income (overseas profits of United Kingdom financial institutions less profits of foreign institutions operating in the United Kingdom), and portfolio investment income (on holdings of overseas securities). The insurance industry is the largest foreign exchange earner among financial institutions with net earnings of more than £3 billion (Table 11). About one-fourth of this represents underwriting income, the bulk of which is earned on overseas business written in the United Kingdom by Lloyd's underwriters. The portfolio investment income of the insurance companies and Lloyd's has risen particularly fast and accounts now for almost one-half of their total earnings. Banks are next in importance to insurance with net overseas earnings of more than £2 billion. Strong growth of their income from portfolio investment and, to a lesser extent, the provision of financial services has more than compensated for negative net income from both interest receipts and direct investment. There has been very rapid growth in both the banks' borrowing from and lending to overseas (see below), mainly in foreign currencies. However, with interest margins small and overseas deposits in the United Kingdom exceeding lending to overseas, net interest income has become negative in recent years. Banks' earnings from their subsidiary companies and branches overseas have increasingly fallen short of those of foreign-owned banks in London (see below). Among the other investing institutions, pension funds have become important foreign exchange earners as they hold an increasing part of their portfolios in foreign securities.

(Table 11. Net overseas earnings of United Kingdom financial institutions)

38. After fluctuating around £1 billion in the second half of the 1970s, total net overseas earnings of financial institutions (excluding commodity trading and non-stock exchange brokerage) have sharply increased in the 1980s, reaching £6 1/2 billion in 1985. As a proportion of GDP, they amounted to 1/2 per cent in 1975 and not much more in 1980 but surpassed 2 per cent in 1985. Having always been an important constituent of the invisible surplus, they have exceeded the latter in the 1980s (Table 11). But this impressive result needs to be kept in perspective. Financial services still amount to not much more than 3 per cent of total exports of goods and services, broadly unchanged from the mid-1970s, and the United Kingdom share in world exports of these services has declined (see below). Excluding investment income, exports of financial services have hardly increased in real terms over the last decade or so. However, imports of these services are relatively small and appear to have grown fairly slowly (although there may be some under-recording (1).

39. An assessment of the financial sector's contribution to the economy should include possible side effects. It has been argued that the booming financial sector has driven up the exchange rate and hence adversely affected the manufacturing sector's performance. But in this respect the development of North Sea oil has been certainly much more important. Moreover, it should be borne in mind that any successful export or import-competing firm is bound

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1. Bank of England Quarterly Bulletin (September 1985), "Services in the United Kingdom Economy".

to increase competitive pressure on other sectors via the exchange rate crowding-out mechanism. Another point, often made, but carrying little weight for the same reasons, is that the City creams off the talent available within the domestic workforce and that the bidding up of salaries by City firms has adverse demonstration effects.

40. Although the financial sector's direct contribution to the economy in terms of output and employment has been rising, it can certainly not be expected to compensate for the shrinking of larger sectors, all the more so because capital intensity and productivity growth in the financial sector are relatively high and the increase in employment opportunities may peter out in the aftermath of its recent restructuring. However, the financial system's importance goes beyond its direct contribution to the economy. As evidenced by the growth of financial transactions, its intermediation role has increased significantly. Indicators for the extent of financial intermediation, such as the financial assets held by residents or the intermediaries' liabilities as a proportion of GDP, show a sharp rise in recent years to high levels by international comparison. This upsurge contrasts with much more moderate growth of intermediation relative to income and wealth in the preceding decades (2).

## B. Sectoral saving/investment patterns and financial flows

41. A major function of the financial system is to provide an efficient channel for funds to pass from savers to investors. In recent years the United Kingdom has saved around one-fifth of GDP (Table 12), slightly down from the 1970s as generally elsewhere but much the same as in the 1950s and 1960s. Contrary to the past, saving in the economy as a whole is now close to the international average, about half way between the United States and Japan. By contrast to most other countries, gross saving by the private business sector exceeds that of the household sector. In the first half of the 1980s savings in the economy as a whole exceeded domestic investment, leading to substantial accumulation of net external assets (amounting to more than one-fifth of GDP by 1985). The swing of the saving/investment balance into sizeable surplus has closely mirrored corporate sector developments (Diagram 7). Apart from cyclical fluctuations, the United Kingdom non-financial private business sector has always been in approximate financial balance. The advent of North Sea oil and improving profitability have transformed the company sector into a significant net contributor of financial savings while the traditional positions of the household and general government sectors as net lender and net borrower, respectively, have not changed fundamentally (Table 12). The public sector's financial deficit in terms of GDP has tended to decline in the 1980s exclusively as a result of a fall in the investment share. The household sector's financial surplus has dropped markedly in recent years in relation to income, though from a historically high level in the early 1980s. The pronounced swing in the personal saving ratio appears to reflect in part structural changes in the financial system (see below). Untypically, the financial institutions have

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2. Rose, H. (1986), "Change in Financial Intermediation in the United Kingdom", Oxford Review of Economic Policy, Vol.2, No.4.

run a financial deficit, probably because they are more involved in real investment in property and in equipment leasing than elsewhere.

(Table 12. Saving and investment by sector)

(Diagram 7. Net lending by sector)

42. The flow of funds matrix in Table 13 shows the pattern of lending and borrowing which financed the sectoral surpluses and deficits. The gross flow into the financial institutions has substantially exceeded the private sector's surplus. In recent years claims on financial institutions and government debt acquired by households have been about three times their financial surplus. About half of the personal sector's additions to financial assets has been placed in life assurance and pension funds. Borrowing by the personal sector has continued to predominantly take the form of loans for house purchase but borrowing from the banks has also grown sharply subsequent to the abolition of credit controls in the early 1980s (see below). Industrial and commercial companies' liabilities have also increased in relation to GDP but to a lesser extent. Companies have continued to rely strongly on banks for their external funds, although most recently there has been a shift towards the capital market, in particular the new long-dated Eurosterling market (see below). Companies devote considerable resources to direct investment overseas: there was a sharp increase in their proportion of external assets after the abolition of exchange controls in 1979, which, however, has been partly reversed since then. The public sector has stopped functioning as a financial intermediary in the 1980s when lending to the private sector has come to a standstill. The major part of its financing needs has been provided by the sale of government securities.

(Table 13. Financial transactions between sectors)

43. A wide range of non-bank financial institutions have acted as important intermediaries in channelling funds from savers to investors. The non-financial private sector's claims on and borrowing from banks amounts only to one-sixth and one-fourth, respectively, of total assets and liabilities. This compares, e.g., with corresponding ratios of one-half and two-thirds for Germany. An outstanding feature of United Kingdom financial markets is the importance of life insurance and pension funds. The proportion of personal sector assets held with investment institutions has increased from one-fourth in the mid-1970s to about 45 per cent, compared with less than 30 per cent in the United States and less than 20 per cent in Japan and Germany (3). In most countries the balance of deposits of the non-financial private sector has swung from banks to other financial institutions. This tendency has been particularly pronounced, however, in the United Kingdom (Table 13) where the largest part of personal sector deposits is placed with building societies (see below). Nevertheless, as noted above, total bank deposits have expanded extremely rapidly in the 1980s as the banks have obtained substantial new deposits from overseas. Although bank lending overseas has also grown explosively (Table 13), the banking sector has continued to switch funds from overseas to the domestic economy.

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3. Davis, E.P. (1986), "Portfolio Behaviour of the Non-financial Private Sectors in the Major Economies", BIS Economic Papers, No.17.

**London as an international financial centre**

44. As an international financial centre London ranks in the top three with New York and Tokyo. Despite the rise of new competitors, the United Kingdom has retained a leading role in the international banking markets, particularly in Eurocurrency activity. The world's largest one hundred banks are all represented in London. Banks located in the United Kingdom, both British and foreign-owned, hold just under a quarter of the international claims booked in the BIS reporting area, considerably more than the banks in Japan and the United States, respectively (Table 14). London's share of Eurobanking activity (cross-border lending in foreign currencies) is rather higher and its leadership is even more pronounced in the rapidly expanding Eurobond market. Some three-quarters of the secondary market turnover of Eurobonds are estimated to pass through the City. Moreover, London is still the world's leader in insurance and reinsurance. The Stock Exchange, however, no longer ranks among the largest in the world. In terms of turnover, it is in fifth position, far behind New York, Tokyo and NASDAQ (the American electronic over-the-counter system), and just behind the German exchanges (Diagram 8). In terms of market capitalisation, it is the third largest, as an impressive number of overseas equities and Eurobonds are listed on the London Stock Exchange, but active trading in non-United Kingdom securities has taken place mainly outside the Exchange.

(Table 14. Shares of international bank lending)

(Diagram 8. Equity turnover in major stock exchanges)

45. Without the Euromarkets, i.e. markets for deposits, loans and securities denominated in currencies held outside their country of origin, London might have lost its position as a leading financial centre. These markets, initially almost exclusively in dollars, were made possible in the late 1950s when several countries decided to make their currencies freely convertible for non-residents. Encouraged by large external deficits and the imposition of regulations in the United States in the 1960s, they were given a further boost in the 1970s by the large balances accumulated by the OPEC countries following the oil price rise. London was the favoured location for the recycling of oil funds after the two oil shocks. In the early 1980s liabilities to the oil exporters accounted for one-sixth of the total external liabilities of banks in the United Kingdom. As noted above, it was mainly the combined effect of London's historic importance and a regulatory environment sympathetic to the pursuit of international banking which made of it the largest centre of the Euromarkets; other factors include the concentration of a full range of financial services in a very small area, the standard of supporting services, and time zone advantages. In order to maintain the United Kingdom's leading position in world financial markets, the authorities have pursued a consistent policy of market liberalisation, removing remaining exchange controls (see below) and encouraging foreign banks and institutions to locate in London.

46. The number of foreign-owned banks (including branches and subsidiaries) in London rose from about 100 in the mid-1960s to almost 500 at the end of 1985 (Table 15), significantly exceeding the number of British-owned banks in the United Kingdom. About 120 foreign securities houses are established in the City. In 1986 the number of foreign banks seems to have more or less

stabilised while employment in foreign banks and securities houses has continued to grow rapidly, reflecting partly the recruitment of new staff but mainly the acquisition of established United Kingdom firms in the context of the Big Bang in the City (see below). Employment in foreign banks and security houses is estimated to have exceeded 50 000 in 1986, compared with less than 10 000 twenty years ago. At present, 63 countries have direct bank representation in London. In terms of numbers of banks, the United States ranks first, while in terms of market share, Japanese banks have become the largest group (Table 15). In late 1985, almost 40 per cent of Japanese-owned banks' international business was accounted for by their London branches and subsidiaries, and the scale of international business conducted by Japanese banks in London approached that of all banks in Japan (4). Foreign banks (including consortium banks) account for about 80 per cent of international bank lending in London, slightly more than ten years ago (Table 15). The foreign banks have also turned their attention to the United Kingdom domestic markets. They have increased their share of sterling and foreign-currency loans to British residents to more than one-fifth and about three-quarters, respectively, and taken an active part in corporate lending in the United Kingdom. The presence of foreign banks and securities firms has made a substantial contribution to both London's international position and the development of domestic financial markets. By increasing competitive pressure they are promoting efficiency and encouraging structural adjustment. However, there is a risk that domestic firms may be overwhelmed by foreign institutions, which have, in many cases, a much stronger capital base. While the authorities have not changed their policy of providing free access to domestic financial markets they are pressing for reciprocal opportunities overseas, especially in the world's leading financial centres, for British institutions. Recent legislation (see below) provides for reciprocity requirements and has increased the authorities' powers to enforce them.

(Table 15. Geographical origin and market shares of foreign banks)

47. Although London has remained a leading financial centre, its dominant position has been gradually eroded. As noted above, the United Kingdom's share of world exports of financial services has declined since the 1960s, though at a slower pace in recent years (5). Its share of international bank lending has dropped from almost 30 per cent in the mid-1970s to below one-quarter, with a tendency to decrease again in recent years subsequent to some recovery in the early 1980s (Table 14). The share of other European centres fell to an even greater extent. Also, some of the fall in the United Kingdom's recorded market share reflects the expansion of the reporting area and exchange rate movements, but there seems to have been an underlying reduction of about 3 percentage points over the last decade (6). A Constant Market Share Analysis, using a methodology applied in the analysis of merchandise export performance, carried out by the Secretariat for the 1978-85

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4. Bank of England Quarterly Bulletin (September 1986), "International Banking in London, 1975-85".

5. Bank of England Quarterly Bulletin (September 1985), op.cit.

6. Bank of England Quarterly Bulletin (September 1986), op.cit.

period, points to a weakening in the banks' competitive position. Over this period, their international lending has shifted to markets growing more rapidly than average. Hence, the fall in the United Kingdom-based banks' world market share reflected other influences than changes in the geographical structure of demand, including possible failure to adjust to the changing structure of demand for financial products and loss in competitiveness.

48. Growth of overseas earnings in insurance and other brokerage has been lower than in banking. Anecdotal evidence suggests that insurance has been affected by protectionism abroad and the development of competing "Lloyd's type" insurance markets overseas. But the loss in market shares has been most pronounced in securities trading. Over the last ten years turnover on the London Stock Exchange has grown at only half the rate achieved by the New York, Tokyo and German Exchanges. As noted above, an important parallel market in Eurobonds and, more recently, international equities has developed in London. But part of the market for international and United Kingdom company shares has shifted overseas, in particular to New York where shares are traded in the form of American Depositary Receipts (ADR) at lower transaction costs (see below).

49. Concerned with the United Kingdom securities industry's ability to compete in domestic and international markets, the authorities have encouraged structural change, including the removal of barriers to foreign entry into an exchange that was constituted as a private club. In the context of those reforms, which culminated in the Big Bang (see below), the Stock Exchange has agreed with the International Securities Regulatory Organisation (ISRO), which represents the big foreign securities firms, to establish a single international and domestic equity market and to merge their respective regulatory functions. This should enhance London's prospects as a major centre for trading international securities. The European Community's decision to gradually remove all barriers to capital movements will present substantial opportunities for the City, given its unparalleled expertise in financial services. However, the worldwide trend towards financial market liberalisation will tend to increase the relative attraction of other centres, all the more so as prudential controls have been tightened in the United Kingdom (see below). Besides New York and Tokyo, London is the logical third leg in the world's emerging around-the-clock trading system. But the application of new information and communication technologies also weakens the case for the physical concentration of financial services. Nonetheless, the existing infrastructure together with the depth of the market and the wide range of instruments available should help to maintain London's position as a major financial centre.

**Financial institutions and markets**

50. For decades the British financial system was remarkably stable in terms of its structure and the operation of individual financial institutions. Since the early 1970s or so the pace of change has, however, accelerated markedly. The importance of non-bank financial institutions in domestic intermediation has increased significantly (Table 16 and Annex II). Traditional lines of demarcation have been eroded, as financial institutions have diversified their activities. Major changes in the 1980s include the softening of boundaries between banks and building societies, the inroads made into domestic banking markets by overseas banks, and, most recently, the

erosion of the distinction between traditional and investment banks, with the acquisition of securities houses by banks in the context of the reform of securities markets.

(Table 16. Main intermediaries' shares)

A. **Deposit-taking institutions**

51. The deposit-taking institutions comprise commercial banks, building societies and finance houses (Annex II). Given the trend towards financial conglomerates marketing the full range of financial services, the traditional distinction between clearing banks, merchant banks and discount houses is becoming increasingly blurred. Initially engaged in retail business, the **clearing banks** have expanded into wholesale and international banking. With the emergence of the Euromarkets and the arrival of a large number of foreign banks, they have lost their dominant position in the banking sector. But the bulk of sterling bank deposits is still held with clearing banks while the overseas banks are mainly handling foreign currency deposits. The London and Scottish clearing banks and other regional banks maintain a considerable branch network spread throughout the United Kingdom. If, for purely stylistic reasons, the United Kingdom and London are used interchangeably throughout the text, it should be borne in mind that a significant part of domestic and even international banking business takes place outside London. Although their share of total intermediary balance sheets has continued to fall (Table 16), banks in general and clearers in particular appear to have stemmed the loss of their share of domestic deposit markets, becoming active lenders to the personal sector, in direct competition with the building societies. Having been already involved in merchant banking (through subsidiaries) and the marketing of securities (through unit trusts), clearing banks have set up large new security trading operations in the context of the Big Bang (see below). There has been a tendency for savings banks to be gradually integrated in the banking sector. The reorganisation of the Trustee Saving Banks (TSB), which started in the 1970s, was brought to an end by the TSB flotation in October 1986. Other institutions, while remaining outside the banking sector, have been allowed to provide a wider range of banking services.

52. The **building society sector** has been one of the major growth elements in the financial system, more than doubling its share in the sterling deposit market since the 1960s. Building societies' sterling liabilities to the public are greater than those of the clearing banks and, in terms of deposits from the personal sector, larger than the total for all banks. More than half of personal sector liquid assets is held with building societies. Among other things, their extraordinary expansion reflects the favourable tax treatment to loans for house purchase and other tax advantages (see below). Raising funds predominently in the retail saving market, the societies have increasingly entered the wholesale money market as borrowers, as they have to face increased competition by banks. Recent legislation (see below) has allowed them to increase their banking activities but still limits their proportion of wholesale funding. While the clearing banks have reduced their branch network, that of the building societies has grown sharply. At the same time, however, there has been a pronounced concentration process. Indeed, since the early 1970s, the number of societies has fallen from about 400 to about 150.

## B. Other financial institutions

53. Other financial institutions comprise life and general insurance companies, pension funds, unit trusts and investment trust companies. These institutions are more important than generally elsewhere, providing about one-half of domestic intermediation (Table 16 and Annex II) and collectively dominating the securities markets. The assets of self-administered pension funds have shown the most rapid expansion (Diagram 9). At about 4 per cent, the ratio of life assurance premiums to GDP is among the highest in the OECD area. Given substantial tax advantages, life assurance and pension funds (LAPFs) have become major vehicles for personal sector saving. More recently, about two-thirds of personal sector savings have been channelled into LAPFs. They hold about one-half of British government stocks and over one-half of the total ordinary share issue of United Kingdom companies quoted on the London Stock Exchange. The most significant change in LAPF portfolios has been the marked rise in the share of overseas assets since the abolition of exchange controls in 1979. General (non-life) insurance represents only a small part of domestic insurance business but is the largest foreign exchange earner among the financial institutions (see above) due mainly to the leading position of Lloyd's in international insurance markets. Foreign business accounts for almost 40 per cent of total general insurance business. After losing ground until the early 1980s, partly due to tax disadvantages, investment and unit trusts have strongly expanded in recent years.

(Diagram 9. Total assets of the major financial institutions)

## C. Securities markets

54. The Stock Exchange is the central market in public sector and United Kingdom company securities. Equities' share in turnover has markedly risen in recent years (to over one-quarter) but the gilt-edged (government bond) market still represents the major segment. Corporate bonds are negligible. The Unlisted Securities Market (see below) has remained relatively small. Shares of small United Kingdom companies are mainly traded in the over-the-counter market, which has most recently been complemented by the Third Market (see below). As noted above, Eurobonds are traded for the most part outside organised capital markets, and the more recent emergence of an off-exchange market in international equities in London has involved trading not only in foreign equities but also in major United Kingdom stocks in both registered and ADR form. Another important market, which has developed outside the Stock Exchange, is the International Financial Futures Exchange (LIFFE). Options are traded on the Stock Exchange. Before last year's structural reforms the Stock Exchange was organised in terms of a strict separation of capacity between broking firms and dealers (jobbers). Single capacity, ownership rules (preventing foreigners and British merchant and clearing banks from becoming members) and minimum commission arrangements constrained the Exchange's ability to adapt and to compete. Those restrictions were gradually eased from 1984 (see below) and completely abolished in late 1986 (the Big Bang). At the same time, the gilt market was opened to outsiders and a computerised quotation and information system (SEAQ) was introduced. A parallel development was the merger with ISRO (see above). Those developments should encourage off-market trading to be conducted through the renamed International Stock Exchange of the United Kingdom and the Republic of Ireland.

D. **Money markets**

55. The entry of overseas banks in connection with the emergence of Euromarkets has led to the development of an extensive market for wholesale funds in London, covering transactions in negotiable instruments and short-term deposits. The discount houses play a prominent role in the traditional secured money market. Acting as market-makers in the call money market and in the Treasury and commercial bill markets, they have privileged access to the Bank as lender of last resort. The role of the discount market has been reduced by the development of parallel markets, mainly in inter-bank unsecured deposits but increasingly also in certificates of deposit, since the 1960s. While banks are the main participants in the strongly expanding Eurocurrency markets, sterling market participants include also other financial institutions, local authorities, and companies. A recent innovation has been the introduction of sterling commercial paper: since April 1986 companies listed on the Stock Exchange are allowed to issue unsecured promissory notes; before they were only able to sell commercial paper in the well-developed United States' markets or Euromarkets.

**The Government's financial reforms**

A. **Liberalisation measures at the turn of the 1970s**

56. The introduction of Competition and Credit Control in the early 1970s (abolition of direct credit controls, dismantling of the clearing banks' interest rate cartel) represented an important move towards financial market liberalisation, which was, however, partly reversed by the periodic reimposition of quantitative controls through the Supplementary Special Deposits Scheme ("the corset"). Another wave of deregulation started soon after the present Government took office in 1979. In view of the development of indigenous oil resources but also reflecting a shift in policy orientation, official restrictions on overseas investment were relaxed, and later in the year foreign exchange controls were abolished altogether (restrictions did not extend to foreign currency business, which had allowed the development of London's Eurocurrency markets). As a consequence, the "corset", already weakened by domestic avoidance, became largely ineffective and was, therefore, abandoned in June 1980. To give markets greater influence in the process of interest rate determination, new monetary control arrangements were introduced in 1981: the continuous posting of an official minimum lending rate was abandoned and the reserve asset ratio for clearing banks replaced by a uniform requirement on all deposit-taking institutions to hold a percentage of their eligible liabilities with the Bank. Finally, official regulation of consumer instalment credit was removed in July 1982.

B. **Recent reforms**

57. The extensive reforms taking place in securities markets and in the regulation of the financial services industry represent a mixture of further liberalisation and greater regulation. The Big Bang on the Stock Exchange removed barriers between specialised functions and institutions. To some extent, this is also true for new legislation dealing with building societies. On the other hand, the Financial Services Act extends the scope of formal regulation and, together with the Building Societies Act and the updating of the Banking Act, tightens supervision to improve investor protection.

i) The **Big Bang** on the Stock Exchange resulted from the Government's decision, in July 1983, to exempt the Stock Exchange from the Restrictive Trade Practices Act subject to specific reforms to its rules and trading arrangements by the end of 1986. Minor changes in the commission structure and the trading rules were already made in in 1984. New ownership rules became effective in March 1986, allowing outsiders to acquire majority participation in Stock Exchange member firms and (domestic and foreign) corporate membership. On 27th October the last and major part of the reform package was brought into effect: minimum commission rates and the compulsory distinction between stockbrokers and jobbers were abandoned, and a new structure of the gilt-edged market, jointly developed by the Stock Exchange and the Bank of England, took effect (with similar rules for broker-dealers and a considerably increased number of market makers).

ii) The **Financial Services Act** 1986 represents the most comprehensive overhaul of legislation regulating investment business for over 40 years. It extends the scope of direct supervision to financial (and commodities) futures and options and to international securities. Most of the powers to authorise and regulate investment business are to be delegated to the Securities and Investments Board (SIB), a private sector body, which in turn may delegate some of them to Self Regulating Organisations (SROs). Among the SROs seeking recognition, The Securities Association (TSA) is the most important. It is the product of the merger of the Stock Exchange and the International Securities Regulatory Organisation (ISRO) and provides regulatory cover for firms conducting business in domestic and international securities. Candidates for SIB recognition as Recognised Investment Exchanges (RIEs), a concept established by the Act, are, among others, the new International Stock Exchange and a separate Eurobond exchange. The Bank of England will continue to supervise the traditional lending and deposit-taking activities of banks and will have special (non-statutory) responsibility for (sterling and foreign exchange) wholesale money markets and the gilt-edged market. Some provisions of the Financial Services Act (such as those concerning alleged insider dealing, listing requirements and, most recently, reciprocity) have already been brought into force. After the recognition of regulatory bodies (probably in the latter part of 1987) it will become a criminal offence to carry on investment business in the United Kingdom without authorisation.

iii) The **Building Societies Act** 1986, most of which became effective at the beginning of 1987, allows building societies, within a limited part of their commercial assets, to undertake some forms of lending new to them: they are now able to make unsecured loans, run insurance broking and provide a number of other financial services, including full current account facilities. Prudential supervision has been strengthened and vested in a new Building Societies Commission.

iv) The **Banking Bill**, currently discussed in Parliament, will replace the 1979 Banking Act. A Board of Banking Supervision will be responsible for advising the Bank of England on the exercise of its supervisory function. The existing two-tier system of authorisation and supervision is to be abolished and replaced by a single set of criteria applicable to all institutions. The Bank of England is to be given powers to obtain information from banks and connected parties and to object to proposed and existing shareholder control of United Kingdom incorporated banks on prudential grounds. The Bill also includes powers to enable the authorities to object to proposed shareholder control from countries which do not treat United Kingdom persons on equal basis with regard to banking, insurance and financial business.

**The financial system and economic performance**

58. As demonstrated above, the financial sector is among the most dynamic of the economy and has maintained an importance in world financial markets which far exceeds that of the country's economic base. Also, the financial system would appear to be performing well its intermediation role between deficit and surplus units. Nevertheless, there are some deficiencies, although they may be less important than generally elsewhere. One source of distortion is the taxation system which privileges certain forms of savings. This affects competition between different types of financial institutions and may distort the allocation of savings between competing investment uses. Market segmentation due to legal and customary barriers -- within the domestic market as well as between the international and domestic market -- has declined as a result of tax changes and financial reforms. Liberalisation measures have increased competitive pressure and cost efficiency but complicated the task of monetary policy and prudential supervision.

**A. Operation and internal efficiency of the system**

59. One way of assessing the efficiency of intermediation is to compare relevant cost and profit ratios drawn from balance sheet statistics. Available indicators for the London clearing banks, which account for less than one-third of the monetary sector, suggest that the cost of intermediation is relatively high by international comparison (Diagram 10). As differences in accounting conventions and the importance of off-balance sheet business limit the comparability of ratio levels across countries, more emphasis should be put on their development over time. The ratio of operating expenses to total assets fell in the first half of the 1980s, indicating efficiciency gains. This allowed some recovery in the net income/asset ratio, though apparently not yet back to levels prevailing in the late 1970s. Nevertheless, the gross earnings margin, an indicator for the overall cost of intermediation, has shown a trend decline since the latter part of the 1970s while being stable or rising in most other countries. Net income from other sources than interest is higher and has grown more than generally elsewhere. Its share in gross earnings increased from one-third at the turn of the 1970s to two-thirds in the mid-1980s (Table 17). Net interest margins have dropped markedly in the 1980s and appear now to be close to levels prevailing in other larger Member countries. Their decline has largely reflected developments in domestic markets. Interest margins on international business have remained broadly stable, though at a considerably lower level, reflecting the large

interbank component of foreign loans. To some extent, the observed narrowing in interest margins may be attributable to the decline in interest rate levels. The presence of non-interest bearing deposits normally implies a less than one-for-one change in the average cost of funds in response to a change in the level of interest rates (endowment income effect). Interest margins have also been squeezed by the falling proportion of non-interest bearing deposits resulting from increasing competition between banks and building societies. Interest spreads, which do not reflect these influences, have not shown the clear underlying decline of margins. Increased competition has probably contributed to the marked fall in capital ratios during the first half of the 1980s (Table 17), which appears to have been reversed, however, more recently, as bank profitability has improved.

(Diagram 10. Cost efficiency and profitability in the banking sector)

(Table 17. London clearing banks: financial indicators)

60. Corresponding indicators for the building societies sector, which is of equal importance in domestic intermediation, are generally much lower (Table 18). Building societies can operate on a considerably finer margin between borrowing and lending rates than other institutions providing retail financial services because of their mutual status with no requirement to pay out a dividend, a low reserve requirement reflecting their asset composition, and low management expenses due to a relatively simple operation. The societies' ratio of operating expenses to total assets rose markedly until the early 1980s, albeit from a very low level, but has stabilised in recent years, mirroring the decelerating growth of branch networks (Table 18). Other income has been of minor importance and relatively stable. Interest margins have tended to rise in spite of increased competitive pressure, given higher operating costs due to non-price competition, as well as higher reserve requirements and tax payments (see below). Into the 1980s, the building societies maintained an interest rate cartel which, if anything, tended to keep lending costs down. This price policy implied a transfer of income from depositors to borrowers, mostly mortgage holders. Facing increased competition by banks in the mortgage market but also on the borrowing side, the societies have adopted a more commercial approach to their business, setting interest rates more in line with market conditions.

(Table 18. Building societies: financial indicators)

61. Since the erosion of the interest cartel and entry of clearing banks, margins are clearly determined competitively in mortgage markets. But the higher degree of concentration and cost of entry in retail banking, along with the low interest elasticity of consumer demand, appear to have protected margins in non-mortgage lending to the personal sector, notwithstanding some signs of a narrowing. Wide differences in some non-mortgage personal loan interest rates seem to persist, although these may in part reflect differences in non-price conditions. There is evidence that margins in corporate lending have narrowed over the past decade (7). The complexity of lending terms, along with the absence of published information, probably restricts

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7. Rose, H., op.cit.

competition, but corporate borrowers have access to a variety of lenders, including overseas banks (accounting already for about 40 per cent of bank lending to the business sector, see below).

62. The tax system has been made more neutral as between different financial institutions, instruments and channels. In particular, reflecting the 1984 Budget, the income and corporation tax treatment of banks and building societies has been brought closer into line, life insurance premium relief has been withdrawn from new contracts, capital gains tax exemption of government securities has been extended to holdings of certain company bonds, and the income tax surcharge on investment income has been abolished. Moreover, the staged reduction in the rate of corporation tax has made companies' choice between equity and debt finance less influenced by tax considerations. But some distortions remain. Complete neutrality of treatment for different types of financial institutions and assets is not necessarily desirable given the different social and economic objectives to which they contribute. But, in particular, it has been suggested that there is little logic underlying the tax treatment of savings in the United Kingdom and the pattern of fiscal incentives is accidental rather than the object of conscious policy (8). Discrimination between different forms of saving has been accompanied by enormous changes in the composition of personal net worth over the last quarter century. The proportion of privileged assets such as dwellings (with mortgage), pension funds and insurance contracts has increased from less than one-half to more than two-thirds, with only a negligible part of the total savings flow over that period going into tax penalised assets. Institutional investors appear to have a strong preference for shares of low specific risk. By encouraging flows into such institutions, the tax system may be leading to higher risk premiums throughout the market than would otherwise be the case. Differences in fiscal privilege are such that changes in the underlying real rate of return on different assets would not be able to equalise the post-tax returns. The priority of tax considerations in making investment decisions is unlikely to improve the efficiency of capital markets.

63. Until last year domestic securities markets were characterised by relatively high transaction costs and inadequately capitalised firms. The rapid expansion of international portfolios of United Kingdom institutions since the abolition of exchange controls benefited Stock Exchange members scarcely at all and, as noted, the market in leading United Kingdom equities was shifting away from the Exchange. The Big Bang of last October more than doubled the number of equity market makers and led to a sharp increase in turnover and a substantial fall in transaction costs, as extra competition and liquidity put downward pressure on (freed) commission rates and market spreads (9). Equity turnover doubled in the six months to March. Part of the fall in transaction costs resulted from a reduction in the rate of stamp duty from 1 per cent to 1/2 per cent as from October (following an earlier reduction from 2 per cent). Commission rates for large equity deals have

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8. Hills, J. (1984), "Savings and Fiscal Privilege", Institute for Fiscal Studies, Report Series No.9.

9. Bank of England Quarterly Bulletin (February 1987), "Change in the Stock Exchange and Regulation of the City"

dropped from about 0.4 per cent to about 0.2 per cent; for very large deals they are now even lower, and many institutional investors deal directly with firms on a net-of-commission basis. Commissions paid on small transactions by individual investors, on the other hand, have dropped only marginally to slightly above 1 1/2 percent. Competition has increased even more in the restructured gilt-edged market where turnover grew sixfold in the six months to March. About one-half of business is done, however, between market-makers whose number has sharply increased. Commission rates in this market have dropped to 0.1 per cent for individual investors and below that level for institutions so that many dealers cannot cover their costs and may have to pull out of the market. So far, however, much higher turnover since the Big Bang has limited trading losses and there has been only one withdrawal from market-making in equities.

## B. Allocative efficiency of the system

### a) Patterns of business finance

64. There is broad agreement that, in general, conditions for business finance are satisfactory and raising of capital has not been a constraint on real investment. Investment performance, as measured by the ratio to GDP, is not out of line with that of most other Member countries. The January 1985 Survey concluded that the main problem for the United Kingdom is unlikely to stem from an insufficient quantity of investment but rather from the inefficient use or poor quality of investment. There are, however, indications that the situation may have changed more recently, latest estimates for capital productivity showing an improved performance both compared with past experience and that of most other countries. The major financial constraint on real investment identified by the Wilson Report (10), namely the price of finance in relation to expected profitability, would seem to continue to play a role, however. Real interest rates to corporate borrowers have remained at high levels, also by international comparison. In contrast, the real rate of return of non-North Sea oil companies, though recovering in recent years, is low by international standards. Hence, the cost of capital appears to have continued to exceed the average rate of return on companies' fixed assets. It is true that evidence of the sensitivity of investment to the cost of finance is by no means conclusive, and enterprises have relied to a considerable (and growing) extent on internal resources (Diagram 11). But the high cost of capital relative to company profitability may help to explain the fact that, atypically, the corporate sector (even excluding North Sea oil) has been a net lender (Table 12), investing to a considerable extent in financial assets rather than in physical capital (Diagram 11). Another possibly worrying feature is that, in relation to investment, expenditure on mergers and acquisitions has grown sharply (to about one-quarter in 1984/85 and about one-half in 1986, approaching the levels reached in previous merger booms). This has been seen, in part, as a manifestation of "short-termism" due to the fact that about 70 per cent of equity in the United Kingdom is owned by financial institutions and funds who

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10. Wilson Report (1980), Committee to Review the Functioning of Financial Institutions, Cmnd.7937, HMSO.

are alleged to be interested in short-term performance rather than providing support for long-term projects.

(Diagram 11. Uses and sources of funds of industrial and commercial companies)

65. The United Kingdom financial system is broadly market-based, with highly active securities markets, dominated by institutional investors, providing a major source of finance for industrial and commercial companies. This is evidenced by the structure of corporate liabilities, as measured by the debt/equity ratio. At a similar level as in the United States, the latter is considerably lower than in countries where banks play the dominating role in the intermediation process, such as Germany and Japan. It has decreased in the 1980s, as generally elsewhere, influenced by rising equity prices and improving profitability (Table 19). Differences between market-based and bank-based systems have tended to decline, however, due to institutional changes and the trends of globalisation of capital markets and securitisation of bank lending. Consequently, the pattern of the flows of funds to firms has been converging (Table 20). Notwithstanding a trend reversal more recently, the recourse of United Kingdom companies to external equity finance and fixed-rate long-term bond finance was relatively small since the 1970s while the role of banks increased. Encouraged, among other things, by increasing competition in domestic markets from foreign banks, who had originally come to London primarily to develop their international lending interests, British banks started to provide a wider range of services, and relations between industry and finance have become much closer in the past decade or so.

(Table 19. Debt/equity ratios of the non-financial corporate sector)

(Table 20. Issue of shares and securities by private non-financial enterprises)

66. Despite the improvement in profitability and an aggregate self-financing ratio of investment of more than 100 per cent in recent years, external funding of companies has continued to grow rapidly. The simultaneous build-up of debt and assets is difficult to explain. Research within the Bank of England suggests that increments in profits are primarily used, in the short run, to build up liquid assets rather than to run down stocks of debt, while higher investment, again in the short run, is largely financed out of debt. To explain the continuation of this phenomenon it has been suggested that increased competition and sophistication may have allowed companies to borrow relatively cheaply and at the same time obtain a satisfactory return on their holdings of liquid assets. To a large extent, however, growth in liquid financial assets can be associated with a continued wave of mergers and acquisitions, although the latter has been increasingly undertaken by means of capital issues. Companies relatively high bank borrowing (Diagram 11) led to a gradual rise in capital gearing (net financial debt as a proportion of total trading assets) during the first half of the 1980s. Income gearing (net interest payments as a proportion of profits after tax) has also tended to rise slightly more recently, following a sharp drop from the high levels in the early 1980s (resulting from high interest rates and depressed profits in the recession). Both ratios have continued to be low, though, by international comparison. But there are substantial sectoral differences, and

70. Since its inception in November 1980, the **Unlisted Securities Market** (USM), the first in Europe, has successfully fulfilled the role of an organised equity market for small and medium-sized companies operating in growth sectors, improving access to equity capital for these companies and reducing the cost to the company of raising funds. Conditions of admission to the USM are easier than those prevailing on the principal exchange but investor protection rules are similar. Starting with 11 companies, the USM has grown to more than 370 company quotations capitalised at almost £5 billion. Market liquidity and price volatility continues to be a problem, but the USM has become broader-based after the near-collapse of its largest sectors (oil and electronics) and has continued to expand after the Big Bang, although there were fears that securities houses, in an increasingly competitive City, would by-pass the more modest business generated by the small companies quoted on the USM. The USM could suffer, however, in the long run, from the creation of the so-called **Third Market** in January 1987. Entry requirements to the latter are less onerous, with most of the responsibilities falling to a sponsor (which has to be a Stock Exchange member), and personal investors qualify for income tax relief under the Business Expansion Scheme (see below), not available for shares quoted on the USM or the main exchange. On the other hand, the Third Market provides investors with a better regulated and more transparent environment than the over-the-counter market for shares of unquoted companies. Trading on the new market has slumped after a buoyant start, but a similar pattern was observed after the introduction of the USM in 1980.

71. The **Business Expansion Scheme** (BES) was set up in 1983 (as a successor to the Business Start-up Scheme) and provides generous income tax relief for new equity investment (direct or through an approved investment fund) by individuals not closely connected with the firms concerned, which must be unquoted United Kingdom companies (or companies quoted on the new Third Market). Eligibility requirements were tightened in 1986 to prevent the promotion of very sound assets (such as land and buildings). Since January, up to a certain limit, investments in ordinary shares of United Kingdom companies listed on the Stock Exchange and in unit trusts are free of tax on dividends and capital gains if they are kept in a **Personal Equity Plan** (PEP) for two years. So far interest of the public has been limited. The scheme is in principle aimed at the small saver and first-time share-buyer who are unlikely to be liable for capital gains tax. Employees can acquire shares of the companies in which they work under a more lenient tax regime. The number of such **employee share schemes** has risen from 30 in 1979 to about 1 200, covering 1 1/2 million employees, as tax incentives to encourage firms to introduce share ownership schemes for all their employees have been further improved. There are also tax incentives for share schemes for key employees and for savings-related share option schemes.

72. Besides the growth of employee share schemes it has been above all the Government's privatisation programme which has boosted wider share ownership. Most companies have been privatised by stock market flotation with special arrangements being made to encourage both employees and small investors to buy shares. The latest survey evidence suggests the number of shareholders in the United Kingdom has risen from 3 million in 1979 to 8 1/2 million, or just under 20 per cent of the adult population, largely as a result of the British Telecom, Trustees Savings Banks and British Gas flotations since late 1984 which attracted altogether almost 10 million shareholders (of whom about 8

the interest burden is markedly higher for small business for which banks continue to be the prime source of funds.

67. Bank lending to business has sharply declined most recently (Diagram 11). One factor contributing was the deceleration of leasing as a result of reduced tax advantages. But, as shown in Table 20, issues of shares and securities by private non-financial enterprises have tended to rise in relation to investment in the last few years, though from a very low level. The long-term corporate bond market has failed to recover, however, in spite of the encouragement provided by the above-mentioned tax measures. The new sterling commercial paper market has shown a steady but not spectacular level of activity, given the remaining restrictions (see above) and strong competition from the corresponding Euromarket. Share issues, however, have continued to rise sharply, though in part due to special factors (such as the sizeable British Gas flotation).

### b) Moves to increase equity participation

68. Although United Kingdom companies have generally operated with a wider equity base and lower capital gearing than companies in many other countries, the deterioration in the balance sheet structure of the corporate sector in the 1970s and into the 1980s (Table 19) had been a matter of concern. In order to strengthen the equity base of companies, it was essential to restore profitability, as internally generated funds have typically provided the bulk of their finance, but also to supplement internal funds by improved access to external equity capital. During its term of office, the Government has taken a wide range of measures to encourage equity finance and equity participation of individuals in particular. "Wider share ownership" is expected to contribute to the emergence of a new "enterprise culture" with increased contacts between individuals and companies and a better understanding of how business works. Institutional investors, despite their position as major shareholders of United Kingdom companies, have maintained little direct contact with the companies in which they invested and have been reluctant to take new risks, which can make it more difficult for small and new firms to raise funds. Hence, the trend towards concentrating share ownership with financial institutions is believed to make the market less effective as a source of investment capital.

69. The supply of equity finance for small and new companies has been significantly improved by the development of venture capital funds and junior stock markets. **Venture capital funds** have expanded rapidly in the 1980s, helped by government schemes providing tax incentives for personal equity investment (see below). Their number has increased from fewer than 20 in 1979 to more than 110, and the amount invested in recent years is, as a proportion of GDP, comparable to that of the United States, accounting for two-thirds of total venture capital investment in the European Community area. The proportion of funds for start-up companies is relatively small, however, with finance for each expansion and management buy-outs and buy-ins accounting for about one-half of the rest. The bulk of venture capital is provided by pension funds. Originally part of larger firms, such as banks, venture firms have been increasingly established as independent firms, though frequently backed by big institutions.

million are estimated to have remained on the register). Despite the privatisation programme and rising equity prices, the proportion of shares in personal sector gross wealth has risen only slightly, after falling from one-quarter in the early 1970s to one-tenth in the early 1980s. Moreover, notwithstanding greatly improved tax incentives and the removal of tax privileges for life assurance (not for pension funds), the proportion of United Kingdom equity held directly by individuals has continued to decline and is now down to about one-quarter (from more than one-half in the 1960s). The greater fall in transaction costs for large institutional investors after the Big Bang (see above) has boosted institutional trading and tended to further increase their share of the total. The latest survey also suggests that a large proportion of shareholders have a stake in only one or two companies and that share ownership is concentrated in the higher age and income groups. Hence, there is still much scope for both deepening and widening share ownership.

## C. Impact on policies and macro-performance

### a) Effectiveness of monetary policy

73. Containment of broad money within gradually declining target limits was the centrepiece of the Government's Medium Term Financial Strategy as unveiled in the 1980 Budget. In the event, economic policy has been more successful in achieving ultimate objectives than in meeting intermediate monetary targets. In view of their persistent overshooting, these have been periodically redefined, revised upwards, or even suspended (see Monetary Policy section in Part II). A major factor behind the breakdown of stable relationships between most monetary aggregates and nominal income appears to have been the fast pace of financial innovation and liberalisation in recent years. The removal of controls around 1980 has not only led to a surge in banking intermediation but triggered an entirely new dynamic in competition between financial intermediaries. With the entry of banks into the mortgage market, rationing of mortgage lending by building societies came to an end. On the liability side, banks had increasing recourse to wholesale market funds to supplement their traditional retail deposits. To support additional lending, both banks and building societies had to offer better terms for deposits, which has led to a strong rise in the proportion of interest-bearing sight deposits. These changes have tended to increase the volume of intermediation and distort the growth of monetary aggregates, making the trend of their income velocity less predictable.

74. For the personal sector, the observed simultaneous build-up of debt and liquidity can be largely explained by households rearranging their portfolio of liabilities and assets in response to the freer availability of credit, particularly at low cost and long term (11). For companies and non-bank financial institutions, which have particularly contributed to accelerated growth of broad money, the rapid expansion of both sides of their balance sheet is more difficult to understand. But, as noted above, one possible explanation is that the narrowing of the costs of intermediation, i.e. the

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11. Bank of England Quarterly Bulletin (December 1986), "Financial Change and Broad Money".

effective spread between deposit and lending rates, due to increased competition and technological change has reduced the incentive to economise on both borrowing and holding deposits. There is evidence that the demand for deposits and loans has become more elastically responsive to shifts in interest spreads while the growth of broad money and private sector bank lending has become insensitive to variations in the general level of interest rates (12). With dividing lines between the functions carried out by the various financial intermediaries becoming blurred, minor changes in relative interest rates may lead asset holders to rearrange their portfolios. Hence, the relationship of such asset holdings to nominal income and to the general level of interest rates tends to become looser and the growth of monetary aggregates tends to become less reliable as a guide to future trends in inflation and nominal incomes.

75. The increasing role of relative interest rates has reduced the authorites' ability to control the growth of monetary aggregates. Since the posting of an official lending rate and the overfunding of the Public Sector Borrowing Requirement were abandoned, the only means available to control monetary growth has been to influence the general level of short-term interest rates through open market operations. The lower interest elasticity of credit demand, and hence expenditure, which has resulted from the structural changes in the financial system, might induce the authorities in their pursuit of monetary objectives to vary interest rates more sharply. Thus, problems of monetary control consequent to financial market deregulation in the early 1980s would seem to have led to higher interest rates than otherwise might have occurred. Reduced domestic potency of policy-induced changes in domestic interest rates appears to have been accompanied, however, by a greater effect on international capital flows and exchange rates, given the abolition of exchange controls and growing integration of financial markets. Indeed, as noted in Part II of this Survey, there has been a shift of the focus of monetary policy to the exchange rate.

b) **Problems of prudential supervision**

76. The described process of deregulation, innovation and structural change has also made the task of prudential supervision more demanding but at the same time also more important. The growing diversity of business of individual institutions initially exposes them to greater risks and makes it more difficult to assess their soundness. With the external separation of broking and dealing functions abolished, the risk of misconduct has increased. Hence, to improve investor protection and deal effectively with fraud, the whole framework of financial market supervision is being up-dated and extended (see above). The new system can be characterised as controlled self-regulation. However, in the wake of various financial scandals, the balance is shifting towards more statutory control: the authorities have seen to it that self-regulatory standards become more stringent (e.g. in the case of Lloyd's and the Takeover Panel) but warned that they would impose statutory controls where necessary. The new regulatory structure is expected to avoid the rigidity and higher costs of more centralised systems. It may, however,

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12. Goodhart, C. (1986), "Financial Innovation and Monetary Control", Oxford Review of Economic Policy, Vol.2, No.4.

prove to be unnecessarily complex. Constructed on functional rather than institutional lines, it may pose formidable co-ordination problems between the different supervisory agencies relevant for any single financial institution conducting a wide range of business. Experience of other countries suggests, however, that there is little alternative: institution-based supervision tends to become ineffective and inconsistent when the distinction of activities becomes blurred.

77. Forthcoming legislation (see above) gives the Bank of England stronger statutory powers, in particular in the prudential control of bank takeovers and large exposures. According to a recent survey, most banks were basing their capital allocation system on the minimum regulatory requirements of the central bank and, hence, had not allocated capital for all off-balance sheet items, including the full range of innovative financial instruments developed in recents years. These items will be included in a common measure of capital adequacy on which United States and United Kingdom regulators have reached agreement. Apart from these and other modifications, the new measure corresponds to the risk asset ratio calculated by the Bank for a number of years. International co-operation in the supervision and regulation of financial markets, including securities markets, is an area where urgent progress is needed, as divergent prudential standards as between different centres threaten the effectiveness of supervision in all centres.

## IV. OUTLOOK AND LONG-TERM PERFORMANCE

### Short-term prospects

78. The latest Secretariat forecast published in mid-June puts the OECD area annual rate of GDP growth at around 2 1/2 per cent over the next eighteen months or so. The United Kingdom's export markets are expected to expand fairly steadily at about 4 1/2 per cent, somewhat faster than world trade. The recent appreciation of sterling has partly reversed the marked improvement in competitiveness since mid-1985 but on the technical assumption of no further nominal exchange rate changes as from the 21st April, the information cut-off day for the OECD Economic Outlook, the effective exchange rate of sterling will remain significantly below its 1986 average. Even so, the competitive position is foreseen to deteriorate as unit labour costs are likely to increase faster than on average in trading partner countries. Hence, export market gains arising from the earlier depreciation of sterling will become smaller and may eventually be reversed. Domestically, as noted in Part II, some tightening of policies is assumed in the period ahead, with public expenditure growth decelerating and interest rates edging up in line with international developments. This policy configuration would seem to be consistent with both a constant exchange rate and gradual deceleration in monetary growth.

79. Domestic demand growth should remain strong this year followed by a likely slowdown in 1988 (Table 21). After a period of weak capital spending but improved profit and output expectations, intention surveys point to a marked pick-up of business investment activity in 1987. However, given the projected deterioration in international competitiveness, the upswing may peter out towards the end of next year. Stockbuilding is expected to accelerate temporarily after the sharp drop in the stock/output ratio last year. Residential construction, which rose steeply during 1986, is likely to grow at a slower pace, given the latest trends in housing starts. Budget plans point to declining public investment and slower growth of public consumption, following the relatively rapid expansion in 1986. Private consumption, though supported by tax cuts and possibly renewed declines in the saving ratio, is also likely to lose momentum as higher inflation will erode personal income gains.

(Table 21. Short-term prospects)

80. With foreign demand weakening, real GDP growth is projected to fall short of that of domestic demand. Employment should continue to rise, however, as slower output growth can be expected to entail a deceleration in productivity gains. Assuming modest labour force growth, unemployment may experience some further decline, notably in 1987. Largely reflecting productivity developments, the growth in unit labour costs is projected to

reaccelerate. The resulting upward pressure on inflation will only in part be offset by the dampening influences from the recent appreciation of sterling. Despite the projected improvement in the terms of trade, the current external account is expected to show a rising deficit. The surplus on invisibles, which had been boosted by special factors in 1986 (lower payments abroad by North Sea companies, abnormally low net transfers to the European Community), is likely to grow at a slower pace, and the rising trend in the trade deficit is projected to be resumed, following the temporary improvement in the trade balance early this year.

81. Among the risks and uncertainties surrounding the projections, the most important are certainly those related to a possible cumulative weakening in economic activity abroad. The underlying strength of the domestic economy would seem to ensure, however, continued strong activity growth in the immediate future. It is true that consumer demand has weakened somewhat and non-residential investment has failed to recover until recently. Yet, the latest quarterly survey of the Confederation of British Industry points to sharply improved business confidence, showing buoyant order, output and investment expectations. The percentage of firms reporting plant capacity as a limit to output (Diagram 12) rose by 10 percentage points between January and April 1987 and is now much higher than at the 1979 peak though still below the peak level of the 1973-74 boom. While this augurs well for higher capital spending, it may also be indicative of imminent inflationary pressures. Skilled labour shortages, on the other hand, have not changed much in the last three years and are much less pronounced than in earlier upswings (Diagram 12). Nonetheless, wage increases have remained high, especially by international comparison, and may well reaccelerate, contrary to what is presently assumed. On the other hand, it cannot be excluded that the present projections underestimate the extent to which recent productivity growth has reflected greater trend efficiency of labour rather than once-and-for-all cyclical gains. Prospects for sustained rapid growth, without inflation taking off and the external deficit widening, would, of course, be clearly improved if productivity growth held up better than assumed in the projections.

(Diagram 12. Limits on output)

**A longer-term perspective**

82. The United Kingdom's recent growth performance compares favourably with that in the 1960s and 1970s when the economy persistently lost ground to the other industrial countries. Entering its seventh year, the current recovery is the longest in British post-war history. The rate of GDP growth achieved since 1981 has been one of the highest in the OECD area. However, as the United Kingdom economy had passed its cyclical trough earlier than many other Member countries, measuring the relative performance since the cyclical peak of 1979 may be more appropriate. Over this period, which corresponds to the Government's term of office, GDP growth averaged 1 1/2 per cent, only slightly more than during the previous cycle and much less than during the earlier ones. This rate was well behind the performance of Japan and the United States and about the same as for OECD Europe (Diagram 13). This less favourable picture reflects the depth of the recession at the beginning of the 1980s: real GDP returned to its 1979 peak only in 1983 and manufacturing output is still running below its 1979 level.

(Diagram 13. Relative economic performance)

83. While of similar size to the post-OPEC I rate, the pattern of growth since OPEC II has been very different. First, the North Sea oil contribution to output growth has been smaller. Second, productivity growth has been considerably higher (though not high by pre-1973 standards) while employment has fallen markedly. Renewed employment growth since 1983 has only sufficed to recuperate a little more than half of the previous losses (Diagram 13) and to broadly stabilise unemployment at a high rate by international comparison. The inflation rate, very high at the turn of the 1970s, had converged to the OECD average by 1983 but a gap has persisted relative to major competitors and periodically even widened. In spite of the high unemployment rate, wages, both nominal and real, have been rising faster than abroad, and the growth in unit labour costs has tended to outpace that in the main trading partner countries. The manufacturing trade balance has shown a trend deterioration and, in 1983, switched into deficit for the first time since the Industrial Revolution. Nonetheless, the current external account was in surplus in the first half of the 1980s thanks to the exploitation of North Sea oil and gas.

84. As noted, the Government's strategy has achieved its primary goal of bringing down the rate of inflation, although there has been little further progress in this area since 1983. It is harder to assess the respective contribution of macro- and microeconomic policies to the recovery, and in particular to the recent favourable growth performance. Increasing awareness of the distorting effects of deregulation and innovation in financial markets has led the authorities to base their judgement of monetary conditions on a wider range of indicators; this shift in emphasis would seem to have helped avoiding an unintended tightening of policy in recent years, although interest rates have remained high and have even risen in real terms. A rough indicator for the supply-side responsiveness of the economy is the split of nominal income growth as between output growth and inflation (Diagram 14). After sharply improving in the earlier part of the recovery, the output/inflation split has been broadly stable since 1983, and the 1987 MTFS projections expect little change up to 1988. This picture is confirmed by the virtual stability of a more appropriate measure, the elasticity of output to nominal aggregate demand. There are no clear signs for a change in the rising trend of import penetration. Following a sharp increase in the early phase of the recovery, the elasticity of manufactured imports to demand showed signs of moderation. But the recent reacceleration of the upturn was again accompanied by a surge of imports, which was only partly reversed early this year.

(Diagram 14. The nominal income split)

85. Recent productivity gains, however, may be indicative of an improvement in supply-side conditions, although they followed a marked activity-linked deceleration. Even so, labour productivity growth in the private business sector since 1979 was significantly higher than previously and among the highest in Member countries where it has tended to decelerate. According to Secretariat estimates, total factor productivity, which may be taken as an indicator for general efficiency, has risen significantly more in the present cycle than in the preceding one, contrary to developments in other major OECD countries. This result is the more noteworthy as it took place in the context of broadly similar average output growth during both cycles. The implied efficiency gains are estimated to have stemmed, with roughly equal weights, from the improvement in labour productivity growth and a deceleration in the

fall of capital productivity. The former was the result of major labour shedding during the recession and early stages of the recovery, while the latter would appear to reflect accelerated scrapping of inefficient capital vintages. Yet, successful supply-side policies can be expected to raise per capita income not only by increasing the productivity of the employed but also by reducing unemployment to its frictional core. Progress has been modest in the second aspect, reflecting, among other things, persistent wage rigidity.

## V. CONCLUSIONS

86. The recovery has now lasted six years, an unusually long period by post-war standards. Growth appeared to be faltering in the second half of 1985 but resumed in 1986 and prospects are good for a seventh year of expansion. The impending downturn was averted by the combined effect of three developments: the fall in the oil price, the decline in the exchange rate, and the reversal of the previous tightening of policy. Oil production, representing about 6 per cent of total output, has levelled off, but the fall in oil prices has resulted in a switch in profitability towards energy-using companies and a substantial real income gain for consumers. In addition, consumers reduced their saving rate despite the windfall gains from lower energy prices. In view of the damping effect of oil prices on inflation and the need for some real exchange rate adjustment, continued downward pressure on sterling was not resisted. Assisted by the the fall in the exchange rate since mid-1985, export growth accelerated sharply in the second half of 1986 and has remained relatively strong in the present year, in contrast to developments in appreciating countries. At the same time, domestic demand has been supported by higher public expenditure, reversing the fall in 1985, and by a decline in interest rates.

(pension contributions)

The '85 fall was largely reversed [illegible] 1984

87. Recent indicators and survey results point to continued rapid activity growth in the near future. Helped by lower interest rates and income tax cuts, domestic demand should remain buoyant, with investment picking up and consumer demand remaining relatively strong. GDP growth may decelerate in 1988, however, as export performance suffers from losses in competitiveness resulting from the recent appreciation of sterling and higher cost increases than abroad. This, in turn, may adversely affect investment activity, while consumer demand is likely to weaken as a result of lower real income growth. Fiscal stimulus to domestic demand will diminish, according to present budget plans. Even so, growth performance over the next eighteen months or so should compare favourably with that of many other Member countries. There are, however, three problem areas: the high rate of unemployment, the persisting inflation differential against trading partner countries and the deterioration in the external balance. The challenge to the authorities is to ensure, through a consistent but flexible implementation of their strategy, that further improvements in the labour market situation be achieved without jeopardising price stability and the external balance.

88. After a protracted period of high and rising unemployment there are first signs of an improvement: the number of unemployed has been falling since mid-1986, with the share in the total of youth unemployment continuing to decline and that of long-term unemployment stabilising. These favourable trends are to a large extent attributable to specific government programmes. Targeted at the young and the long-term unemployed, the measures taken entail

little risk of rekindling inflation. However, while reducing social hardship and enhancing human capital, they cannot substitute for more fundamental improvements in the functioning of the labour market and, in particular the wage formation process. The experience of a continued rapid rise in real wages, in the face of high and until recently rising unemployment, has not been shared by many countries. A number of measures have already been taken to enhance labour market flexibility and others have been announced, such as encouragement of profit-sharing schemes; but considering the high degree of wage stickiness more needs to be done. The Government does not favour the use of an incomes policy, as it would be inconsistent with its goals of deregulation and greater wage differentiation. But the Government has a role to play in public sector wage settlements, which have exceeded the private sector average over the past year or so.

reasonably helpful

89. Wages have failed to respond to the deceleration of inflation linked to the oil price fall. The underlying rate of growth of earnings has shown virtually no change since 1984. Pay settlements in the private sector have come down somewhat, but this has been largely offset by wagedrift, and recent settlements appear to have edged up again in response to higher inflation. Although nominal wage rigidities helped to support demand and output after the oil price fall, the more rapid increase in wages than in other countries represents a major problem. Despite improved productivity performance in the 1980s, unit labour costs have grown more than in trading partner countries. Gains in competitiveness have resulted from real depreciation of sterling. While helping to maintain export market shares, the fall in the exchange rate has made progress towards price stability more difficult. In domestic markets, the competitive position has even weakened, as evidenced by the unabated rise in import penetration. High oil revenues until 1985 concealed the resulting deterioration in the trade balance. With oil prices much lower than those prevailing in the early 1980s and oil production likely to decline, it is clearly important to bring the rates of wage increases and inflation into line with those of main trading partners.

90. Within the framework of the Government's Medium Term Financial Strategy (MTFS), the role of monetary policy has been to reduce the rate of growth of nominal income. But as the relationship between broad money aggregates and nominal income has become increasingly less predictable -- probably reflecting the fast pace of financial innovation and liberalisation -- the conduct of policy has been particularly difficult in recent years. The shift in emphasis away from broad money towards other indicators has continued. The 1987 MTFS dropped the broad money target but maintained growth target ranges for the monetary base. The exchange rate has assumed greater influence on policy than before, although the difficulties in disentangling the impact of oil price changes and political developments from that of changes in monetary conditions limit its usefulness as a guide to monetary management. Given these complications, the flexible implementation of monetary policy would appear to have been relatively successful. Interest rates, although still high in nominal and real terms by international standards, have been allowed to fall considerably since 1985. Their decline was only reversed occasionally when the decrease in the exchange rate threatened to become excessive. Recently, faced with upward pressures on the exchange rate, the authorities have allowed interest rates to fall, although at a moderate pace because of the rapid expansion of credit.

91. Despite the sharp fall in oil revenues, the Public Sector Borrowing Requirement (PSBR) has come down earlier than expected to the medium-term target ratio of 1 per cent of GDP. This goal has been realised, however, at higher tax and expenditure ratios than thought desirable from the point of view of strengthening private initiatives. Although public revenue and expenditure have declined as a proportion of GDP over the past two years, their respective shares are still above 1979 levels. The public debt/GDP ratio has declined somewhat during the course of the 1980s but, at more than 50 per cent, is still high by international standards. Moreover, as discussed in last year's Survey, questions may be raised about the relevance of the PSBR as an indicator of fiscal soundness. The general government financial deficit (excluding, among other things, public asset sales, which have been stepped up significantly) has remained at around 3 per cent of GDP since 1979 and, despite sizeable oil revenue, is much higher than in other major countries such as Japan and Germany. In view of the weakening of activity growth at the turn of 1985 and the subsequent fall in oil revenues, some rise in the financial deficit in 1986 may have been appropriate. However, with the present pace of GDP growth, a broadly neutral stance of policy consistent with a cyclical fall in the financial deficit would appear to be more desirable. Given the income tax cuts, tighter expenditure control than in the past seems therefore to be called for.

Not so: 4% in 79-80 or 5% in 80-81

92. The authorities have continued their efforts to improve the supply side of the economy. However, after major moves in this direction in the first half of the 1980s, progress has slowed. Comprehensive reforms in important areas such as personal taxation, social security and local authorities are still awaiting final decisions. Recent measures, either implemented or announced, comprise adjustments to personal taxation, tax relief on profit related pay, an expansion of employment and training measures, and a significant acceleration in the privatisation programme. By the end of this year, about 40 per cent of previously nationalised companies may have been transferred to the private sector, and the authorities intend to privatise most of the remainder during the term of the next Parliament. The programme appears to have contributed to improved profitability within both the privatised and the state-owned sector. The cumulative effect of the various measures taken so far to improve the functioning of markets can be expected to favourably influence supply-side performance over time. Yet, many rigidities remain and the impact of changes takes time to come through. It is therefore to be hoped that reforms, which do not negatively affect social cohesion, are implemented without undue delays.

is this comma intended ?!

93. In the financial field major deregulation measures were taken already at the end of the 1970s. The abolition of foreign exchange controls for residents has accelerated the internationalisation of financial markets. The move towards a more market-oriented monetary policy and away from quantitative controls has been an inevitable consequence of this first step. Liberalisation measures have blurred the traditional boundaries between financial intermediaries, thereby increasing competitive pressure in domestic markets and cost efficiency of intermediation. At the same time, the task of monetary policy and of prudential control has become more complicated, given more difficult control and interpretation of monetary aggregates. Raising of

capital has generally not been a constraint on real investment, with the presence of an increasing number of foreign institutions enlarging the base for business finance. Possibly worrying features are that the corporate sector has been investing to a considerably extent in financial assets rather than in physical capital and that, in relation to fixed investment, mergers and acquisitions have grown sharply. The former may be in part a consequence of the still high cost of capital relative to company profitability. The latter has been related to short-term oriented strategies of insitutional investors, which have maintained a dominant position in securities markets despite official encouragement of wider share ownership.

94. Recent financial reforms have culminated in the complete reorganisation of the Stock Exchange, encouraged by the authorities' concern for the United Kingdom's ability to compete in domestic and international securities markets. While as an international financial centre London still ranks in the top three with New York and Tokyo, it has lost ground to other centres, with the loss in market shares most pronounced in securities trading. The removal of entry barriers and minimum commissions along with a reduction in the rate of stamp duty has led to a sharp increase in turnover and significant declines in transaction costs. The increased risk of losses and malpractices associated with the liberalisation and internationalisation of financial markets has prompted the authorities to extend the scope of formal regulation and to strengthen supervision. The new framework of financial market supervision can be characterised as controlled self-regulation. Based on functional rather than institutional lines, it may pose considerable co-ordination problems but is expected to avoid the rigidity and higher cost of more centralised systems. All in all, the reforms represent a judicious mixture of liberalisation and greater regulation of markets.

95. In sum, recent economic developments in the United Kingdom compare favourably both with its own past performance and that of other countries. There is no reason for complacency, however, as these appreciable developments follow upon a long period of relative decline and occur against the background of an unsatisfactory performance abroad. The rate of unemployment has hardly decreased and the external balance has moved into deficit. A major problem is the stickiness of wages in the face of high unemployment and falling inflation. So far, there is little evidence that past trends of wage and price increases in excess of those in main trading partner countries have been reversed. Continued efforts to improve supply-side conditions should facilitate the necessary adjustment process. The recovery of rates of return on capital in recent years and the apparent strengthening of total factor productivity growth may be taken as first signs that the economy is moving into the right direction.

psl/15A

CONFIDENTIAL

pp

FROM: A C S ALLAN
DATE: 29 May 1987

MR SEDGWICK

cc Sir P Middleton
Sir T Burns
Mr Evans
Mr Turnbull
Mr Bottrill
Mr Culpin
Mr Davies
Mr Mowl
Miss O'Mara
Mr Matthews
Mr Allum

**OECD ECONOMIC OUTLOOK: COUNTRY NOTE ON UK**

The Chancellor was grateful for your minute of 27 May. He is content for you to proceed as you suggest in your paragraph 3, not seeking any fundamental changes but correcting errors of fact.

2. In addition to the points you mentioned, the Chancellor queried the sentence in paragraph 12 which reads "Bank lending, in particular for consumption, has remained high". As he recalled the figures, the main growth was mortgages and OFIs. If so, this sentence too should be corrected.

ACSA

A C S ALLAN

pvg

FROM: **S J DAVIES**
DATE: 29 MAY 1987[

**MR ALLAN**

cc Sir P Middleton
Sir T Burns
Mr Evans
Mr Peretz
Mr Sedgwick
Mr Turnbull
Mr Bottrill
Mr Culpin
Mr Mowl
Miss O'Mara
Mr Matthews
Mr Allum

**OECD ECONOMIC OUTLOOK**

The Chancellor's comment about the reference to bank lending in paragraph 12 was correct. A note on this has been added to the attached list of points that has now been sent to the OECD.

SJD

**S J DAVIES**

ECONOMIC OUTLOOK : UK CHAPTER

There are three factual points in the text with which this note deals.

**paragraph 4, first sentence**: The deterioration in the balance between real growth and inflation is a feature of the OECD forecast. It is not a feature of the performance of the UK economy in the recent past.

**paragraph 6, third sentence**: This paragraph discusses developments in and contributions to real output growth. The third sentence of paragraph 6 should thus refer to general government consumption volumes rather than real public consumption. In the public expenditure context in the UK 'real' is used for current price figures deflated by the GDP deflator. It is not appropriate to introduce this particular concept of 'real public consumption' in a paragraph about movements in the expenditure components of real GDP. We assume that this was not the Secretariat's intention and that the figures do indeed relate to general government consumption volumes as published in the UK national accounts. If so, this sentence is misleading or possibly wrong. General government consumption volumes did not fall in 1985 (whole year on whole year) or during 1985 (Q4 on Q4). The fall between 1984H2 and 1985H2 was small.

**Volume of General Government Consumption**
**(percentage change over same period a year previously)**

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **1985** | Q4 | 0.2 | **1985** | H2 | -0.2 | **1985** | 0.2 |
| **1986** | Q4 | 2.0 | **1986** | H2 | 2.1 | **1986** | 1.2 |

As explained in a Treasury note to the Treasury Committee (copy attached) in November 1986 "it is.....not advisable to put too much weight on the precise half-yearly profiles", partly because of the well-known difficulties about converting cash plans into volume figures.

We suggest therefore a re-draft of this sentence as follows:

"General government consumption, which had increased only slightly in volume terms in 1985, rose by over 1 per cent in 1986."

**paragraph 14, sixth sentence**: housing starts have definitely not levelled off. The March 1987 Housebuilding press notice from the Department of Environment shows that, despite the bad January weather, total first quarter starts were up 12 per cent on 1986 levels (private starts on the same basis were up 16 per cent).

**paragraph 12, third sentence**: this sentence suggests that lending for consumption has made a disproportionately large contribution to recent growth in bank lending. This is incorrect as the following published figures show (unpublished and as yet not finalised figures for the year to 1987Q1 tell a similar story).

**GROWTH IN BANK LENDING 1985Q4 to 1986Q4**

| | **Percentage change** | **Absolute change (£bn)** |
|---|---|---|
| Lending for consumption | 17.7 | 3.6 |
| Lending for house purchase | 22.2 | 4.7 |
| Lending to OFIs | 52.7 | 12.9 |

From "Second Report from the Treasury and Civil Service Committee Session 1986-87 - The Government's Economic Policy: Autumn Statement" (3 Dec. 1986)



## Appendix 7

### Supplementary note by H M Treasury

At the hearings with both officials and the Chancellor of the Exchequer, Mr Townend argued that the underlying increase in real terms in public expenditure in 1986–87 after correcting for privatisation proceeds and for the effect of the coal strike was greater than the growth of GDP in real terms. The Committee asked for a note on this point.

2. In real terms the change in the planning total was as follows:

| | | Per cent |
|---|---|---|
| | *1985–86* | *1986–87* |
| Planning total, including privatisation proceeds | −2.9 | 2.2 |
| Planning total, excluding privatisation proceeds | −2.5 | 3.5 |

The corresponding figures for general government expenditure which includes debt interest are:

| | | |
|---|---|---|
| GGE excluding privatisation proceeds | −0.3 | 0.8 |
| GGE excluding privatisation proceeds | 0.0 | 2.0 |

3. At the time of the hearings in November 1985, the Treasury estimated that the impact of the coal strike on the planning total would be £2½ billion in 1984–85 and £1¼ billion in 1985–86. The Treasury now estimate that the figure for 1985–86 would be £¾ billion, principally reflecting the sharp improvement in the finances of British Coal.

4. In his evidence the Chancellor of the Exchequer pointed out that, under a system of cash planning and control, there can be fluctuations in the year to year real terms increases if the GDP deflator moves differently from what was expected at the time the plans were made. For example, the GDP deflator in 1985–86 increased by 6 per cent, against the 5 per cent projected at the time of the 1985 Budget. This change in inflation would have made very little difference to the level of cash spending in that year, the change being reflected in a bigger than expected fall in real terms. Similarly, the GDP deflator for 1986–87 is now expected to rise by 3 per cent against 3¾ per cent in the 1986 Budget, while for large parts of the public sector cash spending in this year will be unaffected.

5. To establish the underlying trend it is necessary to look at the developments over a number of years. Between the years 1983–84 and 1986–87, neither of which was affected by the coal strike and a period during which unanticipated movements in the GDP deflator even out, GGE excluding privatisation proceeds—which is the aggregate giving the best guide to underlying movements—increased by 1¾ per cent a year. Over this period, GDP increased by 2¾ per cent a year in real terms.

## GENERAL GOVERNMENT CONSUMPTION

### Note by H M Treasury

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

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

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

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

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

Printed for Her Majesty's Stationery Office by
Brown Knight & Truscott Ltd, London and Tonbridge
Demand No. 0702027 PS6350817 C10 12/86 4146 22126

ASDI ASSOCIATION SUISSE DE DEFENSE DES INVESTISSEURS ASDI
SCHWEIZER INVESTOREN-SCHUTZ-VEREINIGUNG
ASSOCIAZIONE SVIZZERA DI DIFESA DEGLI INVESTITORI
SWISS INVESTORS PROTECTION ASSOCIATION

Secretariat: POB 3413, 4002 Basel, tf: 061/496736

Mr J B Shepherd (IR) for advice

June 3, 1987

re: Council of Europe Commitee of Ministers, meeting of June 18-26 on OECD/CE Convention on Mutual Administrative Assistance in Tax Matters

Your Excellency,

This is to present you our compliments and to bring the following fiscal sovereignty matter to Your Excellency's personal attention.

Tax matters - particularly those affecting foreign investors - are too important a subject to be left for tax people alone to be decided. Any deviation from fundamental sovereignty and fiscal principles is likely to adversely affect your taxpayers' trust in your national institutions, your ability to attract foreign investments and, consequently, your economic development programs and international position. Fighting, instead of favoring the businessmen's use of tax advantages constitutes such a mutually harmful deviation from sound principles. Exchanging secret taxpayer data as well as otherwise collaborating with foreign tax authorities behind the back of one's own taxpayers - even if no illegal practices are suspected - undermines any country's fiscal sovereignty and violates the fundamental pact between citizen and State. And due to the dense transnational business links, no industrialized country could escape the harmful consequences of such a fiscal drag net simply by not signing the respective convention neighboring countries may have imposed on their own internationally active business community.

These, in a nutshell, are the conclusions of your major national trade and industry associations and of the International Chamber of Commerce. And unless Your Excellency's Government sees merit in undercutting its own national and international economic interests - in favor of the US Treasury assistent secretary J.Roger Mentz's imperialistic aim of "enforcing American tax laws on overseas investments" (WSJ May 19) -, you may wish to consider instructing your delegation to the forthcoming June meeting of the Council of Europe Ministerial Commitee:

a) to abstain, or to vote against putting the convention on the agenda;

b) to request the convention and its explanatory report to be published p r i o r to its further eventual consideration by the Commitee of Ministers in light of the results of a full public debate on the matter (art.21, lit.b CE Statute); and

c) to request a Special Advisory Commitee to be set up (ibid. art.17) in order to publicly examine the questions (1) whether the "human rights and fundamental freedoms" protected by art.1 of the CE Statute include the freedom to move to where the individual considers fiscal and other conditions to suit his purposes best, and (2) whether this freedom of establishment and other principles provided for in both the CE and the OECD statutes are at all compatible with any bi- or multilateral convention designed to "prevent tax avoidance".

We take this opportunity to avail our services and to extend to Your Excellency the assurance of our highest considerations.

SWISS INVESTORS PROTECTION ASSOCIATION H.Anton Keller

cc: ICC, National Commitee

1. Nigel - PS/ get copy of draft at x
2. Tony
3. C

Thanks. I trust you will be able to get this significantly amended. Apart from the generally carping tone, to which you refer, they plainly are wrong about the past trend & present level of the GGFD, & have failed to take account of the revisions to the c/a.

From: J ODLING-SMEE

12th June 1987

CHANCELLOR OF THE EXCHEQUER 12/6

cc Sir Peter Middleton
Sir Terence Burns
Sir Geoffrey Littler
Mr Cassell
Mr Evans
Mrs Lomax
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Bottrill
Mr Culpin
Mr S Davies
Mr Gieve
Mr Grice
Mr Ilett
Mr S Matthews
Mr Mowl
Mr Riley
Miss Sinclair
Miss O'Mara
Mr Kelly

Some amendment clearly needed (fig for 1986 - & not to mention the surplus forecast for 1987) AA

PS. AA! PSR forward comments to R Culpin ASAP

Nor, incidentally, does it make much sense to berate the UK for a c/a deterioration attributable to the growth slowdown — presumably temporary — overseas. NL

**OECD EDRC SURVEY OF THE UK**

The OECD is planning to publish the annual economic survey of the UK in July. The attached draft is due to be discussed at a meeting of the OECD Economic Development and Review Committee on Wednesday, 17th June. Messrs Sedgwick, Ilett and I shall attend. After the meeting we shall have a drafting session with the Secretariat in which we shall attempt to alter the draft so that it is more favourable from our point of view. Major changes will have to have been endorsed by the Economic and Development Review Committee.

2. About half of the draft is devoted to the chapter on financial markets, which is the special topic in this year's review. (The last two surveys had respectively the supply side and the labour market as their special topics.) The rest of the survey follows the usual pattern, with chapters on recent trends, policies, prospects and conclusions.

3. The main conclusions of the draft are:

?

- the economy is likely to show strong growth this year, the seventh year of expansion, but growth may decelerate in 1988 while inflation rises and the current account moves into deficit

Does this take a Treasury forecast for 1987 & 1988 v data?

- the problem areas are unemployment, higher inflation than in other major countries and the balance of payments

- more measures are needed to encourage labour market flexibility (no concrete suggestions except for a mention of the government's role in public sector pay determination)

- progress on supply side measures generally has been slow and reforms should be speeded up

- the flexible implementation of monetary policy has been relatively successful

understates

- the fiscal deficit has not fallen very much since 1979 and is higher than in other major countries (based on the general government financial deficit)

- a broadly neutral stance of fiscal policy consistent with a cyclical fall in the financial deficit is desirable this year

- expenditure control should be tighter

- financial liberalisation has complicated monetary policy

- there may have been too much short termism in financial markets, contributing to the imbalance between financial and physical investment by companies

- the stock exchange and related reforms have been a judicious mixture of libera-lisation and regulation.

4. Although some of these points are wrong and need to be corrected (eg the claim that the fiscal deficit has not come down), we can accept many of them. There is, however, a general tone of carping criticism of the government's position and the performance of the British economy throughout. We have prepared a long list of drafting changes which we shall negotiate with the Secretariat in order to correct errors and alter the tone. We shall not, however, be able to change their forecast for 1988 (Table attached) which is identical to that which will be published in the Economic Outlook on 19th June. We have already pushed them as far as they will go on this, and they will not contemplate publishing a different forecast within a few weeks. However, I hope that in general we shall be able to make some significant improvements to the text -including textual references to the prospects for 1988 - although I do not suppose we shall get our way on everything.

5. You might like to glance at the introduction and conclusions (paragraphs 1-5 and 86-95), and possibly more briefly at the other chapters.

JOS

**J ODLING-SMEE**

## Table 21. Short-term prospects

Percentage changes from previous period, seasonally adjusted annual rates

| | Treasury | OECD | | | | | |
|---|---|---|---|---|---|---|---|
| | 1987 | 1987 | 1988 | 1987 | | 1988 | |
| | | | | I | II | I | II |
| **Volumes (1980 prices)** | | | | | | | |
| Private consumption | 3 3/4 | 3 3/4 | 3 1/2 | 3 1/4 | 4 | 3 1/2 | 3 |
| Government consumption | 1 | 1 1/2 | 1 | 3/4 | 1 | 1 | 1 |
| Gross fixed investment | 4 | 2 3/4 | 3 1/2 | 3 | 5 1/4 | 3 1/2 | 1 1/2 |
| Public | -1 | -1 3/4 | - 3/4 | 1 3/4 | - 3/4 | - 3/4 | - 3/4 |
| Private | 5 | 4 1/4 | 4 1/2 | 3 1/4 | 7 | 4 1/2 | 2 1/4 |
| Final domestic demand | 3 1/4 | 3 1/4 | 3 | 2 1/2 | 3 3/4 | 3 | 2 1/2 |
| Stockbuilding (1) | 1/4 | 0 | 0 | 1/4 | 1/4 | 0 | 0 |
| Total domestic demand | 3 1/2 | 3 1/4 | 3 | 3 | 3 3/4 | 3 | 2 1/2 |
| Exports | 4 | 4 1/2 | 1 1/2 | 2 3/4 | 1 3/4 | 1 1/2 | 1 1/2 |
| Imports | 6 | 4 1/2 | 4 1/4 | -2 | 5 1/4 | 4 1/4 | 3 1/2 |
| Foreign balance (1) | -1/2 | 0 | - 3/4 | 1 1/2 | - 1 | - 3/4 | - 1/2 |
| GDP (2) | 3 | 3 1/4 | 2 1/4 | 3 1/2 | 2 3/4 | 2 1/4 | 1 3/4 |
| **Memorandum items:** | | | | | | | |
| GDP deflator | .. | 4 1/2 | 5 1/4 | 4 3/4 | 5 1/4 | 5 1/2 | 5 1/4 |
| GDP at current prices | .. | 8 | 7 3/4 | 8 1/4 | 8 1/4 | 7 3/4 | 7 1/4 |
| Real personal disposable income | 3 1/2 | 3 3/4 | 3 1/4 | 4 | 3 1/2 | 3 | 2 3/4 |
| Personal saving ratio | .. | 11 | 10 3/4 | 11 | 10 3/4 | 10 3/4 | 10 1/2 |
| Consumer prices (3) | 4 | 4 | 4 1/2 | 4 1/4 | 4 1/4 | 4 1/2 | 4 1/2 |
| Employment | .. | 1 | 1 | 1 1/4 | 1 | 1 | 3/4 |
| Unemployment rate (4) | .. | 11 1/4 | 11 | 11 1/2 | 11 | 11 | 10 3/4 |
| Manufacturing production | 4 | 4 1/4 | 3 1/4 | 3 1/2 | 4 | 3 | 2 1/2 |
| Current balance of payments | | | | | | | |
| (£ billion) | -2 1/2 | -1 1/2 | -3 1/2 | -1 | -2 1/4 | -3 | -4 |
| ($ billion) | .. | -2 1/2 | -6 | -1 1/4 | -3 3/4 | -5 | -7 |

1. Change as a per cent of GDP in the previous period.

2. Compromise estimate of GDP at market prices for OECD and at factor cost for the Treasury.

3. Private consumption deflator for OECD and fourth quarter retail price index for the Treasury (growth rate over same period a year earlier).

4. Per cent of the labour force, including school-leavers.

Sources: Financial Statement and Budget Report, 1987-88 and OECD projections.

psl/33A

**UNCLASSIFIED**

FROM: A C S ALLAN
DATE: 15 June 1987 BF ~~19/6~~ 22/6.

MR ODLING-SMEE

cc Sir P Middleton
Sir T Burns
Sir G Littler
Mr Evans
Mr Sedgwick
Mr Culpin
Mr Ilett
Mr S Matthews
Miss O'Mara

**OECD EDRC SURVEY OF THE UK**

The Chancellor was grateful for your minute of 12 June. He trusts you will be able to get the draft significantly amended. Apart from the generally carping tone, to which you refer, he notes that the OECD are clearly wrong about the past trends and present level of the GGFD, and have failed to take account of the revised current account figures for 1986 (not to mention the surplus so far recorded in 1987). Nor did he feel that it made sense to berate the UK for a current account deterioration attributable to the growth slowdown - presumably temporary - overseas.

2. He would be grateful for a report back on how you get on at the Review Committee; and, if the outcome is not satisfactory, what further action we might take.

ACSA

A C S ALLAN

172:1

CONFIDENTIAL UNTIL 23.01 HOURS
THURSDAY 18 JUNE
THEN UNCLASSIFIED

FROM: MISS M O'MARA
DATE: 17 JUNE 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Lavelle
Mr H P Evans
Mr Odling-Smee
Mr Scholar
Mr Sedgwick
Mr Culpin
Mr S J Davies
Mr S Matthews
Mr Mowl
Mr Pickford
Mr Dyer (+1 for No. 10)
Mr Colenutt
Mr Kerley
Mr Cropper
Mr Tyrie
JB/03

**OECD ECONOMIC OUTLOOK, JUNE 1987**

The OECD will be lifting the embargo on their 'Economic Outlook' at 11pm* on Thursday 18 June. We therefore expect press comment the following morning.

*ie midnight in Paris

2. You will recall that we tried persistently to improve the drafting of the UK chapter at earlier stages and that while the Secretariat took account of our comments on tone, they made little adjustment to their forecast, other than for the current account (Mr Sedgwick's minute of 27 May). You agreed we should not press for any more fundamental changes (Mr Allan's minute of 29 May). Despite this, the Secretariat still seem to have failed to take account of the small number of factual comments we subsequently sent them (eg on bank lending for consumption).

3. I attach notes both on the general outlook (prepared by IF2) and on the Secretariat's assessment of the UK. The latter is more likely to attract comment, with attention no doubt focussing on the OECD's forecast of a deceleration in growth, a substantial current deficit and an inflation rate which remains above the OECD average. But the OECD's warning that the risks of a worsening world economic situation have increased and their reference to an apparent weakening of private sector confidence related to exchange rate uncertainty are also bound to be picked up.

MOM

MISS M O'MARA

4111/031/njo

# OECD ECONOMIC OUTLOOK NO 41: JUNE 1987

## WORLD ECONOMIC PROSPECT AND POLICIES

### Line to take

a. OECD's latest assessment of World economic outlook supports view in FSBR that growth of major industrialised countries of over 2 per cent should be achieved whilst inflation remains at historically low levels.

b. Share OECD Secretariat's view that chief threat to continuing steady growth is posed by the persistence of current account imbalances of US, Japan and Germany and risk of renewed currency instability. Support their recommendations that countries pursue compatible policies to ease external adjustment. US must make substantial reductions in the budget deficit in 1988 and beyond and that Japan and Germany need to maintain growth of domestic demand in excess of the growth rate of productive potential.

c. Welcome continued support of OECD for prudent fiscal and monetary policies and for effort to reduce structural rigidities.

### Factual

1. The main elements of OECD's most recent forecast are shown in the attached table, which is published on page (iv) of the "Outlook".

2. Total OECD **output** growth is expected to decline slightly in 1987 to 2¼ per cent. The Major seven economies are expected to have growth rates of ranging from 3¼ per cent in the UK to under 2 per cent in Germany and France.

3. **Inflation** (as measured by private consumption deflators) is expected to pick up to 3½ per cent in the OECD as a whole (from 2¾ per cent last year). In the Major Seven, inflation is expected to rise to 3 per cent in 1987 (from 2 per cent in 1986), ranging from zero in Japan to almost 5 per cent in Italy.

4. **Unemployment** in the OECD is expected to remain at just over 8 per cent of the labour force for the next eighteen months. In the European OECD economies the unemployment rate is expected to remain at 11 per cent this year and rise slightly in 1988.

5. The OECD expects large current **account** imbalances to persist over the next eighteen months although they are forecast to have peaked in the first half of this year. These forecasts are dependent on the OECD's traditional consumption of fixed exchange rates (using rates on 21 April in this instance).

6. The OECD's general policy recommendations is that the three major countries deal with the problem of external adjustment by pursuing internationally agreed commitments to 're-balance' fiscal policy.

In particular the OECD calls for:

i. the continued reduction of the US budget deficit;

ii. domestic demand growth in Japan and Germany at a rate faster than the growth of potential output;

iii. the maintenance of a relatively easy stance of monetary policy.

7. Several microeconomic measures are also recommended for all countries to improve economic performance. They include:

i. less price support for agricultural goods;

ii. resistance to pressure for protectionist trade measures;

iii. a reduction in industrial subsidies;

iv. improved labour mobility;

v. removal of restrictions on prices and wages.

8. The OECD forecast does not include the latest stimulatory package announced by Prime Minister Nakasone that will raise Japanese domestic demand growth (as the OECD suggest). The size of the impact on the economy remains unclear.

<u>OECD comments supportive of the Government's stance</u>

1. "The Exchange rate changes of the last two years seem likely to have arrested the trend towards ever-widening current account imbalances".

2. "In view of the outlook for a continuation of low inflation, policies seem to be consistent with a further market-led decline in interest rates".

3. "For reducing swings in exchange rates ... fiscal rebalancing is the key macroeconomic policy requirement".

4. "Only if structural conditions are progressively improved is growth likely to be sufficiently strong to make substantial inroads into unemployment."

5. "[In World agricultural markets] ... production and investment decisions should be increasingly guided by market signals".

6. "Price moderation could be promoted directly by strengthened competition, internally and domestically, deregulation [and] privatisation."

7. "A continuation of recent trends towards more flexible and competitive markets would make investment in new and risky ventures easier to finance."

Defensive

a. OECD forecast a slowdown in growth in 1987

Only expected to be marginally lower than in 1986 (2½ to 2¼ per cent for both OECD and Major seven). World economy is managing another year of steady, if unspectacular growth, without high inflation.

b. OECD forecast no fall in unemployment in OECD in next two years

Results in part from continued growth of labour force offsetting increases in employment of 1-1¼ per cent a year. OECD share Government's view that structural reforms necessary to secure a sufficient rate of growth of output to reduce unemployment. A relaxation of fiscal/monetary policies would not make lasting reduction in unemployment.

c. Danger of disorderly exchange-market conditions and/or intensified protectionist measures

Agree with OECD that either of these would impair strength of world growth. Important to recognise that current account imbalances will take time to correct. Support OECD's policy recommendations for major three economies (see line to take). Welcome recent fiscal package in Japan that should help to alleviate problems.

## Summary of projections[a]

Seasonally adjusted at annual rates

| | 1985 | 1986 | 1987 | 1988 | 1987 I | 1987 II | 1988 I | 1988 II |
|---|---|---|---|---|---|---|---|---|
| | Percentage changes from previous period | | | | | | | |
| **Real GNP** | | | | | | | | |
| United States | 2.7 | 2.5 | 2½ | 2¾ | 2¾ | 2¼ | 2¾ | 2¾ |
| Japan | 4.7 | 2.5 | 2 | 2 | 1¾ | 1½ | 1¾ | 2½ |
| Germany | 2.5 | 2.4 | 1½ | 2 | ¼ | 1½ | 2 | 2¼ |
| OECD Europe | 2.6 | 2.5 | 2 | 2 | 1¾ | 2 | 2¼ | 2 |
| Total OECD | 3.0 | 2.5 | 2¼ | 2¼ | 2¼ | 2¼ | 2½ | 2½ |
| **Real total domestic demand** | | | | | | | | |
| United States | 3.4 | 3.5 | 1½ | 2 | 1¼ | 1¼ | 2 | 2¾ |
| Japan | 3.8 | 4.0 | 2½ | 2¼ | 1¾ | 2 | 2 | 2¾ |
| Germany | 1.5 | 3.7 | 2¾ | 2¾ | 1¾ | 2½ | 3 | 2¾ |
| OECD Europe | 2.4 | 3.8 | 2¾ | 2½ | 2¼ | 2½ | 2½ | 2½ |
| Total OECD | 3.1 | 3.6 | 2¼ | 2¼ | 1¾ | 2 | 2¼ | 2¼ |
| **Inflation (private consumption deflator)** | | | | | | | | |
| United States | 3.5 | 2.1 | 4 | 4½ | 4½ | 4½ | 4½ | 4½ |
| Japan | 2.1 | 0.6 | 0 | 1¾ | –¼ | ¼ | 3 | ½ |
| Germany | 2.1 | –0.4 | ¾ | 1½ | ¾ | 1½ | 1½ | 1½ |
| France, United Kingdom, Italy, Canada | 6.0 | 3.8 | 3¾ | 3¾ | 4¼ | 3¾ | 3¾ | 3¾ |
| Other OECD countries | 8.4 | 7.0 | 6 | 5 | 6 | 5½ | 5 | 4¾ |
| Total OECD | 4.5 | 2.8 | 3½ | 3¾ | 3¾ | 3¾ | 4 | 3½ |
| | $ billion | | | | | | | |
| **Current balances** | | | | | | | | |
| United States | –117.7 | –140.6 | –147 | –126 | –149 | –145 | –132 | –120 |
| Japan | 49.2 | 86.0 | 95 | 87 | 95 | 95 | 86 | 88 |
| Germany | 13.2 | 35.8 | 37 | 29 | 40 | 34 | 29 | 29 |
| Total OECD | –58.9 | –19.7 | –23 | –30 | –16 | –29 | –34 | –27 |
| OPEC | 3.8 | –31.9 | –17 | –12 | –20 | –13 | –12 | –12 |
| Non-oil developing countries | –23.3 | –10.9 | –9 | –11 | –7 | –10 | –11 | –12 |
| | Per cent of labour force | | | | | | | |
| **Unemployment** | | | | | | | | |
| United States | 7.2 | 7.0 | 6¾ | 6½ | 6¾ | 6¾ | 6½ | 6½ |
| Japan | 2.6 | 2.8 | 3 | 3 | 3 | 3 | 3 | 3 |
| Germany | 8.3 | 8.0 | 8 | 8¼ | 8 | 8 | 8¼ | 8¼ |
| OECD Europe | 11.1 | 11.0 | 11 | 11¼ | 11 | 11 | 11¼ | 11¼ |
| Total OECD | 8.4 | 8.3 | 8¼ | 8¼ | 8¼ | 8¼ | 8¼ | 8¼ |
| | Percentage changes from previous period | | | | | | | |
| **World trade**[b] | 3.6 | 4.0 | 2¼ | 4 | –½ | 3¾ | 4 | 4 |

*a)* Assumptions underlying the projections include :
- no change in actual and announced policies;
- unchanged exchange rates from 21st April 1987; in particular $1 = yen 142.1, DM 1.81.
- Dollar price (OECD fob imports) for internationally traded oil of $ 18 per barrel.

*b)* Arithmetic average of the growth rates of the world import volume and the world export volume.

The cut-off date for other information used in the compilation of the projections was 12th May 1987.

## UK economy

### Factual

(i) Economy continues to expand, with oil price fall giving consumers substantial real income gain. Exchange rate fall has boosted export growth, with higher public expenditure supporting domestic demand.

(ii) Economy experiencing declining fiscal boost, taking account of both privatisation proceeds and economic cycle. Forecast assumes some tightening of policy, with slight deterioration of UK competitiveness and weakening of domestic demand in 1988.

(iii) Economy forecast to grow in 1987 by 3¼ per cent (market prices) but by only 2¼ per cent at an annual rate in 1988H1 and 1¾ per cent at an annual rate in 1988H2. Unemployment likely to fall further but inflation forecast to rise slightly to 4½ per cent in 1988H1 (with GDP deflator at 5½ per cent) and current balance to return to deficit (£2.4 billion in 1987H2 at an annual rate and £3.7 billion in 1988).

(iv) Rapid wage increases are fundamental problem, with rise in unit labour costs likely to pick up.

(v) Government's $15 oil price assumption "very cautious" but "expenditure targets" may come under pressure again, especially from growth in public sector pay. May be some overshoot of planning total.

### Positive

(i) 3¼ per cent projected growth in 1987 exceeds that forecast by OECD for all other major 7.

(ii) OECD forecast UK unemployment will continue to fall.

(iii) OECD acknowledge improvement in financial sentiment, attributed to oil market developments and "more favourable outlook for the domestic economy".

Defensive

(i) OECD project deceleration in activity. Since 1981, OECD's initial forecast for growth in following full year has been consistently pessimistic (see attached table).

(ii) Oil price fall gave consumers substantial real income gain: Not true once account taken of consequential changes eg exchange rate fall and higher level of non-oil taxation than otherwise.

(iii) Higher public spending supporting domestic demand: While public expenditure rose in real terms between 1985-86 and 1986-87, so did tax receipts. Overall effect on domestic demand unlikely to be more than marginal.

(iv) Fiscal boost to economy declining. Fiscal policy not currently stimulating domestic demand and very little change projected for medium term.

(v) Inflation projected to remain above OECD average. But gap has narrowed dramatically since 1979.

(vi) Balance between real growth and inflation deteriorating. This is a feature of OECD forecast, not of performance of UK economy in recent past. UK growth this year highest of all major 7 and inflation now seems likely to fall slightly below Budget forecast of 4 per cent for end 1987.

(vii) Rapid wage growth: Government has emphasised repeatedly that maintenance of firm monetary conditions will prevent wage growth boosting price inflation. But excessive wage increases will harm employment prospects.

(viii) Current deficit on rising trend. Deficit for 1986 (£1.1 billion) shown to be overstated on latest figures (£0.1 billion). Current account performing better so far in 1987 than UK Government predicted at Budget time. OECD forecast for 1988 well (£1 billion) above average of independent forecasts. Treasury Budget forecast for 1988H1 showed no deterioration in trend.

(ix) Weak investment performance in 1986. Partly consequence of 1984 corporate tax reforms. But June DTI Investment Intentions Survey reveals industrial investment expected to rise by 8 per cent in 1987 and at about same rate in 1988 (for both years improvement on December Survey).

(x) General government deficit rose as percentage of GDP in 1986. General government deficit only one of number of indicators of fiscal stance. PSBR fell between 1985-86 and 1986-87, even excluding privatisation proceeds.

(xi) Public spending likely to overshoot. Plans include substantial reserve, larger as percentage of planning total than in either 1984-85 or 1985-86. Additional provision for local authorities and social security announced in autumn should mean reduced call on reserve, so better chance of avoiding overspend. Since introduction of cash planning in 1982, average overrun on previous year's PEWP plans only 0.8 per cent (half that, excluding effects of coal strike).

(xii) OECD assume policy tightening: Reason for doing so unclear. Slower growth of public expenditure not evidence for this since Government aims to keep PSBR/GDP ratio unchanged and privatisation proceeds constant in cash terms. [OECD may be assuming tighter monetary policy, with interest rates edging up in line with world developments.]

(xiii) Interest rates will rise. Purely OECD's assumption for purpose of forecast. UK interest rates will continue to be held at levels which maintain steady downward pressure on inflation.

# OECD FORECASTS

GDP - MARKET PRICES

| DATE OF FORECAST | 1980 MP | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| JULY 1980 | −2¼ | | | | | | | | | | |
| DECEMBER 1980 | −2¼ | −2 | | | | | | | | | |
| JULY 1981 | | −1½ | ¼ | | | | | | | | |
| DECEMBER 1981 | | −2 | ¼ | | | | | | | | |
| JULY 1982 | | | 1¼ | 1¾ | | | | | | | |
| DECEMBER 1982 | | | ½ | 1 | | | | | | | |
| JULY 1983 | | | | 1¾ | 2¼ | | | | | | |
| DECEMBER 1983 | | | | 2½ | 2¼ | | | | | | |
| JULY 1984 | | | | | 2½ | 2¼ | | | | | |
| DECEMBER 1984 | | | | | 2 | 3 | | | | | |
| JUNE 1985 | | | | | | 3¼ | 2½ | | | | |
| DECEMBER 1985 | | | | | | 3¼ | 2¼ | | | | |
| MAY 1986 | | | | | | | 3 | 2¼ | | | |
| DECEMBER 1986 | | | | | | | 2¼ | 2¾ | | | |
| OUTTURN | −2.4 | −1.4 | 1.5 | 3.4 | 2.9 | 3.5 | 2.7 | | | | |

ps3/56K

**UNCLASSIFIED**

FROM: A W KUCZYS
DATE: 19 June 1987

MISS O'MARA

cc Sir P Middleton
Sir T Burns
Sir G Littler
Mr H P Evans
Mr Culpin
Mr S J Davies

**OECD ECONOMIC OUTLOOK, JUNE 1987**

The Chancellor was grateful for your minute of 17 June. He has commented: "Very poor show" (meaning the OECD!).

A W KUCZYS

OS29

BF 22/6

FROM: J ODLING-SMEE

DATE: 19 JUNE 1987

**CHANCELLOR**

cc Sir Peter Middleton
Sir Terence Burns
Sir Geoffrey Littler
Mr Cassell
Mr Evans
Mrs Lomax
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Bottrill
Mr Culpin
Mr S Davies
Mr Gieve
Mr Grice
Mr Ilett
Mr S Matthews
Mr Mowl
Mr Riley
Miss Sinclair
Miss O'Mara
Mr Kelly

Ch
Seems OK in view (a bit SDP-ish - clearly want an incomes policy)
AA

Thanks. Some worthwhile proposals!

**OECD EDRC SURVEY OF THE UK**

1. Messrs Sedgwick, Ilett and I attended the EDRC meeting on 17th June and the drafting session with the Secretariat on 18th June. The EDRC generally complimented the UK on its economic performance, although they expressed concern that unemployment remained high. They saw high pay settlements, in the public as well as the private sector, as a major part of the problem. They urged us to keep up the momentum on supply side measures, especially those affecting the labour market.

2. There were no serious suggestions for significant changes in macroeconomic policies. Some of the Europeans (Belgium, Italy and Netherlands) argued, perhaps influenced by the competitive advantage that the UK has gained recently, that we should join the EMS. Spain took the opposite position, and France and Germany did not comment.

3. We argued strongly that the Secretariat's forecast for 1988 was too pessimistic, especially for the balance of payments. The Committee were sympathetic, but the Secretariat said that they

could not change their forecast at this late stage, given that the Economic Outlook was just about to be published. However, we did manage to persuade them to reduce their forecasts of the current account deficit in 1987 and 1988 by a flat £1 bn, reflecting the revision to the data for 1986 (table attached). And the references to the current account in the text have all been altered so as to remove the suggestion that this was a potentially serious problem.

4. At the drafting session we managed to change the tone in many places. In particular, we have removed the suggestion that fiscal policy remains as loose at it was in the late 1970s, and we have increased the emphasis given to the PSBR rather than the PSFD or GGFD. I attach the introduction and conclusions, more or less as they were agreed (one or two minor corrections are still required). The changes from the original draft are side-lined. You might like to look in particular at:

**Paragraph 87**, where the reference to the fiscal stimulus has been removed and the balance of payments is no longer presented as a problem area;

**Paragraph 91**, where the emphasis on the GGFD has been reduced;

**Paragraph 92**, which contains slightly stronger language about the need for supply side reforms;

**Paragraph 95**, which sums up the whole chapter.

5. The next stage is for the revised draft to be re-submitted to the EDRC at a meeting in the last week of June or the first week of July. On past form no revisions should arise out of this. The survey will then be published in the second half of July (date to be fixed).

JOS

**J ODLING-SMEE**

### Table 21. Short-term prospects

Percentage changes from previous period, seasonally adjusted annual rates

| | Treasury | OECD | | | | | |
|---|---|---|---|---|---|---|---|
| | 1987 | 1987 | 1988 | 1987 | | 1988 | |
| | | | | I | II | I | II |
| **Volumes (1980 prices)** | | | | | | | |
| Private consumption | 3 3/4 | 3 3/4 | 3 1/2 | 3 1/4 | 4 | 3 1/2 | 3 |
| Government consumption | 1 | 1 1/2 | 1 | 3/4 | 1 | 1 | 1 |
| Gross fixed investment | 4 | 2 3/4 | 3 1/2 | 3 | 5 1/4 | 3 1/2 | 1 1/2 |
| Public | -1 | -1 3/4 | - 3/4 | 1 3/4 | - 3/4 | - 3/4 | - 3/4 |
| Private | 5 | 4 1/4 | 4 1/2 | 3 1/4 | 7 | 4 1/2 | 2 1/4 |
| Final domestic demand | 3 1/4 | 3 1/4 | 3 | 2 1/2 | 3 3/4 | 3 | 2 1/2 |
| Stockbuilding (1) | 1/4 | 0 | 0 | 1/4 | 1/4 | 0 | 0 |
| Total domestic demand | 3 1/2 | 3 1/4 | 3 | 3 | 3 3/4 | 3 | 2 1/2 |
| Exports | 4 | 4 1/2 | 1 1/2 | 2 3/4 | 1 3/4 | 1 1/2 | 1 1/2 |
| Imports | 6 | 4 1/2 | 4 1/4 | -2 | 5 1/4 | 4 1/4 | 3 1/2 |
| Foreign balance (1) | -1/2 | 0 | - 3/4 | 1 1/2 | - 1 | - 3/4 | - 1/2 |
| GDP (2) | 3 | 3 1/4 | 2 1/4 | 3 1/2 | 2 3/4 | 2 1/4 | 1 3/4 |
| **Memorandum items:** | | | | | | | |
| GDP deflator | .. | 4 1/2 | 5 1/4 | 4 3/4 | 5 1/4 | 5 1/2 | 5 1/4 |
| GDP at current prices | .. | 8 | 7 3/4 | 8 1/4 | 8 1/4 | 7 3/4 | 7 1/4 |
| Real personal disposable income | 3 1/2 | 3 3/4 | 3 1/4 | 4 | 3 1/2 | 3 | 2 3/4 |
| Personal saving ratio | .. | 11 | 10 3/4 | 11 | 10 3/4 | 10 3/4 | 10 1/2 |
| Consumer prices (3) | 4 | 4 | 4 1/2 | 4 1/4 | 4 1/4 | 4 1/2 | 4 1/2 |
| Employment | .. | 1 | 1 | 1 1/4 | 1 | 1 | 3/4 |
| Unemployment rate (4) | .. | 11 1/4 | 11 | 11 1/2 | 11 | 11 | 10 3/4 |
| Manufacturing production | 4 | 4 1/4 | 3 1/4 | 3 1/2 | 4 | 3 | 2 1/2 |
| Current balance of payments | | | | | | | |
| (£ billion) | -2 1/2 | ~~-1 1/2~~ -1/2 | ~~[illegible]~~ -2 1/2 | ~~[illegible]~~ 0 | ~~-2 1/4~~ -1 1/4 | ~~[illegible]~~ -2 | ~~[illegible]~~ -3 |
| ($ billion) | .. | ~~-2 1/2~~ | ~~-6~~ | ~~-3 1/4~~ | ~~-3 3/4~~ | ~~-5~~ | ~~-7~~ |
| | | | (equivalent | changes | to | $ | figures) |

1. Change as a per cent of GDP in the previous period.

2. Compromise estimate of GDP at market prices for OECD and at factor cost for the Treasury.

3. Private consumption deflator for OECD and fourth quarter retail price index for the Treasury (growth rate over same period a year earlier).

4. Per cent of the labour force, including school-leavers.

Sources: Financial Statement and Budget Report, 1987-88 and OECD projections.

UK Economic Survey - OECD
18/6/1987

## INTRODUCTION

1. The United Kingdom is enjoying continued expansion. In spite of the importance of North Sea oil, the economy has coped better with the impact of lower oil prices than many others in the OECD area. Output growth in 1987 is likely to exceed that for most other Member countries. Recent developments also compare favourably with the generally disappointing long-term performance of the United Kingdom (Part IV), characterised by a decline in per capita income relative to other industrial countries. Measured from the previous cyclical peak in 1979, performance is less impressive, with manufacturing output still a little lower and GDP growth broadly in line with the European Community average. This reflects output losses in the initial years of the Government's medium-term-oriented strategy, which successfully reduced inflation, though accompanied by a strong rise in unemployment. Since then the strategy has been largely maintained and implemented flexibly. The policy approach appears to have contributed to the favourable recent performance which is reviewed in Part I.

2. After slowing down in the second half of 1985, due mainly to weaker foreign demand, activity growth reaccelerated in the course of 1986, with consumer demand boosted by strong real income gains. More recently, there has been a sharp revival in export growth, assisted by the depreciation of the pound sterling since mid-1985. Unemployment has declined since mid-1986, helped by labour market measures. Inflation dropped following the oil price fall but has picked up since then, reflecting the marked decline in the exchange rate through 1986. Wage increases have remained high but their inflationary impact has been damped by the cyclical acceleration of productivity growth. Largely as a result of the sharp drop in energy prices, the current external account moved from surplus in 1985 to broad balance in 1986.

3. As discussed in Part II, the buoyancy of government revenues has enabled the Government to achieve its long-term objective for the PSBR sooner than would otherwise have been the case. Despite sharply lower oil revenues the Government has been able to raise expenditure from previous plans and reduce the personal income tax rate, while setting the PSBR at only 1 per cent of GDP for 1987/88 (having achieved a PSBR ratio a little below 1 per cent in 1986/87). Monetary developments have been characterised by very rapid expansion of broad money and credit and by on-target growth of narrow money and high real interest rates. The exchange rate has also had an important role as an indicator of monetary conditions. Given the inflation differential, interest rates have tended to be higher than abroad. The Government has continued to attempt ~~and~~ to improve the output/inflation split through microeconomic policies. Recent developments in this area include major financial market reforms, increased proceeds from the privatisation

programme, personal income tax adjustments and additional labour market measures.

4. On the basis of these policies and the technical assumptions of unchanged oil prices and exchange rates, the growth of activity is projected to continue, albeit at diminishing rates. A revival of business fixed investment and stockbuilding is expected to partly compensate for decelerating expansion of private consumption and export demand. Unemployment should continue to decline slightly. According to Secretariat projections, inflation is likely to drift upwards and the current external account to move into small deficit. The strength of output growth consistent with the inflation objective in the medium term will depend much on further progress in improving supply-side conditions (Part IV), and any marked reduction in unemployment will hinge on moderation in pay settlements.

5. Previous Surveys have examined various issues related to the supply side of the economy, the latest focusing on the labour market. The special chapter of the current Survey (Part III) deals with the financial markets. The financial system is one of the most valuable assets of the United Kingdom economy. Dynamic and highly developed, it has maintained a role in world markets far exceeding that of the economy as a whole. Nevertheless, its leading position has been eroded in some fields. In order to improve the functioning of financial markets, the Government has taken a number of liberalisation measures, commencing with the abolition of exchange controls in 1979, and has encouraged a complete reorganisation of the Stock Exchange.

## V. CONCLUSIONS

86. The recovery has now lasted six years, an unusually long period by post-war standards. Growth appeared to be faltering in the second half of 1985 but resumed in 1986 and prospects are good for a seventh year of expansion. The recovery was helped by the fall in the oil price, the decline in the exchange rate, and no change in policy stance following the tightening in 1985. Oil production, representing about 6 per cent of total output at prices prevailing in 1985, has levelled off, but the fall in oil prices has resulted in a switch in profitability towards energy-using companies and real pre-tax gains for consumers. In addition, consumers reduced their saving rate despite the windfall gains from lower energy prices. In view of the damping effect of oil prices on inflation and the need for some real exchange rate adjustment, continued downward pressure on sterling was not resisted. Assisted by the the fall in the exchange rate since mid-1985, export growth accelerated sharply in the second half of 1986 and has remained relatively strong in the present year, in contrast to developments in appreciating countries. At the same time, domestic demand has been supported by a decline in nominal interest rates and the resumption of growth of public expenditure on goods and services.

Is this true (% growth rate coming down for GGE @ least).

87. Recent indicators and survey results point to continued rapid activity growth in the near future. Helped by lower interest rates and income tax cuts, domestic demand should remain buoyant, with investment picking up and consumer demand remaining relatively strong. GDP growth may decelerate in 1988, however, as export performance suffers from losses in competitiveness resulting from the recent appreciation of sterling and higher cost increases than abroad. This, in turn, may adversely affect investment activity, while consumer demand is likely to weaken as a result of lower real income growth. Fiscal policy will be broadly neutral in its impact on domestic demand according to present budget plans. Nevertheless growth performance over the next eighteen months or so should compare favourably with that of many other Member countries. There are, however, two main problems: the high rate of unemployment and the persisting inflation differential against trading partner countries. The challenge to the authorities is to ensure, through a consistent but flexible implementation of their strategy, that further improvements in the labour market ~~situation be~~ are achieved while maintaining external equilibrium and downward pressure on inflation.

88. After a protracted period of high and rising unemployment there are ~~first~~ signs of an improvement: the number of unemployed has been falling since mid-1986, with the share in the total of youth unemployment continuing to decline and that of long-term unemployment stabilising. These favourable trends are to some extent attributable to specific government programmes. Targeted at the young and the long-term unemployed, the measures taken entail little risk of rekindling inflation. However, while reducing social hardship and enhancing human capital, they cannot substitute for more fundamental improvements in the functioning of the labour market and, in particular the wage formation process. High unemployment has not depressed real wage growth to the same extent as in other countries. A number of measures, such as the encouragement of profit-sharing schemes, have already been taken to enhance

labour market flexibility, and others have been announced. The Government does not favour the use of an incomes policy, as it would be inconsistent with its goals of deregulation and greater wage differentiation. But the Government has a role to play in public sector wage settlements, and this is especially important in the light of recent increases agreed in parts of the public services.

89. Wages have failed to respond to the deceleration of inflation linked to the oil price fall. The underlying rate of growth of earnings has shown virtually no change since 1984. Pay settlements in the private sector have come down somewhat, but this has been largely offset by wagedrift, and ~~recent~~ settlements could now have bottomed out. Although nominal wage rigidities helped to support demand and output after the oil price fall, the more rapid increase in wages than in other countries represents a major problem. Despite improved productivity performance in the 1980s, unit labour costs have grown more than in trading partner countries. Gains in competitiveness have resulted from depreciation of sterling. While helping to maintain market shares, the fall in the exchange rate has made further progress towards price stability more difficult. Rising oil and invisibles earnings more than compensated for the widening of the deficit in the non-oil trade balance. With oil prices much lower than those prevailing in the early 1980s and oil production likely to decline, it is therefore important that wage growth should moderate so that inflation can decline further and external difficulties be avoided.

90. Within the framework of the Government's Medium Term Financial Strategy (MTFS), the role of monetary policy has been to reduce the rate of growth of nominal income. But as the relationship between broad money aggregates and nominal income has become increasingly less predictable -- probably reflecting the fast pace of financial innovation and liberalisation -- the conduct of policy has been particularly difficult in recent years. The shift in emphasis away from broad money towards other indicators has continued. The 1987 MTFS dropped the broad money target but maintained growth target ranges for the monetary base. The exchange rate has continued to play an important role in assessing monetary conditions, although it has to be interpreted alongside all other developments, including those outside the United Kingdom, such as the evolution of oil prices. One of the aims of policy, especially since the Louvre Accord, has been to avoid excessive fluctuations in the exchange rate. Given the need to allow for all these considerations, the flexible implementation of monetary policy in recent years would appear to have been relatively successful. Interest rates, although still high in nominal and real terms by international standards, have been allowed to fall considerably since 1985. Their decline was only reversed occasionally when the decrease in the exchange rate threatened to become excessive. Recently, faced with upward pressures on the exchange rate, the authorities have allowed interest rates to fall, although at a moderate pace partly because of the rapid expansion of credit.

91. Despite the sharp fall in oil revenues, the Public Sector Borrowing Requirement (PSBR) has come down earlier than expected to the medium-term target ratio of 1 per cent of GDP. This goal has been realised, however, at higher tax and expenditure ratios than thought desirable from the point of view of strengthening ~~private initiatives~~ incentives in the private sector. Public revenue and expenditure as a proportion of GDP peaked in 1982 and 1984 respectively and have been on a downward trend since, but their respective shares are still above 1979 levels. The public debt/GDP ratio has declined somewhat during the course of the 1980s but, at more than 50 per cent, is still high by international standards. Moreover, as discussed in last year's Survey, the PSBR needs to be interpreted carefully in assessing the stance of fiscal policy. The public sector

financial deficit (which excludes the effect of the significant step up in privatisation proceeds in recent years) has been brought down to well under 3 per cent in the last two years compared to an average of over 5 per cent in the second half of the 1970s. Over the same period, the general government financial deficit, which excludes borrowing by public corporations, fell from 4 per cent to under 3 per cent. The latter is now close to the OECD average. Although some cyclical variation in the financial deficit is appropriate, a main requirement is that it should fall further as a share of GDP over the medium term. Given the Government's intention to hold the PSBR to 1 per cent of GDP, this should occur gradually as privatisation proceeds ~~to~~ fall as a share of GDP. In view of ~~Given~~ the present pace of GDP growth, it is important that the planned deficit in 1987/88 should not be exceeded, requiring firm control~~s~~ of expenditure.

92. The authorities have continued their efforts to improve the supply side of the economy. Major moves in this direction have already been made. It is necessary, however, to keep up the momentum by implementing wide-ranging reforms in important areas such as personal taxation, social security, local authorities and housing. Recent measures, either implemented or announced, comprise adjustments to personal taxation, tax relief on profit related pay, an expansion of employment and training measures, and a ~~significant~~ continuation of ~~acceleration in~~ the privatisation programme. The Government has now privatised more than a third of what was the state-owned industrial sector in 1979, and there are significant further privatisations planned for the new Parliament. The programme appears to have contributed to improved profitability within both the privatised and the state-owned sector. The cumulative effect of the various measures taken so far to improve the functioning of markets can be expected to favourably influence supply-side performance over time. Yet, many rigidities remain and the impact of changes takes time to come through. Reforms should therefore be implemented without undue delays.

93. In the financial field major deregulation measures were taken already at the end of the 1970s. The abolition of foreign exchange controls for residents has accelerated the internationalisation of financial markets. The move towards a more market-oriented monetary policy and away from quantitative controls has been an inevitable consequence of this first step. Liberalisation measures have blurred the traditional boundaries between financial intermediaries, thereby increasing competitive pressure in domestic markets and cost efficiency of intermediation. At the same time, the task of monetary policy and of prudential control has become more complicated, given more difficult control and interpretation of monetary aggregates. Raising of capital has generally not been a constraint on real investment, with the presence of an increasing number of foreign institutions enlarging the base for business finance. Possibly worrying features are that the corporate sector has been investing to a considerably extent in financial assets rather than in physical capital and that, in relation to fixed investment, mergers and acquisitions have grown sharply. The former may be in part a consequence of the still high cost of capital relative to company profitability. The latter may be related to short-term oriented strategies of institutional investors, which have maintained a dominant position in securities markets despite official encouragement of wider share ownership.

94. Recent financial reforms have culminated in the complete reorganisation of the Stock Exchange, encouraged by the authorities' concern for the United Kingdom's ability to compete in domestic and international securities markets. While as an international financial centre London still ranks in the top three with New York and Tokyo, it has lost ground to other centres, with the loss in

market shares most pronounced in securities trading. The removal of entry barriers and minimum commissions along with a reduction in the rate of stamp duty has led to a sharp increase in turnover and significant declines in transaction costs. The increased risk of losses and malpractices associated with the liberalisation and internationalisation of financial markets has prompted the authorities to extend the scope of formal regulation and to strengthen supervision. The new framework of financial market supervision can be characterised as controlled self-regulation. Based on functional rather than institutional lines, it may pose considerable co-ordination problems but is expected to avoid the rigidity and higher cost of more centralised systems. All in all, the reforms represent a judicious mixture of liberalisation and greater regulation of markets.

95. In sum, recent economic developments in the United Kingdom compare favourably both with its own past performance and that of other countries. There is no reason for complacency, however, as these appreciable developments follow upon a long period of relative decline and occur against the background of an unsatisfactory performance of other major economies. The rate of unemployment, although decreasing, is still at a high level and the external current balance is projected to deteriorate. A ~~The~~ major problem is the stickiness of wages in the face of high unemployment. Given low inflation in other countries, wages need to adjust more if inflation is to decline further and external equilibrium is to be maintained. Continued efforts to improve supply-side conditions will facilitate the necessary adjustment process. The recovery of rates of return on capital in recent years and the apparent strengthening of total factor productivity growth may be taken as first signs that the economy is moving in the right direction.

ps2/61R UNCLASSIFIED

RO

FROM: CATHY RYDING
DATE: 23 June 1987

MR ODLING-SMEE

cc Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Evans
Mrs Lomax
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Bottrill
Mr Culpin
Mr S Davies
Mr Gieve
Mr Grice
Mr Ilett
Mr S Matthews
Mr Mowl
Mr Riley
Miss Sinclair
Miss O'Mara
Mr Kelly

**OECD EDRC SURVEY OF THE UK**

The Chancellor was grateful for your minute of 19 June, and has commented that you have agreed some worthwhile improvements.

CR

CATHY RYDING

OECD

AUG 87

NOV 87

CONFIDENTIAL
until 0100 hours on Saturday 8 August
then UNCLASSIFIED

file

**FROM:** MISS M O'MARA
**DATE:** 3 August 1987

pup

MR CULPIN

passed to Mr Culpin

The conclusion @ x shows ... circulation

cc Chancellor of the Exchequer*
Chief Secretary*
Financial Secretary*
Paymaster General*
Economic Secretary*
Sir P Middleton*
Sir T Burns*
Mr F E R Butler*
Sir G Littler
Mr Byatt*
Mr Cassell*
Mr Lavelle
Mr H P Evans*
Mrs Lomax*
Mr Odling-Smee
Mr Scholar*
Mr Sedgwick
Mr Turnbull*
Mr Bottrill
Mr S J Davies
Mr Gieve*
Mr Ilett
Mr S Matthews
Mr Pickford
Mr Courtney
Mr Guy
Mr Hudson
Mr D E W Owen
Mr Patterson
Mr D Savage
Mr Dyer for No. 10
Mr Cropper*
Mr Tyrie*
Mr Emrys Davies - UKDEL OECD
JB/09

*Without annex

**OECD SURVEY OF UK**

The OECD are publishing their 1987 Survey of the UK at 0100 on Saturday 8 August. The media should receive embargoed copies in the next couple of days, so comment will appear in the weekend's press. We will let you have a printed version of the Survey as soon as one arrives. (We already have a typescript, if you need to refer to it.)

2. This year's UK Survey follows on the heels of the OECD's June 'Economic Outlook' which itself contained a chapter on the UK. The Survey covers much the same ground, albeit in more detail, and so may arouse less press interest than usual.

3. The Treasury commented extensively on the text of the Survey in draft and we appear to have secured most of the revisions for which we were pressing. It gives a generally favourable assessment of UK macroeconomic policy. While it is difficult to find many wholehearted endorsements of the current stance, there are no serious suggestions for significant change. The approach to monetary policy is said to have "continued to be rather pragmatic" (Chapter II, paragraph 7) but the Secretariat acknowledge that the UK has no fixed exchange rate target.

4. The text of the Survey helpfully contrasts current UK performance with current European and previous UK performance. However, it also notes that growth comparisons taken from the cyclical peak of 1979 are less flattering than those starting in 1981, that the increase in employment since 1983 has recouped little more than half the previous losses and that the manufacturing trade balance switched into deficit in 1983 for the first time since the War and points to our relatively poor international performance on unemployment, inflation, wages and unit labour costs (Chapter IV, paragraph 6).

5. Each year, the OECD focus on a specific aspect of the UK economy which they discuss in particular detail. 1987's topic is the financial markets. The OECD's descriptive material is fair and, within the limitations of space, quite useful, containing some hitherto unpublished CSO data on the contribution of the financial sector to UK GDP. The section on London as an international financial centre is accurate, if slightly grudging, and the Secretariat's assessment of the impact of the financial system on the UK's economic performance, while sometimes superficial, generally supports the Government's policies. The Survey discusses whether the booming financial sector has driven up the exchange rate and so adversely affected manufacturing and whether it has creamed off domestic talent or has unhelpfully bid up salaries. However, the Secretariat conclude North Sea oil has been the dominant influence on the exchange rate and that the success of any export or import competing firm is bound to increase competitive pressure on other sectors (Chapter III, paragraph 8).

6. The major area of disagreement between the Treasury and Secretariat remains the Survey's relatively pessimistic forecast for 1988. The Secretariat conclude "On the basis of [major financial market reforms, increased privatisation proceeds, personal income tax adjustments and additional labour market measures] and the technical assumptions of unchanged oil prices and exchange rates, the growth of activity is projected to continue, albeit at diminishing rates. A revival of business fixed investment and stockbuilding is expected to partly compensate for decelerating expansion of private consumption and export demand. Unemployment should continue to decline slightly... inflation is likely to drift upwards and the current external account to move into small deficit." (Introduction paragraph 4.) While sympathetic to the UK's objections to this description of the prospect, the Secretariat were reluctant to change forecasts already published in the June 'Economic Outlook', although they did reduce their forecasts of the 1987 and 1988 current account deficits.

7. For the medium-term, the Secretariat note the "strength of output growth consistent with the inflation objective in the medium term will depend much on further progress in improving supply-side conditions and any marked reduction in unemployment will hinge on

moderation in pay settlements." (Introduction, paragraph 4.) They comment that "the more rapid increase in wages than in other countries represents a major problem" and that despite the UK's improved productivity performance, "unit labour costs have grown more than in trading partner countries". (Conclusions, paragraph 4.) "In view of still relatively low profitability ...and the need to create new job opportunities..., real labour cost levels may still be considered as excessive relative to labour productivity levels. Even more important to stress may be the persistence of high nominal wage increases which exert upward pressure on inflation and tend to restrain output and employment growth, given the Government's nominal income-based strategy." (Chapter IV, paragraph 9.) So "it is... important that wage growth should moderate." (Conclusions, paragraph 4.)

8. The Secretariat conclude that the challenge facing the UK authorities "is to ensure, through a consistent but flexible implementation of their strategy, that further improvements in the labour market are achieved while maintaining external equilibrium and downward pressure on inflation." (Conclusions paragraph 2.)

9. The attached annex (not copied to all) contains a list of positive points made in the Survey to which you could draw the media's attention and some defensive lines to take, supplied by a number of Treasury divisions.

MOM

MISS M O'MARA

ANNEX

## A Macroeconomic policy

### Positive

(i) "The policy approach appears to have contributed to the favourable recent performance..." (Introduction, paragraph 1.)

(ii) "The conduct of monetary policy has been particularly difficult, as the information content of most monetary aggregates about conditions in the economy has been persistently blurred by the effects of deregulation and innovation in financial markets." (Chapter II, paragraph 1.) "...the flexible implementation of monetary policy in recent years would appear to have been relatively successful." (Conclusions, paragraph 5.)

(iii) "...a main requirement is that [the PSFD] should fall further as a share of GDP over the medium-term. Given the Government's intention to hold the PSBR to 1 per cent of GDP, this should occur gradually as privatisation proceeds fall as a share of GDP." (Conclusions, paragraph 6.)

### Defensive

(i) Increasing difficulties in interpretation mean that Government is ignoring broad money as an indicator of monetary conditions? Not at all. Behaviour of broad money fully taken into account in assessing monetary conditions. But has to be balanced against evidence from other indicators.

(ii) Monetary policy now focussed on exchange rate? No change in policy. Conditions are assessed in light of movements in narrow and broad money and behaviour of other financial indicators, in particular exchange rate. Desire to see exchange rate stability. Balance struck between exchange rate level and domestic monetary growth consistent with aims for money GDP and inflation.

(iii) UK nominal and real interest rates higher than in other developed countries? Level of UK nominal rates reflects number of factors, including fact that UK inflation still higher than in main competitor countries. No uniquely correct way of calculating real rates, because depend on expectations of future inflation. But latest figures suggest UK real rates only slightly above average of G7.

(iv) Failure to use direct controls/overfunding means UK interest rates unnecessarily high? Wishful thinking. Policies which distort markets are inherently undesirable. Apart from that, direct controls have become increasingly ineffective in modern financial markets, as other countries have discovered in recent years.

(v) Domestic demand recently supported by resumption of growth in public spending? Both public expenditure and tax receipts rose in real terms between 1985-86 and 1986-87. Overall change in effect of fiscal policy on domestic demand unlikely to be more than marginal. As Secretariat state (Conclusions, paragraph 2), fiscal policy remains broadly neutral according to present plans.

(vi) Some overshooting of planning total possible? Premature to speculate. Reserve in 1987-88 larger as percentage of planning total than in 1984-85 or 1985-86. Survey accepts that downward trend of public spending as proportion of GDP likely to be continued, as Cabinet reaffirmed on 23 July.

(vii) Response of employers to PRP "tepid"? No. Even though Finance Act introducing tax relief only just received Royal Assent, over 21,000 employers already written to Inland Revenue to express interest in its details and order in advance copies of Guidance Notes. Include over 120 of top 250 UK companies.

## B Economic performance

### Positive

(i) "In spite of the importance of North Sea oil, the economy has coped better with the impact of lower oil prices than many others in the OECD area. Output growth in 1987 is likely to exceed that for most other Member countries. Recent developments also compare favourably with the generally disappointing long-term performance of the United Kingdom..." (Introduction, paragraph 1.)

(ii) "The United Kingdom's recent growth performance compares favourably with that in the 1960s and 1970s when the economy persistently lost ground to the other industrial countries. Entering its seventh year, the current recovery is the longest in British post-war history. The rate of GDP growth achieved since 1981 has been one of the highest in the OECD area." (Chapter IV, paragraph 5.)

(iii) "The United Kingdom's economic performance since the large oil price fall at the beginning of 1986 has compared favourably, and increasingly so, with that of the OECD area as a whole." (Chapter I, paragraph 1.)

(iv) "...the United Kingdom's competitive position is [still] considerably better than two years ago... improved competitiveness has already favourably influenced real export performance." (Chapter I, paragraph 10.)

(v) "More recently [than 1986 as a whole], import demand has weakened, due partly to less buoyant domestic demand, and the deterioration in the real foreign balance has been sharply reversed." (Chapter I, paragraph 5.)

(vi) "The favourable trends of merchandise trade recorded during the first four months of this year suggest that the current account has switched back into surplus." (Chapter I, paragraph 12.)

(vii) "Reflecting above all the sharp decline in import volumes, but already reversed in the deterioration in the terms of trade, the trade deficit dropped markedly in the first quarter of 1987, back to the level of a year earlier." (Chapter I, paragraph 11.)

(viii) "Recent productivity gains... may be indicative of an improvement in supply-side conditions, [although they followed a marked activity-linked deceleration through 1985. Even so,] labour productivity growth in the private business sector since 1979 was significantly higher than previously and among the highest in Member countries where it has tended to decelerate. According to Secretariat estimates, total factor productivity... has risen significantly more in the present cycle than in the preceding one, contrary to developments in other major OECD countries. This result is the more noteworthy as it took place in the context of broadly similar average output growth during both cycles." (Chapter IV, paragraph 8.)

(ix) "...the buoyancy of government revenues has enabled the Government to achieve its long-term objective for the public sector borrowing requirement (PSBR) sooner than would otherwise have been the case. Despite sharply lower oil revenues the authorities have been able to raise expenditure from previous plans and reduce the personal income tax rate, while setting the PSBR at only 1 per cent of GDP for

1987/88 (having achieved a PSBR ratio a little below 1 per cent in 1986/87)." (Introduction, paragraph 3.)

(x) "...at an annual rate of less than 2 per cent, real growth of public spending (national accounts definition) in the 1980s has been significantly lower than previously. The ratio of government expenditure to GDP has declined since 1984... and it is planned to come down to the 1979 level by 1988." (Chapter II, paragraph 3.)

(xi) "The recovery of rates of return on capital in recent years and the apparent strengthening of total factor productivity growth may be taken as first signs that the economy is moving in the right direction." (Conclusions, paragraph 10.)

X| (xii) "In sum, recent economic developments in the United Kingdom compare favourably both with its own past performance and that of other countries." (Conclusions, paragraph 10.)

**Defensive**

(i) Performance less impressive when measured from 1979. Still a major improvement in productivity and output performance relative to Europe over this period. But no secret that Government inherited deep seated problems in 1979 and transition period needed to get economy on to sustainable growth path.

(ii) Little further progress in reducing inflation or improving output/inflation split since 1983.

- Inflation in 1986 reached lowest level for almost 20 years.
- Situation in 1983 not as balanced or sustainable as now. Both exchange rate and profit margins have adjusted to more sustainable levels without any deterioration in output-inflation split.

(iii) Good relative output performance due to lower oil price; bad relative inflation performance. Unlikely that UK growth has benefited relative to other countries from falling oil price [Secretariat's statement (Chapter I) about asymmetry between gainers and losers factually incorrect] but clear UK's relative inflation performance adversely affected because fall in oil costs offset by consequent depreciation of sterling.

(iv) Inflation has picked up. Not true of GDP deflator and only marginally true of RPI once changes in mortgage interest payments excluded.

(v) No "significant moderation" in wage growth. Secretariat acknowledge there has been a fall in pay settlements, offset by higher overtime etc. Government is as concerned as Secretariat to see deceleration in pay.

(vi) Unemployment remains high by international standards. Downward trend in unemployment now firmly established. Currently largest three, six and twelve monthly fall on record. UK has had largest fall in percentage unemployment rate of all major industrialised countries over last year. Even OECD's unduly pessimistic forecast indicates unemployment should continue to decline.

(vii) Movements in current account. Move from current surplus to broad balance in 1986 largely reflected oil price fall, as Secretariat acknowledge (Chapter I, paragraph 12).

(viii) Fall in imports in early 1987 only temporary, due to weak domestic demand? Always expected some rise in imports in 1987. Strong growth in GDP and manufacturing output in recent months suggest domestic supply responding well to demand. Imports of intermediate goods and semi-manufactures rising as industry expands.

(ix) Debt/GDP ratio has remained high by international standards. Debt/GDP ratio will continue to fall, given Government's objective of holding to 1 per cent PSBR/GDP ratio. Will ensure debt/GDP ratio will not rise even when prices stable.

(x) Public sector and general government financial deficits have fallen less than PSBR. PSFD for 1987-88 projected in FSBR to fall from 2¾ to 2¼ per cent of GDP. Ratio should decline further in years ahead as PSBR is held to 1 per cent of GDP and privatisation proceeds gradually fall as share of GDP. Survey acknowledges this.

(xi) Ratio of GGE/GDP peaked in 1984. UK Government's figures show ratio (including or excluding privatisation proceeds) declining since 1982-83. Difference seems to be definitional. [UK definitions of GGE include net lending. OECD definition seems to exclude both net lending and privatisation proceeds ie is equal to general government current plus capital expenditure.]

## C Economic prospects

### Positive

(i) "The underlying strength of the domestic economy would seem to ensure... continued strong activity growth in the immediate future." (Chapter IV, paragraph 4.)

(ii) "Recent indicators and survey results point to contined rapid activity growth in the near future ...domestic demand should remain buoyant, with investment picking up and consumer demand remaining relatively strong ...growth performance over the next 18 months or so should compare favourably with that of many other Member countries." (Conclusions, paragraph 2.)

(iii) "... prospects are good for a seventh year of expansion... export growth accelerated sharply in the second half of 1986 and has remained relatively strong in the present year, in contrast to developments in appreciating countries." (Conclusions, paragraph 1.)

(iv) "The United Kingdom's export markets are expected to expand fairly steadily at about 4½ per cent, somewhat faster than world trade." (Chapter IV, paragraph 1.)

(v) "Employment should continue to rise... Assuming modest labour force growth, unemployment may experience some further decline, notably in 1987." (Chapter IV, paragraph 3.)

(vi) "...it cannot be excluded that the present projections underestimate the extent to which recent productivity growth has reflected greater trend efficiency of labour other than once-and-for-all cyclical gains. Prospects of a sustained rapid growth, without inflation taking off and the external deficit widening, would, of course, be clearly improved if productivity growth held up better than assumed in the projection." (Chapter IV, paragraph 4.)

### Defensive

(i) Wage increases "may well reaccelerate". But Secretariat's central forecast is for moderation of pay. Also acknowledge that productivity growth may be faster than they project.

(ii) Competitiveness projected to deteriorate as UK unit labour costs rise faster than competitors'. Because of fast productivity growth, UK unit labour costs rose only slightly faster than competitors' during 1986. Commitment to firm monetary policy will in time narrow gap between UK and world inflation.

(iii) Inflation likely to drift upwards in future. OECD inflation forecast unduly pessimistic, particularly for 1988. While short-term fluctuations inescapable, Government committed to monetary and fiscal policies which will keep inflation on underlying downward trend. High pay settlements will restrain output and employment growth, as Survey recognises (Chapter IV), but wrong to infer that Government will accommodate wage pressure in higher inflation over medium-term, as Survey tends to suggest elsewhere.

(iv) Fall in exchange rate has made further progress to price stability more difficult. Exchange rate depreciation in response to lower oil prices does not generally make progress to price stability more difficult than in absence of oil price fall. Simply offsets favourable impact on domestic prices of lower oil price.

(v) Export growth projected to weaken, despite steady growth in UK markets; recent gains in export market share will be reversed. No sign of worsening export prospects in latest CBI Survey. UK volume share of developed countries' exports rising since early 1980s, following years of decline. No prospect of reversal in trend.

(vi) Current account forecast to show slightly rising deficit. FSBR forecast showed current account improving between 1987 and 1988 H1. So far in 1987 current account in surplus by £0.2 billion

(vii) Net trade expected to have negative influence on growth. Not surprising, given UK economy growing faster than most other major economies. Full effects of competitiveness gain not yet come through. Should continue to encourage exports and restrain imports so that net trade does not constrain growth.

(vii) Economy approaching capacity constraints? Latest CBI Survey provides little support for this view. Three times as many firms see sales as constraint on output as capacity. June Investment Intentions Survey indicates rise in industrial investment of 8 per cent in both 1987 and 1988.

D **Financial markets** (Chapter III)

**Positive**

(i) - Survey shows growth of financial sector's contribution to GDP (6 per cent of net value added in 1975; 7½ per cent in 1985), employment (6½ per cent of total in mid-1970s; more than 9 per cent now) and net overseas earnings (£6 billion in 1985, excluding commodity trading and non-stock brokerage).

- "...the United Kingdom financial sector's share in total value added is among the highest in the OECD area."
- "[The financial sector's share in total employment] is among the highest and fastest rising of Member countries."
- "Having always been an important constituent of the invisible surplus, [net overseas earnings] have exceeded the latter in the 1980s."

(Paragraphs 4, 5 and 7.)

(ii) UK saving has stayed around one-fifth of GDP, but declined in other countries, so that in contrast to past, UK now close to international average. (Paragraph 10.)

(iii) "...the financial sector is among the most dynamic of the economy and has maintained an importance in world financial markets which far exceeds that of the country's economic base. Also, the financial system would appear to be performing well its intermediation role between deficit and surplus units." (Paragraph 28.)

(iv) "London has succeeded in maintaining its importance as an international financial centre by attracting the Eurocurrency and Eurobond markets." (Paragraph 1.) "As an international financial centre London ranks in the top three with New York and Tokyo. Despite the rise of new competitors, the United Kingdom has retained a leading role in the international banking markets, particularly in Eurocurrency activity... Some three-quarters of the secondary market turnover of Eurobonds are estimated to pass through the City. Moreover, London is still the world's leader in insurance and reinsurance." (Paragraph 13.)

(v) "....it was mainly the combined effect of London's historic importance and a regulatory environment sympathetic to the pursuit of international banking which made of it the largest centre of the Euromarket; other factors include the concentration of a full range of financial services in a very small area, the standard of supporting services, and time zone advantages. In order to maintain the United Kingdom's leading position in world financial markets, the authorities have pursued a consistent policy of market liberalisation, removing remaining exchange controls... and encouraging foreign banks and institutions to locate in London." (Paragraph 14.)

(vi) "...the existing infrastructure together with the depth of the market and the wide range of instruments available should help to maintain London's position as a major financial centre." (Paragraph 19.)

(vii) "In late 1985... the scale of international business conducted by Japanese banks in London approached that of all banks in Japan." (Paragraph 16.)

(viii) "Net interest margins [for the London clearing banks] have dropped markedly in the 1980s and appear now to be close to levels prevailing in other larger Member countries." (Paragraph 29.)

(ix) "Removal of entry barriers and minimum commissions along with the reduction in the rate of stamp duty has led to a sharp increase in turnover and significant declines in transaction costs." (Conclusions, paragraph 9.) "The Big Bang of last October more than doubled the number of equity market makers and led to a sharp increase in turnover and a substantial fall in transaction costs... Equity turnover doubled in the six months to March... competition has increased even more in the restructured gilt-edged market where turnover grew six-fold in the six months to March." (Paragraph 33.)

(x) "There is broad agreement that, in general, conditions for business finance are satisfactory and raising of capital has not been a constraint on real investment. Investment performance, as measured by the ratio to GDP, is not out of line with that of most other Member countries... latest estimates for capital productivity [show] an improved performance both compared with past experience and that of most other countries." (Paragraph 34.)

(xi) "...relations between industry and finance have become much closer in the past decade or so." (Paragraph 35.)

(xii) "The supply of equity finance for small and new companies has been significantly improved by the development of venture capital funds in junior stock markets. Venture capital funds have expanded rapidly in the 1980s, helped by government schemes providing tax incentives for personal equity investment." (Paragraph 39.)

(xiii) "The tax system has been made more neutral as between different financial institutions, instruments and channels." (Paragraph 32.)

(xiv) "[The new framework of financial market supervision based] on functional rather than institutional lines... may pose considerable co-ordination problems but is expected to avoid the rigidity and higher cost of more centralised systems. All in all, the reforms represent a judicious mixture of liberalisation and greater regulation of markets." (Conclusions, paragraph 9.)

**Defensive**

(i) London's share of international banking, though high, is decreasing. Mainly reflection of rise of Japan and other new financial markets. London has done better than other European centres; still has quarter of all international banking.

(ii) Over last 10 years, turnover on London Stock Exchange grown at only half rate of New York, Tokyo and Germany. Statement only true pre-Big Bang. Since month before Big Bang, equity turnover on London Stock Exchange has increased between two and three-fold.

(iii) Domestic financial firms may be overwhelmed by well-capitalised foreign institutions? Survey recognises contribution foreign institutions have made to London's position as international financial centre and to improving competition domestically. Government committed to free competition in London and to pressing for reciprocal access by British institutions overseas.

(iv) Short-term strategies of institutional investors may have led to sharp growth of mergers and acquisitions? Survey suggests this as possible explanation of currently higher levels of mergers and acquisitions. But mergers and acquisitions have usually increased during economic upswings and institutional investors do not necessarily take particularly short-term view.

(v) Corporate sector tending to invest in financial assets rather than physical capital. As Survey makes clear, partly reflection of companies building up both sides of balance sheet as result of lower spreads and transactions costs; improves intermediation and allocative efficiency. Physical investment and capital productivity growing satisfactorily and net real rate of return for non-North Sea ICCs in 1986 highest since 1973.

(vi) "Little logic" underlying tax treatment of savings in UK. Survey recognises tax system has been made more neutral as between different financial institutions, instruments and channels. Remaining incentives (eg for pension provision) based on considerations of social policy.

(vii) Prudential control more complicated, with considerable co-ordination problems. Survey endorses UK approach: "Experience of other countries suggests... that there is little alternative [to functional-based supervision]; institution-based supervision tends to become ineffective and inconsistent when the distinction of activities becomes blurred." (Chapter III, paragraph 46.)

FROM: JANET BARBER
DATE: 2 SEPTEMBER 1987

MR WILLIAMS

cc Mr Mortimer
Mr Savage
Mr Bostock - UKREP
(without attachment)

**SUNDAY TIMES ARTICLE ON UK/FRANCE COMPARISON OF LIVING STANDARDS**

You said that the Chancellor had asked about the source for this article, quoted as being the European Commission.

2. I have consulted IF2, and we are not aware of any recent Commission publication which would have given the information in the article.

3. IF2 think that the story might derive from joint OECD/European Communities Statistical Office work on purchasing power parities and real per capita GDP. An OECD press notice published in February this year (copy attached) produced **provisional estimates** for 1986. This showed real GDP per head in the UK to be 96-97% of that in France. It is possible that this exercise is being updated, and that Mr Smallwood has heard about some new figures, and he may have applied French and UK growth rates to them or to the February ones.

4. The OECD/Eurostat information for 1985 was quoted in an EPR article in March-April this year. The article said then that UK GDP was close to that of France.

5. You may wish to pursue this with Mr Smallwood. UKREP would find it easier to follow up the matter with the Commission if we knew more about the source of the figures.

S Pickford to speak Smallwood.

Janet Barber

JANET BARBER
EC1

Ch /
Looks to me as if Smallwood must have got some new figures from the Commission. I'll ask David Bostock to pursue

AA

yes pse

M/6



$2.028 million (419 loans), of which roughly 75 percent has been disbursed.

Grants amounted to $207 million (189 grants), while the fund made contributions to other international development aid institutions totalling $971.9 million.

Interviewed by the Kuwaiti News Agency (KUNA) the Director General of the Fund Dr. Seyyed Abdulai said that although 1986 was a very bad year for many developing countries the fund was able to maintain the number of assistance granting operations at the 1985 level, with 20 development project loans, one balance of payments support operation and 24 grants. The total value of aid committed, however, was $90.1 million. He said one reason for its limited aid commitments in 1986 was the fact that many developing countries are going through structural economic changes which the fund refrains from financing.

He said the Opec Fund consciously refrains from financing such changes so as not to set terms and conditions regarding the recipient's domestic or foreign trade policies. For this reason the fund has not been able to spend the $120 million originally programmed, Abdulai said. The fund started its seventh bi-annual lending programme at the beginning of 1986 and had about $250 million to spend on development finance, balance of payments support and grants.

Purchasing power parities and international comparisons of price levels and real per capita GDP in OECD countries OECD PRESS RELEASE, 10/2/87.

PPPs in 1985 and 1986

The OECD and the Statistical Office of the European Communities (Eurostat) have jointly completed the calculation of a new set of Purchasing Power Parities (PPPs) for 1985. PPPs are the rates of currency conversion which equalise the purchasing powers of different currencies - i.e., make it possible to buy the same basket of goods and services in all countries. Thus, PPPs are the rates which equalise price levels in the sense that, if prices in different countries are all converted into a common currency unit, here the U.S. dollar, by means of PPPs the resulting dollar prices are the same, on average, in all countries. The method used to calculate PPPs is to make detailed comparisons between the prices of individual goods and services in different countries and special price surveys were carried out for this purpose by OECD and Eurostat in 1985. This press release reports on the first results derived from these new surveys with updates to 1986.

The PPPs shown in the accompanying tables refer to GDP as a whole. It should be noted, therefore, that they cover the entire range of final goods and services, including government services, many of which are not traded internationally. The PPPs have been calculated specifically for statistical purposes to enable international price and volume comparisons to be made for GDP and its components. Although PPPs also figure in international trade theory, the PPPs shown here have not been designed for this purpose and do not necessarily throw much light on equilibrium exchange rates.

PPPs tend to be fairly stable over time as they change only to the extent that rates of inflation differ from one country to another. For example, the PPP for the Deutschemark against the U.S. dollar was unchanged at 2.48 in both 1985 and 1986 because there was no significant difference between the rates of inflation for Germany and the United States between 1985 and 1986 at the GDP level. Similarly, the PPP for the Japanese yen moved only slightly from 225 to 223 between 1985 and 1986.

## Comparative price levels

When prices are converted into dollars (or some other common currency) at exchange rates, considerable differences are often found between the resulting dollar price levels for different countries. This means that when statistical aggregates, such as GDP per capita, are also converted into dollars using exchange rates, the differences observed between countries are likely to reflect differences in the dollar price levels as much as differences in the quantities of goods and services produced. The extent to which dollar price levels actually varied in 1985 and 1986 is shown by the figures in the third column of the accompanying tables under the heading "Comparative Dollar Price Levels". In 1985, dollar prices in most countries were lower than those in the United States, but by 1986 dollar prices in many European countries, and Japan, were higher than in the United States because of the depreciation of the U.S. dollar. In general, price levels tend to be lower in countries with relatively low levels of per capita GDP. This can be seen not only by comparing with the United States but by making comparisons within Europe; for example, price levels in countries such as Portugal or Greece tend to be much lower than in countries such as Germany, Denmark or Sweden when prices are converted at exchange rates.

## Real Per Capita GDP

In order to make real comparisons of productivity or living standards, it is necessary to eliminate price differences between countries by converting the GDP figures by means of PPPs instead of exchange rates. The real measures of comparative GDP per capita given in column 4 of the accompanying tables show that, in volume terms, the per capita GDP of the United States continues to be well ahead of most other OECD countries (despite some confusion on this point caused by recent movements in exchange rates). The only country approaching the U.S. level is Canada, whose real per capita GDP is about 90 per cent of that of the United States.

Although in nominal terms (i.e. converted at exchange rates) some countries, especially Japan, have recently moved much closer to the United States, this narrowing of the gap almost entirely reflects an upward movement in the exchange rate converted dollar prices inside Japan relatively to actual U.S. prices. The narrowing does not mean that Japanese citizens are becoming almost as rich as U.S. citizens, as the quantities of goods and services produced per capita in Japan remain about 30 per cent below the U.S. level.

Within Europe, three main groups of countries can be identified: a high income group -- Norway, Luxembourg, Sweden, Denmark and Germany -- with per capita GDP from around 75 to 85 per cent of the U.S. level; a middle income group -- Austria, Finland, Belgium, France, Netherlands and the United Kingdom -- with per capita GDP between 60 to 70 per cent of the U.S. level; and finally a low income group -- Greece, Ireland, Portugal and Spain -- with per capita GDP ranging from 35 to 50 per cent of the U.S. level. Italy falls between the low and middle income groups with a per capita GDP of about 57 per cent of that of the United States.

## Purchasing Power Parities and International Comparisons of Price Levels and Real Per Capita GDP in OECD countries

### 1985

| | PPP | Exchange Rate | Comparative Dollar Price Levels | GDP per Capita (U.S. dollars) | | International Volume Index |
|---|---|---|---|---|---|---|
| | Currency Units per US dollar | | (1)/(2) | Real(*) | Nominal(**) | col. 4 US = 100 |
| | (1) | (2) | (3) | (4) | (5) | (6) |
| United States | 1.00 | 1.00 | 100 | 16494 | 16494 | 100 |
| Canada | 1.25 | 1.37 | 91 | 14959 | 13635 | 91 |
| Japan | 225 | 239 | 94 | 11666 | 10997 | 71 |
| Austria | 17.05 | 20.69 | 82 | 10610 | 8743 | 64 |
| Finland | 5.98 | 6.20 | 97 | 11421 | 11024 | 69 |
| Norway | 8.51 | 8.59 | 99 | 14098 | 13960 | 85 |
| Sweden | 8.21 | 8.60 | 95 | 12586 | 12006 | 76 |
| Belgium | 44.5 | 59.4 | 75 | 10718 | 8022 | 65 |
| Denmark | 9.73 | 10.6 | 92 | 12322 | 11312 | 75 |
| France | 7.33 | 8.98 | 82 | 11333 | 9251 | 69 |
| Germany | 2.48 | 2.94 | 84 | 12158 | 10243 | 74 |
| Greece | 77 | 138 | 56 | 5914 | 3294 | 36 |
| Ireland | 0.69 | 0.95 | 73 | 7062 | 5123 | 43 |
| Italy | 1269 | 1909 | 66 | 9445 | 6278 | 57 |
| Luxembourg | 42.5 | 59.4 | 71 | 13636 | 9745 | 83 |
| Netherlands | 2.53 | 3.32 | 76 | 11332 | 8628 | 69 |
| Portugal | 66 | 170 | 39 | 5212 | 2032 | 32 |
| Spain | 95 | 170 | 56 | 7629 | 4255 | 46 |
| United Kingdom | 0.57 | 0.78 | 73 | 10882 | 7943 | 66 |

(*) Converted at PPPs
(**) Converted at exchange rates

### 1986

| | PPP | Exchange Rate | Comparative Dollar Price Levels | GDP per Capita (U.S. dollars) | | International Volume Index |
|---|---|---|---|---|---|---|
| | Currency Units per US dollar | | (1)/(2) | Real(*) | Nominal(**) | col. 4 US = 100 |
| | (1) | (2) | (3) | (4) | (5) | (6) |
| United States | 1.00 | 1.00 | 100 | 17200 | 17200 | 100 |
| Canada | 1.24 | 1.39 | 89 | 15700 | 14100 | 91 |
| Japan | 223 | 169 | 132 | 12200 | 16200 | 71 |
| Austria | 17.15 | 15.27 | 112 | 11200 | 12500 | 65 |
| Finland | 6.13 | 5.07 | 121 | 11900 | 14400 | 69 |
| Norway | 8.09 | 7.39 | 109 | 15100 | 16500 | 88 |
| Sweden | 8.50 | 7.12 | 119 | 13200 | 15800 | 77 |
| Belgium | 45.0 | 44.7 | 101 | 11300 | 11300 | 65 |
| Denmark | 9.83 | 8.09 | 122 | 13000 | 15800 | 76 |
| France | 7.48 | 6.93 | 108 | 11800 | 12800 | 69 |
| Germany | 2.48 | 2.17 | 114 | 12900 | 14700 | 75 |
| Greece | 90 | 139 | 65 | 6100 | 3900 | 35 |
| Ireland | 0.71 | 0.75 | 96 | 7300 | 7000 | 42 |
| Italy | 1329 | 1491 | 89 | 9900 | 8800 | 58 |
| Luxembourg | 43.3 | 44.7 | 97 | 14300 | 13900 | 83 |
| Netherlands | 2.47 | 2.45 | 101 | 11800 | 11900 | 68 |
| Portugal | 76 | 148 | 51 | 5500 | 2800 | 32 |
| Spain | 102 | 140 | 73 | 8000 | 5900 | 47 |
| United Kingdom | 0.57 | 0.68 | 84 | 11400 | 9600 | 66 |

(*) Converted at PPPs
(**) Converted at exchange rates

Note: The figures of per capita GDP in 1986 are provisional estimates based on the estimated rates of inflation and growth between 1985 and 1986 given in Economic Outlook No. 40.

MR 12/57

UNCLASSIFIED

FROM: S J PICKFORD
DATE: 4 September 1987

PS/CHANCELLOR

Ch/ This points to our treating the assertions in the ST story with caution.

cc: PS/FST
Mr Culpin
Miss O'Mara
Miss Barber
Mr Tyrie
Mr Norgrove (No 10) - personal

**HAS THE UK OVERTAKEN FRANCE?**

You asked me to find out what was the basis for Chris Smallwood's article in last week's Sunday Times (cutting attached).

2. I spoke to Chris Smallwood. The starting point for his article was the OECD press release of 5 February 1987 (copy attached). This reported studies to calculate purchasing power parities for 1985. The press release updates those estimates to 1986 based, according to Smallwood, on movements in real GDP between the two years.

3. Smallwood has then calculated that, since he estimates the UK's growth between 1986 and 1987 will be 4 per cent and the French growth rate more like one per cent, that the gap in purchasing power parities in 1986 will be closed by the end of the year. He told me he had talked to statisticians at Eurostat and described his calculations. He claimed that the statisticians had agreed that his methodology seemed correct and that the resulting numbers also looked plausible. But to claim, as the headline does, that his calculations have official backing seems to be stretching the truth.

S J PICKFORD

SUNDAY TIMES

# Official: We're as wealthy as the French

1/≡

by Christopher Smallwood Economics Editor

**BRITONS are climbing up the league table of rich nations. Their living standards are poised to overtake those in France for the first time since 1976, the European Commission confirmed this weekend.**

**This supports the findings of British tourists that although the French have a lot of money to spend, the prices in their shops are higher and money doesn't go so far.**

**But the official view yesterday received a predictable snub from French good-livers who put the whole matter down to *folie de grandeur* on the part of the upstart British. Gerard Lauzier, ferocious strip-cartoonist, playwright and devotee of the Gallic lifestyle, placed the story in "the Loch Ness category".**

**The commission's evidence is impressive. It calculated the cost of the average "shopping basket" of goods and services in the 12 member-countries to discover how much people on average incomes can buy. It shows the gap in living standards between Britain and France has been closing during the 1980s and by the middle of last year was only 3%.**

**But since then Britain's economy has been growing strongly, by some 4%, more than double the French rate. The standard of living of the average Briton can be expected to draw level with that of his French counterpart around the end of this year, moving ahead in 1988.**

**Under 2,000 headings of products and services, the survey shows that Britons pay less than the French for a range of items from Granny Smith apples and Swiss rolls to ladies' briefs and the services of a char. Even the cats have it better in Britain: the experts discovered that 27p worth of pet food in London cost 34p in Paris.**

**The idea of the affluent British will surprise many economists who usually compare average incomes across the foreign exchanges. This way, France looks more than 30% better off than Britain, and West Germany 50% better off.**

**But the commission's studies mirror what every British tourist has long suspected: taking account of high continental prices — and in Italy's case, its formidable black economy — living standards in France are not higher than in Britain, and are not in fact much different from Italy's. The West Germans remain the rich of Europe, but by a smaller margin than they like to imagine. They are currently 10% to 15% better off than the British. It all means that the popular picture of Britain's relative decline has been exaggerated. Britain's living standards should soon be second only to West Germany's in Europe.**

**The news is dismissed as heresy in France. The playwright Lauzier said tartly: "I hear people do enjoy themselves in London. I must go some day." He maintains that the French have the best of it — best food, best lifestyle and (especially) best mistresses. They are now, apparently, among the most expensive mistresses. When the commission went shopping it found that a bouquet of 10 carnations cost £2.58 in Britain and £2.98 in France.**

Sunday, August 30, 1987

SUNDAY TIMES

# Confidence drops

by Christopher Smallwood, Economics Editor

41≡

THE LATEST Mori opinion poll for The Sunday Times shows that, since the general election, optimism over the British economy is continuing to decline.

The balance of respondents expecting the general economic condition of the country to improve rather than get worse has fallen from 23% in June to 7% now. The drop has been particularly marked among middle-aged and middle-class people and in the north of England.

At the same time, a survey of more than 3,000 companies, including 2,000 manufacturing companies, by the Association of British Chambers of Commerce, due to be published this week, suggests that although the home market for manufactured goods continues to be exceptionally buoyant, with little sign of the expansion being halted by capacity constraints, there is growing concern that export orders are slipping back.

There are also fears that if interest rates are maintained at their current high level, investment is likely to suffer.

The main points from this survey are:

- A record balance of companies anticipating a rise in manufacturing orders from the home market, with non-manufacturing business doing even better than manufacturing industry;
- A slide in export orders for manufactured goods, coupled with a surge in imports;
- A fall in capacity utilisation between the first and second quarters of this year;
- A rise in the number of companies reporting difficulties in recruiting skilled labour;
- The Midlands and Merseyside doing significantly worse than other regions of England.

The survey's suggestion that exports are falling as imports surge ahead is likely to confirm fears in the City that the balance of payments is deteriorating. The pound closed slightly firmer on Friday, at 72.5 against the basket of currencies, but the currency markets were nervous in advance of this Tuesday's trade figures, which are widely expected to show a deficit for July.

The money markets continue to signal that the next move in interest rates is more likely to be up than down, with the key three-month interbank rate rising to 10.5%. But advance indications are that the next set of figures for M0 — the government's central money-supply indicator — and for bank lending will show a substantial improvement on the July numbers which triggered the rise in base rates from 9% to 10% earlier this month.

Unless the trade figures are particularly bad, the currency markets' attention is likely to focus on the dollar next week. European central banks intervened to support the dollar on Friday but the American currency failed to recover.

This is because the markets are convinced that significant reductions in trade imbalances are still a long way off. There was growing concern about Aemrica's trade deficit even before the news that Japan's trade surplus last month increased to $7.7 billion, following the announcement earlier in the week of an increase in West Germany's surplus.

Despite the intervention of the central banks, there was little change in the dollar's value on Friday, although it dipped to DM1.81, the lowest level against the D-mark for several months. But many dealers expect the dollar to continue to slide, leaving sterling on the sidelines.

The London stock market recovered some of its nerve last week, following the violent gyrations earlier in the month. The FT 30 share index gained 32 points over the week to close at 1,759.8, and the wider FT-SE 100 index rose 43 points to close at 2,249.7.

SUNDAY TELEGRAPH

# Profit from this opportunity

30

**THE attack of the dooms and glooms in the United Kingdom market provides, says Scottish Mutual, the insurance and investment group, an opportunity to make a profit. It lists seven reasons:-**

- ☆ **Inflation is not about to take off in Britain;**
- ☆ **Interest rates should not rise significantly;**
- ☆ **The industrial sector outlook is still positive;**
- ☆ **The British economy is not about to be submerged by a tidal wave of overheating;**
- ☆ **Nor is the United Kingdom market about to drown under the weight of new paper;**
- ☆ **The international outlook has improved;**
- ☆ **Britain's financial markets currently represent sound value.**

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Head copy to
Mr Bolophin

OECD

# Press Release

NOT FOR PUBLICATION BEFORE
TUESDAY 10th FEBRUARY 1987
00h01 HOURS PARIS TIME

PRESS/A(87)9

Paris, 5th February 1987

## PURCHASING POWER PARITIES AND INTERNATIONAL COMPARISONS OF PRICE LEVELS AND REAL PER CAPITA GDP IN OECD COUNTRIES

### PPPs in 1985 and 1986

The OECD and the Statistical Office of the European Communities (Eurostat) have jointly completed the calculation of a new set of Purchasing Power Parities (PPPs) for 1985. PPPs are the rates of currency conversion which equalise the purchasing powers of different currencies - i.e., make it possible to buy the same basket of goods and services in all countries. Thus, PPPs are the rates which equalise price levels in the sense that, if prices in different countries are all converted into a common currency unit, here the U.S. dollar, by means of PPPs the resulting dollar prices are the same, on average, in all countries. The method used to calculate PPPs is to make detailed comparisons between the prices of individual goods and services in different countries and special price surveys were carried out for this purpose by OECD and Eurostat in 1985. This press release reports on the first results derived from these new surveys with updates to 1986.

The PPPs shown in the accompanying tables refer to GDP as a whole. It should be noted, therefore, that they cover the entire range of final goods and services, including government services, many of which are not traded internationally. The PPPs have been calculated specifically for statistical purposes to enable international price and volume comparisons to be made for GDP and its components. Although PPPs also figure in international trade theory, the PPPs shown here have not been designed for this purpose and do not necessarily throw much light on equilibrium exchange rates.

PPPs tend to be fairly stable over time as they change only to the extent that rates of inflation differ from one country to another. For example, the PPP for the Deutschemark against the U.S. dollar was unchanged at 2.48 in both 1985 and 1986 because there was no significant difference between the rates of inflation for Germany and the United States between 1985 and 1986 at the GDP level. Similarly, the PPP for the Japanese yen moved only slightly from 225 to 223 between 1985 and 1986.

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Comparative price levels

When prices are converted into dollars (or some other common currency) at exchange rates, considerable differences are often found between the resulting dollar price levels for different countries. This means that when statistical aggregates, such as GDP per capita, are also converted into dollars using exchange rates, the differences observed between countries are likely to reflect differences in the dollar price levels as much as differences in the quantities of goods and services produced. The extent to which dollar price levels actually varied in 1985 and 1986 is shown by the figures in the third column of the accompanying tables under the heading "Comparative Dollar Price Levels". In 1985, dollar prices in most countries were lower than those in the United States, but by 1986 dollar prices in many European countries, and Japan, were higher than in the United States because of the depreciation of the U.S. dollar. In general, price levels tend to be lower in countries with relatively low levels of per capita GDP. This can be seen not only by comparing with the United States but by making comparisons within Europe; for example, price levels in countries such as Portugal or Greece tend to be much lower than in countries such as Germany, Denmark or Sweden when prices are converted at exchange rates.

Real Per Capita GDP

In order to make real comparisons of productivity or living standards, it is necessary to eliminate price differences between countries by converting the GDP figures by means of PPPs instead of exchange rates. The real measures of comparative GDP per capita given in column 4 of the accompanying tables show that, in volume terms, the per capita GDP of the United States continues to be well ahead of most other OECD countries (despite some confusion on this point caused by recent movements in exchange rates). The only country approaching the U.S. level is Canada, whose real per capita GDP is about 90 per cent of that of the United States.

Although in nominal terms (i.e. converted at exchange rates) some countries, especially Japan, have recently moved much closer to the United States, this narrowing of the gap almost entirely reflects an upward movement in the exchange rate converted dollar prices inside Japan relatively to actual U.S. prices. The narrowing does not mean that Japanese citizens are becoming almost as rich as U.S. citizens, as the quantities of goods and services produced per capita in Japan remain about 30 per cent below the U.S. level.

Within Europe, three main groups of countries can be identified: a high income group -- Norway, Luxembourg, Sweden, Denmark and Germany -- with per capita GDP from around 75 to 85 per cent of the U.S. level; a middle income group -- Austria, Finland, Belgium, France, Netherlands and the United Kingdom -- with per capita GDP between 60 to 70 per cent of the U.S. level; and finally a low income group -- Greece, Ireland, Portugal and Spain -- with per capita GDP ranging from 35 to 50 per cent of the U.S. level. Italy falls between the low and middle income groups with a per capita GDP of about 57 per cent of that of the United States.

Purchasing Power Parities and International Comparisons of Price Levels and Real Per Capita GDP in OECD countries

1 9 8 5

| | PPP | Exchange Rate | Comparative Dollar Price Levels | GDP per Capita (U.S. dollars) | | International Volume Index |
|---|---|---|---|---|---|---|
| | Currency Units per US dollar | | (1)/(2) | Real(*) | Nominal(**) | col. 4 US = 100 |
| | (1) | (2) | (3) | (4) | (5) | (6) |
| United States | 1.00 | 1.00 | 100 | 16494 | 16494 | 100 |
| Canada | 1.25 | 1.37 | 91 | 14959 | 13635 | 91 |
| Japan | 225 | 239 | 94 | 11666 | 10997 | 71 |
| Austria | 17.05 | 20.69 | 82 | 10610 | 8743 | 64 |
| Finland | 5.98 | 6.20 | 97 | 11421 | 11024 | 69 |
| Norway | 8.51 | 8.59 | 99 | 14098 | 13960 | 85 |
| Sweden | 8.21 | 8.60 | 95 | 12586 | 12006 | 76 |
| Belgium | 44.5 | 59.4 | 75 | 10718 | 8022 | 65 |
| Denmark | 9.73 | 10.6 | 92 | 12322 | 11312 | 75 |
| France | 7.33 | 8.98 | 82 | 11333 | 9251 | 69 |
| Germany | 2.48 | 2.94 | 84 | 12158 | 10243 | 74 |
| Greece | 77 | 138 | 56 | 5914 | 3294 | 36 |
| Ireland | 0.69 | 0.95 | 73 | 7062 | 5123 | 43 |
| Italy | 1269 | 1909 | 66 | 9445 | 6278 | 57 |
| Luxembourg | 42.5 | 59.4 | 71 | 13636 | 9745 | 83 |
| Netherlands | 2.53 | 3.32 | 76 | 11332 | 8628 | 69 |
| Portugal | 66 | 170 | 39 | 5212 | 2032 | 32 |
| Spain | 95 | 170 | 56 | 7629 | 4255 | 46 |
| United Kingdom | 0.57 | 0.78 | 73 | 10882 | 7943 | 66 |

(*) Converted at PPPs
(**) Converted at exchange rates

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Purchasing Power Parities and International Comparisons of Price Levels and Real Per Capita GDP in OECD countries

1 9 8 6

| | | | PPP | Exchange Rate | Comparative Dollar Price Levels | GDP per Capita (U.S. dollars) | | International Volume Index | |
|---|---|---|---|---|---|---|---|---|---|
| | | | Currency Units per US dollar | | (1)/(2) | Real(*) | Nominal(**) | col. 4 US = 100 | |
| | | | (1) | (2) | (3) | (4) | (5) | (6) | |
| * | United States | 1 | 1.00 | 1.00 | 100 | 17200 | 17200 | 100 | 1 |
| | Canada | 2 | 1.24 | 1.39 | 89 | 15700 | 14100 | 91 | 2 |
| | Japan | 8 | 223 | 169 | 132 | 12200 | 16200 | 71 | 8 |
| | Austria | 14 | 17.15 | 15.27 | 112 | 11200 | 12500 | 65 | 14 |
| | Finland | 9 | 6.13 | 5.07 | 121 | 11900 | 14400 | 69 | 9* |
| | Norway | 3 | 8.09 | 7.39 | 109 | 15100 | 16500 | 88 | 3 |
| | Sweden | 5 | 8.50 | 7.12 | 119 | 13200 | 15800 | 77 | 5 |
| 7 | Belgium | 13 | 45.0 | 44.7 | 101 | 11300 | 11300 | 65 | 13 |
| 2 | Denmark | 6 | 9.83 | 8.09 | 122 | 13000 | 15800 | 76 | 6 |
| 4 | France | 10 | 7.48 | 6.93 | 108 | 11800 | 12800 | 69 | 10 |
| 3 | Germany | 7 | 2.48 | 2.17 | 114 | 12900 | 14700 | 75 | 7 |
| 11 | Greece | | 90 | 139 | 65 | 6100 | 3900 | 35 | 18 |
| 10 | Ireland | | 0.71 | 0.75 | 96 | 7300 | 7000 | 42 | 17 |
| 8 | Italy | 15 | 1329 | 1491 | 89 | 9900 | 8800 | 58 | 15 |
| 1 | Luxembourg | 4 | 43.3 | 44.7 | 97 | 14300 | 13900 | 83 | 4 |
| 5 | Netherlands | 11 | 2.47 | 2.45 | 101 | 11800 | 11900 | 68 | 11 |
| 12 | Portugal | | 76 | 148 | 51 | 5500 | 2800 | 32 | 19 |
| 9 | Spain | | 102 | 140 | 73 | 8000 | 5900 | 47 | 16 |
| 6 | United Kingdom | 12 | 0.57 | 0.68 | 84 | 11400 | 9600 | 66 | 12 |

(*) Converted at PPPs
(**) Converted at exchange rates

Note: The figures of per capita GDP in 1986 are provisional estimates based on the estimated rates of inflation and growth between 1985 and 1986 given in Economic Outlook No. 40.

FROM: J M G TAYLOR
DATE: 7 September 1987

MR PICKFORD

cc PS/Financial Secretary
Mr Culpin
Miss O'Mara
Miss Barber
Mr D Savage
Mr Tyrie
Mr Norgrove (No.10) - Personal

**HAS THE UK OVERTAKEN FRANCE?**

The Chancellor was grateful for your minute of 4 September.

2. He has asked to see the OECD press release for 1987 as soon as it comes out - presumably in February 1988. He has commented that, meanwhile, we can say we are well ahead of Italy and will soon have overtaken France.

J M G TAYLOR

RJ8.23

UNCLASSIFIED

FROM: J M G TAYLOR
DATE: 11 September 1987

MR G P SMITH

cc Mr Scholar
PS/IR

OECD ANNUAL TAX SURVEY

The Chancellor has seen the enclosed press cutting. He would like a note picking out the salient points in this survey. I should be grateful if you could provide this.

JT

J M G TAYLOR

THE GUARDIAN

# Taxes 'up by 5.2 pc' since Thatcher

By Christopher Huhne, Economics Editor

Britain has had one of the highest increases in taxes of all the developed economies since Mrs Thatcher — committed to reducing them — came to power in 1979, international figures showed yesterday.

The annual tax survey from the Inter-governmental Organisation for Economic Co-operation and Development in Paris shows that the share of Britain's national income taken in taxes rose from 32.9 per cent in 1979 to 38.1 per cent in 1985, a rise of 5.2 percentage points compared with an average rise of 3 percentage points.

The survey by the OECD, an organisation of the 23 leading industrial non-Communist countries, showed Britain's tax rise was the fifth-largest out of the 23 member countries. It was exceeded only by Spain, Portugal, Greece and Italy, all relatively low-income countries where public spending and taxation could be expected to rise more rapidly than national income.

The figures show Britain's taxes rose again in 1986 to reach 39.1 per cent of national income. Britain's 1979-86 tax rise is the third highest, but the comparison is incomplete because only 15 countries have so far reported.

Britain remains an averagely taxed country despite the rise under Mrs Thatcher, ranking 10th in 1985 after Sweden (50.5 per cent), Denmark (49.2 per cent), Norway (47.8 per cent), Belgium (46.9 per cent), France (45.6 per cent), Netherlands (45 per cent), Luxembourg (42.8 per cent), Austria (42.5 per cent) and Ireland (39.1 per cent). The OECD average share was 37.2 per cent.

In 1979 Britain ranked 11th in terms of the total tax burden, with a share 1.3 percentage points below the average, compared with 0.9 per cent above the average in 1985.

The rise in taxes since 1979 is due to government determination to cut public borrowing at a time when public expenditure on unemployment benefit and defence has risen enough to push up the overall total. Some of the tax increase is due to the doubling of VAT and the rise in national insurance contributions (offset by cuts in income tax). But a large part is also due to the North Sea tax take.

OECD officials said yesterday that the rise in the 1986 tax take was due to a 0.2 per cent of GDP rise in taxes from incomes and profits (largely due to corporate tax buoyancy), a 0.3 per cent rise in social security payments (due to high earnings growth and expanding employment) and a 0.4 per cent rise in property taxes (mainly rates).

The British tax system builds in a steady, automatic rise in taxes as a share of national income because the thresholds at which income tax rates become payable are raised only in line with prices each year.

*"Revenue Statistics of OECD member countries 1965-1986." OECD, Paris, 1987.*

THE GUARDIAN

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32

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RJ8.23

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bf with advice or 30/9

FROM: J M G TAYLOR

DATE: 11 September 1987

MR G P SMITH

Note passed on Ch comments to Mr S. (He will pass the action copy on to Miss Evans). JT 11/9

cc Mr Scholar
PS/IR

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