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PART A

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PART A

CHEVENING 1984 -AND FSBR/PSBR PAPERS

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PART A

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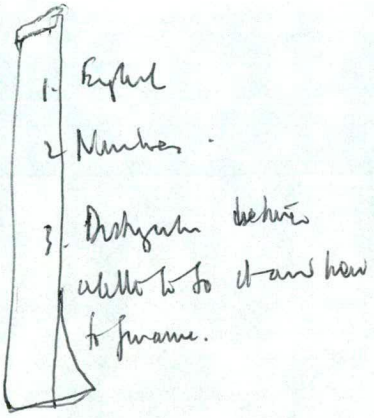


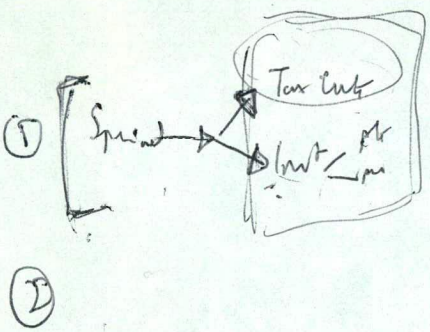
FROM: J ODLING-SMEE
DATE: 23 December 1983

MR MIDDLETON

cc Sir T Burns
Mr Bailey
Mr Byatt
Mr Scholar
Mr Riley
Mr Spackman

FINANCING PUBLIC EXPENDITURE : OUTLINE OF A PAPER FOR CHEVENING

Sir Terence Burns asked me to send you the attached outline.



J ODLING-SMEE

57/1/12

FINANCING DIFFERENT TYPES OF PUBLIC EXPENDITURE

Outline of a Discussion Paper

This paper is concerned with financing different types of public expenditure, particularly where the expenditure is lumpy and there is a continuing flow of benefits to be derived from that expenditure. In general this involves capital expenditure of one kind or another, and it includes the acquisition of assets previously owned by the private sector. Although the bulk of the analysis is in terms of asset acquisition it can be carried over to asset sales.

2. The analysis is in terms of a world of zero inflation. Therefore it provides the framework for deriving the appropriate borrowing profile in a world of stable prices. Allowing for inflation would mean taking into account the impact of the inflation tax and the effect of inflation on the real value of debt outstanding. These can be grafted on to the analysis.

3. The important operational questions are

- how to treat capital transactions in relation to the appropriate levels of borrowing;
- the extent to which asset sales and capital expenditure are conceptually equivalent, although of opposite sign;
- how to assess their movement in relation to the public expenditure planning and control procedures.

4. The paper will attempt to define the characteristics of three different kinds of expenditure and asset transactions.

(a) Income-earning capital expenditure. Examples: building a power station, developing an oil field, nationalising a profitable industry. The transaction involves:

(i) a once-and-for-all capital expenditure
(ii) an income stream from the asset
(iii) interest payments on the outstanding debt

If the project is profitable we would expect the flow of income (ii) net of depreciation to exceed the interest charges on the original expenditure. Cumulatively there is no need for any taxation; if the project is profitable there will be a dividend to distribute in the form of lower taxes.

(b) Expenditure that yields a future 'income' stream for the private sector. Examples: roads, education, defence hardware. This transaction involves:

(i) a once-and-for-all capital expenditure
(ii) an "income" that takes the form of future benefits to the private sector that are usually partly or wholly non-pecuniary
(iii) interest payments on the outstanding debt

If the project is profitable we would expect the flow of benefits, net of depreciation, to exceed the interest charges on the original expenditure. It will be necessary to raise taxes to provide an income to the government which when added to any higher tax receipts stemming from the higher private income, is equal to the interest charges. If the investment project is profitable this should leave the private sector with higher post-tax income or benefits than would have been the case without the investment and higher taxation. However at constant level of higher tax rates there is likely to be a borrowing requirement in the initial period and a surplus in later periods as the borrowing is repaid.

(c) Expenditure that yields no future benefits. Examples are money transfer payments and wasteful capital expenditure: this needs to be financed from taxation and there is no problem of an imbalance of expenditure and tax revenue through time.

5. The question is the extent to which it is legitimate to borrow in cases (a) and (b) above. (Borrowing to finance wasteful capital expenditure is not legitimate because it would impose an unjustified burden on future taxpayers - as measured by the excess of debt interest payments (iii) over income (ii). Hence the classification under case (c).) The argument for borrowing is that it is disruptive and inefficient to raise taxes and lower them in line with the variations in expenditure and income when they are so uneven. Financial markets will be willing to lend if they can be assured that the income will emerge to finance the loan, either from higher trading receipts or from taxation. As we have described, this should be possible if the project yields either income or benefits to the private sector for which it is generally acceptable that they should pay taxes.

6. One objection to such borrowing is that it will crowd out private sector investment. But if the rate of return on the public sector project is higher than on private sector projects this should not matter. But there needs to be good reason why the public sector rather than the private sector should be carrying out the project, otherwise the presumption must be that it would be more effectively done by the private sector.

7. This points to the case for public borrowing to finance asset accumulation and a debt repayment to offset asset sales. But for this purpose asset and capital transactions must be seen on a net basis, ie after allowance for depreciation (and implicitly the repayment of principal). This implies

(a) that with a one-shot expenditure there will be borrowing in the first year and repayment in subsequent years;

(b) that a steady level of capital expenditure for many years in practice means little in the way of borrowing as aggregate depreciation will tend towards the level of gross expenditure;

(c) when capital expenditure is growing over time, new expenditure will exceed depreciation (net capital expenditure is positive) and continuous aggregate borrowing is legitimate.

Although the main focus of interest here is capital expenditure, the distinction between expenditure that justifies borrowing and other expenditure does not correspond to the capital/current split. Some current expenditure (eg education) yields future benefits, and some wasteful capital expenditure does not.

8. Asset sales fall into this framework in reverse. Relative to the position when the assets are owned by the public sector the borrowing requirement in the initial year of sale should be reduced. In subsequent years it can be increased to some extent as there is no longer any need to repay debt in line with the depreciation of the asset once it is transferred to the private sector. The cumulative amount of the increased PSBR in these later years will approximate to the sale price of the asset. Effectively the receipts from the sale are spread over what would have been the lifetime of the asset.

9. Efficiency aspects of asset sales: in many cases assets will be more efficient when operated by the private sector. Since the purchase price will (ignoring capital market imperfections) tend to reflect expected profitability in the private sector, the Government will gain financially from the sale. Savings on debt interest payments ((iii) in para 4) will exceed income forgone (ii). Since the PSBR should change (be lower in the year of the sale, higher afterwards this means that taxes can be lower (or other expenditure higher) in the years following the sale than if there had been no difference in efficiency between the public and private sectors.

10. Some complications that affect the measurement of the stream of income obtained from an asset, although not the general principles:

(a) some income from assets (eg land) comes in the form of capital gains rather than interest or dividends;

(b) council house rents net of maintenance expenditure are only tenuously related to the cost of borrowing and the price at which the houses are sold.

11. Discussion of the similarities and differences between new capital expenditure and purchases and sales of existing assets. Similarities stem from fact that both existing and new assets provide a future income stream, and so initial PSBR can be higher when expenditure incurred or asset purchased and lower afterwards during repayment period. Differences associated with financial consequences: new expenditure adds to demand and puts upward pressure on interest rates for given monetary growth or debt-income ratio; an asset purchase does not (or does only to a much lesser extent).

12. Some operational implications:

- there is a case for taking account of shifts in the net asset position of the public sector in decisions about borrowing and expenditure.

- this applies to both asset sales (purchases) and investment: but the different financial implications of the two also have to be taken into account.

- measures of the net asset position of the public sector are needed: in principle these should include all expenditures that yield future benefits, even those that are "current" (eg education).

13. Questions for discussion:

- arguments for and against the special recognition of net capital expenditure in PSBR decisions

- arguments for and against any special treatment in public expenditure planning and control

- similarities and differences between capital expenditure and asset sales

- practical implications.

A53

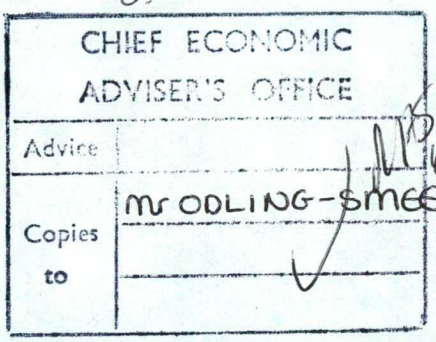
CONFIDENTIAL

From: J WILLIAMS
Date: 3 January 1984

NOTE FOR THE RECORD

c. Mr Odling Smee

cc Sir T Burns
Mr Bailey
Mr Cassell
Mr Battishill
Mr Norgrove



CHEVENING

This note is to record the decisions taken at the meeting to consider the preparation of the papers for Chevening chaired by Sir Peter Middleton this morning. Sir T Burns, Mr Bailey, Mr Cassell and Mr Battishill were present.

2. Sir Peter Middleton said the aim should be to have the five papers for Chevening submitted to him by this weekend and to Ministers by next Tuesday/Wednesday. On the individual papers:

(i) Financing public expenditure - it was agreed that Mr Bailey jointly with Sir Terence Burns would add to the paper sections on the implications of the arguments in Mr Odling-Smee's draft outline for the classification of public expenditure and for policy more generally and what should be said publicly.

(ii) Private sector debt/income ratio - Mr Cassell said he was working on a first draft of the paper which should be ready by the end of this week.

(iii) Tax structure - it was agreed that this paper should aim to be set out where matters stood on the range of tax reforms under consideration, with costings

35(1)

where possible.

(iv) Treatment of the PSBR in the FSBR - Mr Battishill said he was working up a paper which would also be ready by the end of the week.

(v) Macro-economic paper - Sir Terence Burns said he was working on a first draft of the paper.

3. It was also agreed that PCC on Tuesday 10 January should consider the macro-economic policy paper (v) and the Central Unit paper on the treatment of the PSBR (iv).

JW.

J WILLIAMS

SECRET

A53

FROM: J O KERR
DATE: 5 January 1984

cc Sir T Burns
Mr Bailey
Mr Scholar

Talk to PEM

SIR P MIDDLETON

CHEVENING

I have told the Chancellor about the papers which you envisage putting to Chevening participants next Tuesday. He is content. He has however not yet totally excluded the idea of some discussion on LTPE at Chevening, and he may raise this at his meeting with you and the Chief Secretary (and the copy addressees of this minute) on LTPE on Tuesday. I gather that some new material by Mr Bailey and Mr Scholar, and by Sir T Burns, is in preparation, and may be ready for submission to the Chancellor before Tuesday's meeting: that would clearly be very helpful. I myself am however doubtful about the desirability - primarily on security grounds - of circulating such material to all Chevening participants, and it might perhaps be best if any Chevening LTPE discussion were un-scripted. But that too can be discussed on Tuesday.

J O KERR

A563

FROM: I C R BYATT
DATE: 6 JANUARY 1984

SIR T BURNS

c Sir P Middleton
Mr Bailey
Miss M P Brown
Mr Odling-Smee
Mr Scholar
Mr Houston
Dr Rickard
Mr Spackman

FINANCING PUBLIC EXPENDITURE: CHEVENING PAPER

> "In many cases assets will be more efficient when operated by the private sector. Since the purchase price will (ignoring capital market imperfections) tend to reflect expected profitability in the private sector, the Government will gain financially from the sale. Savings on debt interest payments will exceed income forgone."
>
> (paragraph 10 of Mr Bailey's draft)

I am worried that this could be misleading, even if we are covered by the caveat concerning "capital market imperfections".

2. Ideally we should have properly worked examples of the consequences of privatisation for the public finances, allowing for a whole range of factors, including the changed financing of future capital investment. I am organising these, beginning with BT, but they will take a little time to do. Meanwhile I want to concentrate on one aspect of the issue relevant to the above quotation which seems to me to be an important one.

3. In practice, privatisation proceeds are falling well short of the CCA value of the underlying assets and are likely to do so in the future. In the case of BT the sale price may be no more than 50% of CCA asset values. Two explanations, apart from state inefficiency, are possible:-

(a) the Gleneagles Hotel* situation (also Britoil) where an asset is sold at a time dictated by political circumstances rather than by when the sale price will be maximised, and

/(b) the

---

* BR sold the Gleneagles Hotel for £10 million; £20 million is now bid for it.

(b) the fact that the discount rates implicit in the price/earnings ratios on which stock market valuations are often based are higher than those in the gilts market. P/E ratios are calculated after tax; the current figure of around 12 implies a very high discount rate.

4. If, for either reason, or a combination of both, sale proceeds are well below the asset values on which the public sector achieves a given rate of return, then there could be a loss to the public sector finances, even though the private sector uses the assets more efficiently.

5. Let me illustrate with examples which are highly simplified, but I hope not over-simplified. I assume assets are indestructable and yield a constant real return. I ignore future investment which in practice would reduce the tax yield.

6. Assume:-

(i) a capital asset with a book value of £100 on which the public sector is earning 5% (£5 a year) pretax. Assume further that the private sector could raise the return to £6. On this it would pay corporation tax of £3. On the basis of a P/E ratio of 12 it would pay £36 for the asset. The Government therefore avoids gilt sales of £36. If the return on gilts is 3%, the saving will be £1.1. Overall, however, the Government loses £(5-3-1.1) = £0.9 a year;

(ii) an asset with a book calue of £100, on which the public sector is earning 1% (£1 a year). Assume that by increased efficiency (not, because there may be regulation, higher prices) the private sector doubles the return to £2. At a P/E ratio of 12 it would only pay £12 for the asset. The Government would therefore gain £(-1+1+0.4) = £0.4.

The results depend critically on the assumptions, but they show that the public sector will not always gain, and its gain could be quite small even for a large increase in efficiency.

/7. In these

7. In these two examples the public sector gain or loss is a function of:-

(a) the difference between bond and equity rates;

(b) the tax regime;

(c) the difference between required rates of return on <u>assets</u> (not investment) in the public and private sector. Although we set the RRR in line with what the private sector earns, we do not wholeheartedly pursue the policies which would flow from this. Privatisation will not necessarily mean deregulation and so prices may continue to be constrained;

(d) the difference between the efficiency of physical asset use in the public and private sectors.

Additionally, selling an asset at a time when it is liable to fetch a low price will further reduce any public finance gain or increase any loss.

8. At this stage, in advance of more sophisticated calculations, I suggest a small redraft to the second and third sentences of paragraph 10 in Mr Bailey's draft to read:-

"But whether the Government will gain financially from the sale, in the sense that savings on debt interest payments will exceed income forgone, will also depend on the tax regime and on the price at which the assets are sold to the private sector."

IB

CONFIDENTIAL

FROM: T BURNS
DATE: 11 JANUARY 1984

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr Bailey
Mr Littler
Mr Cassell
Mr Ridley
Mr Battishill
Mr Kerr
Mr Lord
Mr Portillo
Sir Lawrence Airey - IR
Mr A Fraser - C&E

CHEVENING

I attach a paper on the Policy Background to the MTFS.

T BURNS

THE POLICY BACKGROUND TO THE MTFS

THE FIRST FOUR YEARS

1. The Medium Term Financial Strategy has now been in place for four years. It was introduced in 1980 at a time of high and increasing inflation, following large increases in world oil and other commodity prices and the breakdown of the previous administration's incomes policy. It set out targets for monetary growth and an illustrative path for the PSBR, with the aim of bringing inflation down progressively. Essentially the strategy has been successful, though the outturn has differed in a number of details from expectations at the time.

Economic Performance*

2. Recent behaviour of money GDP, output, and inflation is set out in the table below:

% growth	1973-79 average	1979-80	1980-81	1981-82	1982-83	1983-84 E
Money GDP	16.8	19.9	13.7	9.7	9.2	8
Output	1.7	2.6	-4.1	-0.1	2.3	3
Inflation						
- GDP deflator	14.8	16.8	18.6	10.0	6.7	5
- RPI	15.0	15.8	16.3	11.5	7.1	4½

E = latest estimate

After growing by nearly 20% in 1979-80, money GDP decelerated to 9-10% by 1981-82 and has since remained broadly stable. The deceleration was rather sharper than assumed in the 1980 MTFS, which did not envisage nominal GDP growth under 10% until 1982-83, and then only for one year.

3. Inflation has also come down more sharply than anticipated in 1980, and has consistently been lower than forecast. The precise figures depend on the measure of prices used; but using the GDP deflator, inflation fell from nearly 19% in 1980-81 to 10% in the next year and an estimated 5% this year.

* Detailed comparison of present estimates of output and inflation with figures in successive versions of the MTFS is given in an Annex.

4. The pattern of output has been broadly as anticipated in 1980, with falls in the first two years followed by increases in the next two. But the amplitude of the swings has been slightly greater than anticipated. The 4% fall in 1980-81 was greater than forecast, though from a higher level in 1979-80, and the recovery slightly faster, particularly in 1982-83. In the first year of the MTFS, both output and inflation turned out lower than expected; but in subsequent years lower money GDP growth has gone with a more favourable split between output and prices.

5. There have been marked fluctuations in income shares over the last four years. The share of non-oil company profits, which started 1980 just below 10% - well below the levels ruling in the 1960s and early 1970s - fell sharply to reach about 6½% in the first half of 1981. Since then, however, there has been a recovery back to the level of early 1980. Meanwhile the share of wages and salaries has fallen by 3 points since 1980 to around 56%. This pattern was not anticipated in 1980: a fall in the wage share was foreseen; but the extent of the fall in profits, reflecting in part the unexpectedly high interest rates and real exchange rate, and the subsequent recovery was not.

6. The incidence of policy, with particularly strong pressures on the company sector in the first two years, led to a sharp shake-out of labour. Productivity in manufacturing - though not elsewhere in the economy - has risen much more than expected; and this has evidently proved an easier way for manufacturing firms to relieve the pressure on them than cutting real wages. As a result employment has fallen, and unemployment risen, much more sharply than envisaged when the strategy was set out in 1980, even though the level of output is much as was envisaged.

The overall stance of policy

7. The four year programme in the 1980 MTFS showed declining growth in £M3 and an accompanying profile for the PSBR which was intended, given the other economic assumptions being made at the time, to give an acceptable path for real interest rates. In the event, both monetary growth and the PSBR have declined substantially since 1980 although the precise targets have been revised

in subsequent versions of the MTFS and the scope of the monetary target has been widened to include PSL2 and M1 as well as £M3.

Monetary Growth

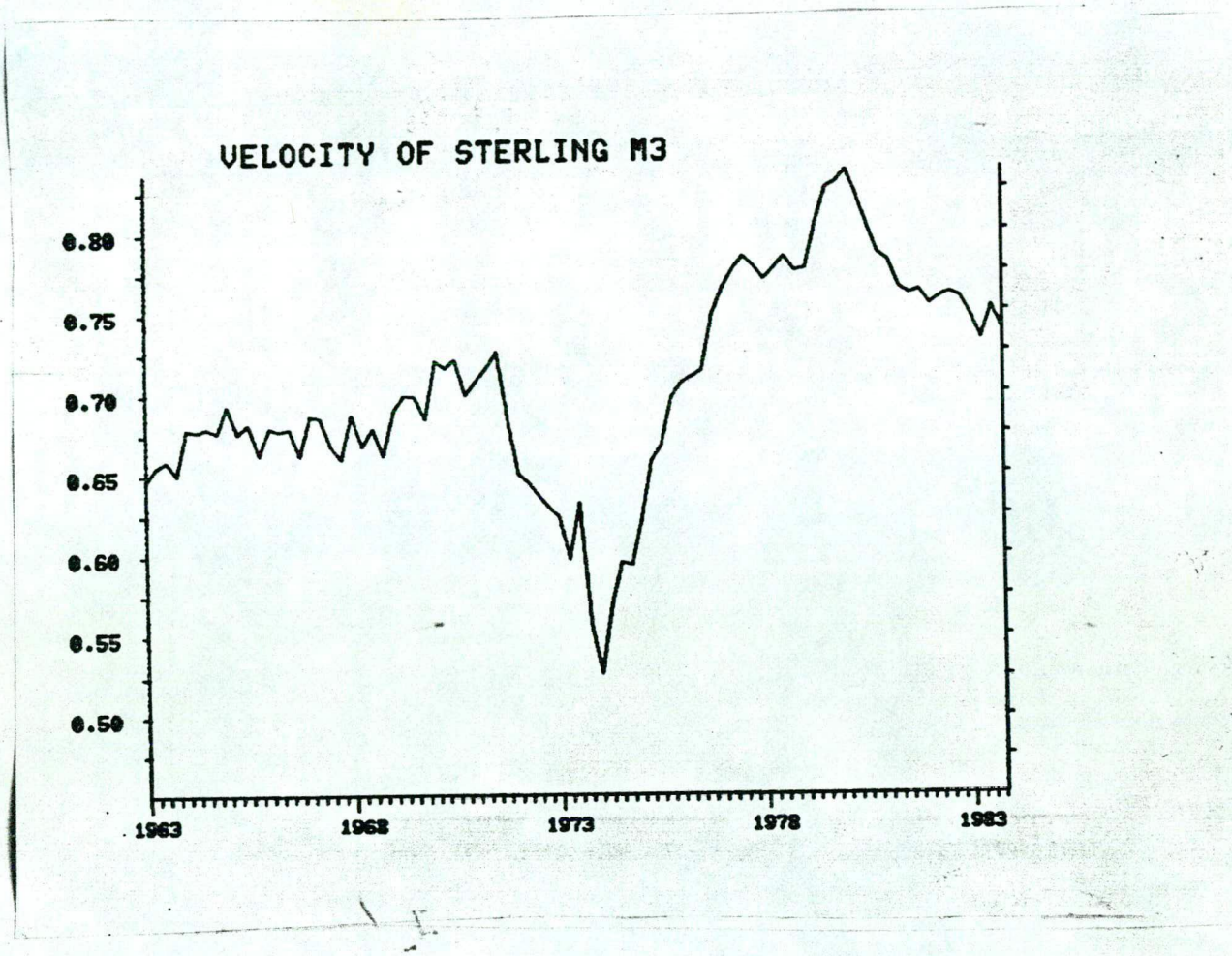
% changes*	1973-79 average	1979-80	1980-81	1981-82	1982-83	1983-84^{E}
Money GDP	16.8	19.9	13.7	9.7	9.2	8
MO	12.8	7.6	8.3	2.5	5.3	7
M1	13.3	3.3	12.4	3.9	14.9	13
£M3	12.1	11.5	21.2	12.0	11.5	11
PSL2	12.3	11.5	15.3	10.8	11.4	13

E = latest estimate for target period

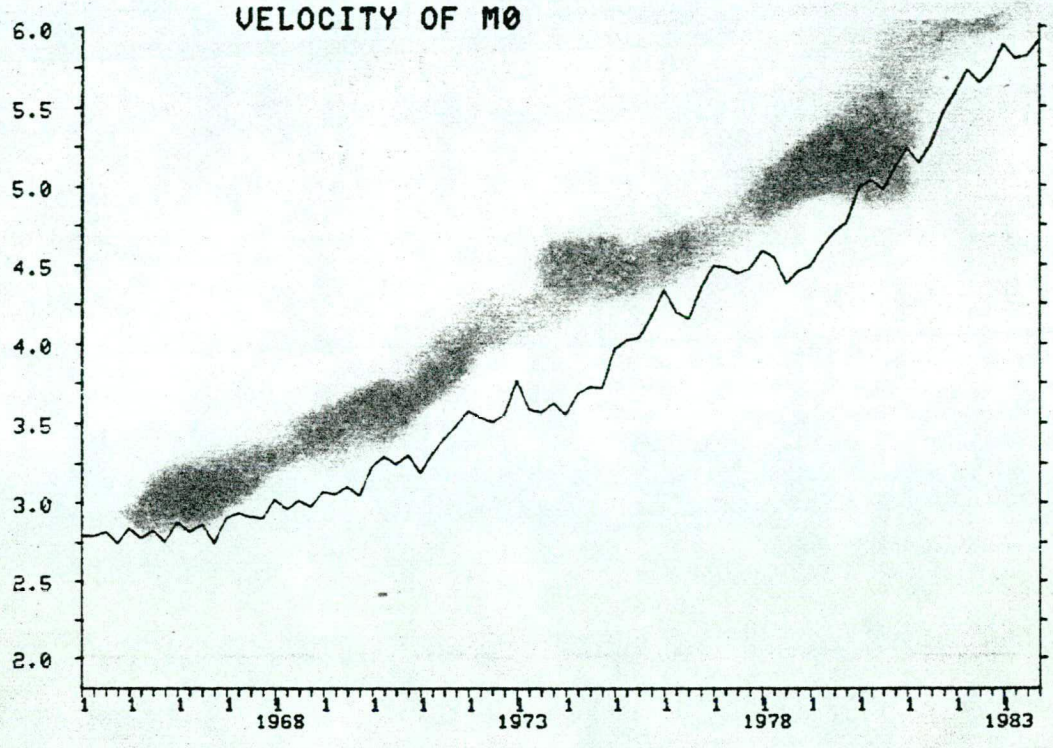
* Apart from money GDP, the growth rates quoted are % changes through the financial year (ie mid-April to mid-April).

8. In spite of unexpectedly rapid deceleration of prices and money GDP, the growth of broad money has exceeded our forecasts throughout the period. £M3 growth was well above the target ranges in 1980-81 and 1981-82, though subsequently it has been just within the higher ranges set in the 1982 MTFS. Throughout the period, broad money growth has exceeded the growth of money GDP, in contrast to the experience of the 1970's on which monetary ranges in the 1980 MTFS were largely based.

9. There have been a number of reasons for this. Financial deregulation, and particularly the ending of the corset in 1980, has led to greater intermediation by the banking system and an increase in the provision of credit to the private sector. The private sector increased its net saving substantially in 1980-81 to compensate for the effects of increased inflation on the real value of its wealth, and kept much of the increase in liquid form. High real interest rates since then may have encouraged a higher wealth/income ratio. Rapid broad money growth relative to money GDP has coexisted with tight financial conditions and better than expected progress on inflation.



10. Narrow money has behaved rather differently. The growth of M0 has been consistently some way below the growth of money GDP, as suggested by previous trends, and fell progressively from 1979-80 to 1981-82 under the influence of financial innovation and high nominal interest rates. Since then, nominal interest rates have come down and the growth of M0 has picked up somewhat, though remaining below money GDP growth. The path of M2 has been similar. The behaviour of M1 has been significantly more bumpy, reflecting its greater interest sensitivity. But taken together, the narrow aggregates have given a better indication of the tightness of policy than the broad aggregates.



11. The real money supply fell sharply in 1979-80 on all definitions as the inflation rate increased. For narrow money the fall continued almost unabated for another two years before turning up in the last two years. Real broad money has risen continuously since 1980-81.

Real Monetary Growth

% changes	1973-79 average	1979-80	1980-81	1981-82	1982-83	1983-84^{E}
M0	0.4	- 11.6	- 3.3	- 6.3	1.3	1.6
M1	0.8	- 5.2	0.3	- 5.0	10.5	6.4
£M3	- 0.3	- 8.4	10.8	2.4	7.2	4.0
PSL1	- 0.1	- 8.4	2.9	1.3	7.1	2.9

E = Estimate

12. In terms of the PSBR, attempts to tighten fiscal policy in the first two years of the last parliament were not successful. The PSBR in 1980-81 turned out significantly higher than the figure in the 1980 MTFS, due to a considerable extent to the effects of recession. But 1981-82 marked a step change by comparison with the previous two years. The PSBR as a share of GDP was reduced from 5¼% in 1979-81 to under 3½% in the next three years. This contrasts with a progressive tightening of fiscal policy which the government was aiming for, and reflects an unexpectedly low PSBR in 1981-82 and an unexpectedly high figure in prospect for this year.

13. Some commentators have argued that fiscal policy has become less tight in the last two years, and there is probably some truth in this. The proponents of this view point to an increasing contribution of asset sales, among other things, arguing that these are rather different from other constituents of the PSBR. The table below gives figures for the PSBR adjusted for asset sales, and for the public sector and general government financial deficits (PSFD and GGFD).

The Stance of Fiscal Policy

£ billion (share of GDP)	Average 1979-81	1981-82	1982-83	1983-84^{E}
PSBR	11.6 (5.2)	8.8 (3.4)	9.2 (3.3)	10.0 (3.3)
PSBR plus asset sales	12.4 (5.6)	9.4 (3.6)	10.7 (3.8)	12.3 (4.1)
PSFD	9.8 (4.4)	6.1 (2.4)	8.8 (3.1)	10.0 (3.3)
GGFD	7.4 (3.3)	4.8 (1.9)	7.2 (2.6)	9.5 (3.1)

E = latest estimate

14. The broad picture from these various indicators is that fiscal policy was probably tighter in 1981-82 than in the last two years; and there has been little change in the last year. But they confirm that fiscal policy is now tighter than in 1979-81, though probably less so than the reported PSBR figures suggest.

The figures for the GGFD show a smaller fall since 1979-81 and a stronger rise in the last two years than the other indicators. But despite the attention they have recently received, figures for the GGFD are not appropriate as a measure of fiscal stance. By omitting movements in the borrowing requirement for Nationalised Industries they exclude a significant change in fiscal policy as Nationalised Industry prices were raised to economic levels following a period of subsidisation.

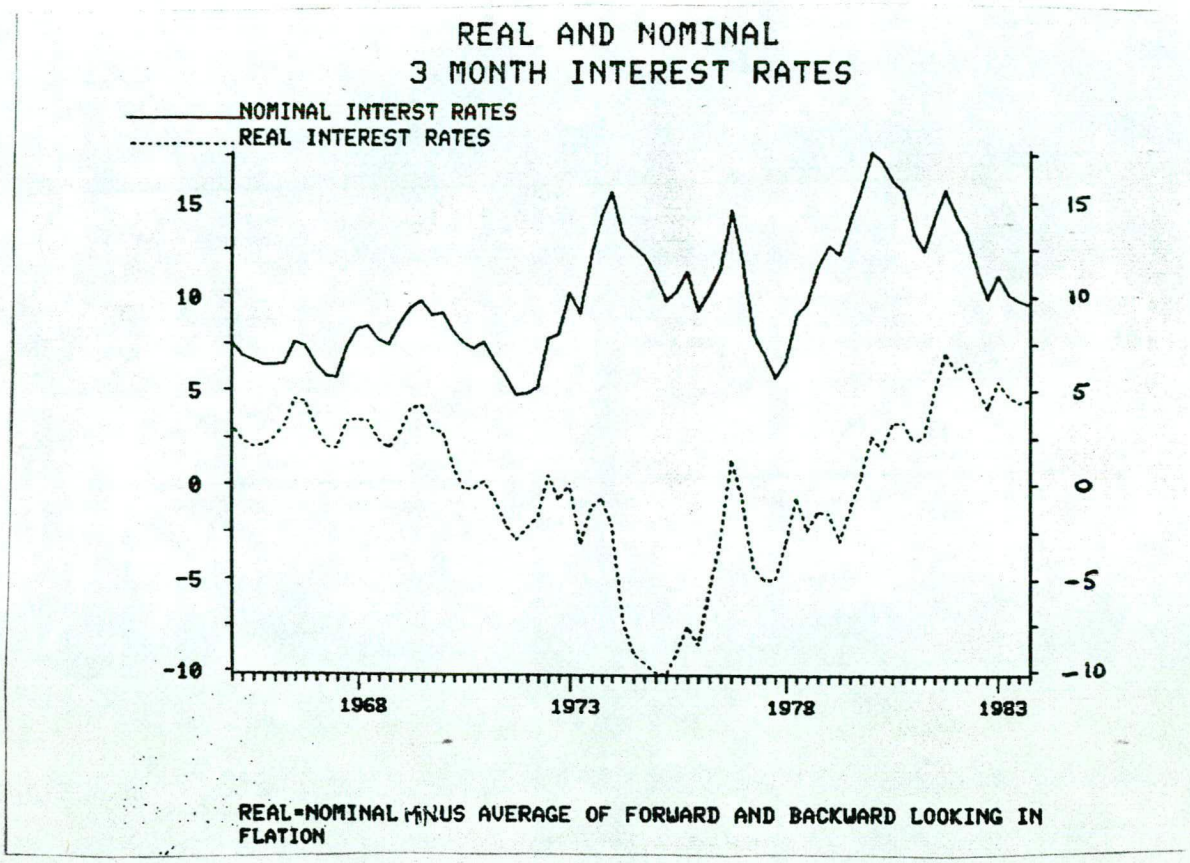
15. Fiscal conditions have undoubtedly become easier in the last two years. This partly reflects a higher nominal fiscal deficit, but mainly the effect of lower inflation. Various indicators of the real fiscal balance are shown below. They all show a significant turnround since 1981-82, which has contributed to the recovery in output.

Fiscal conditions

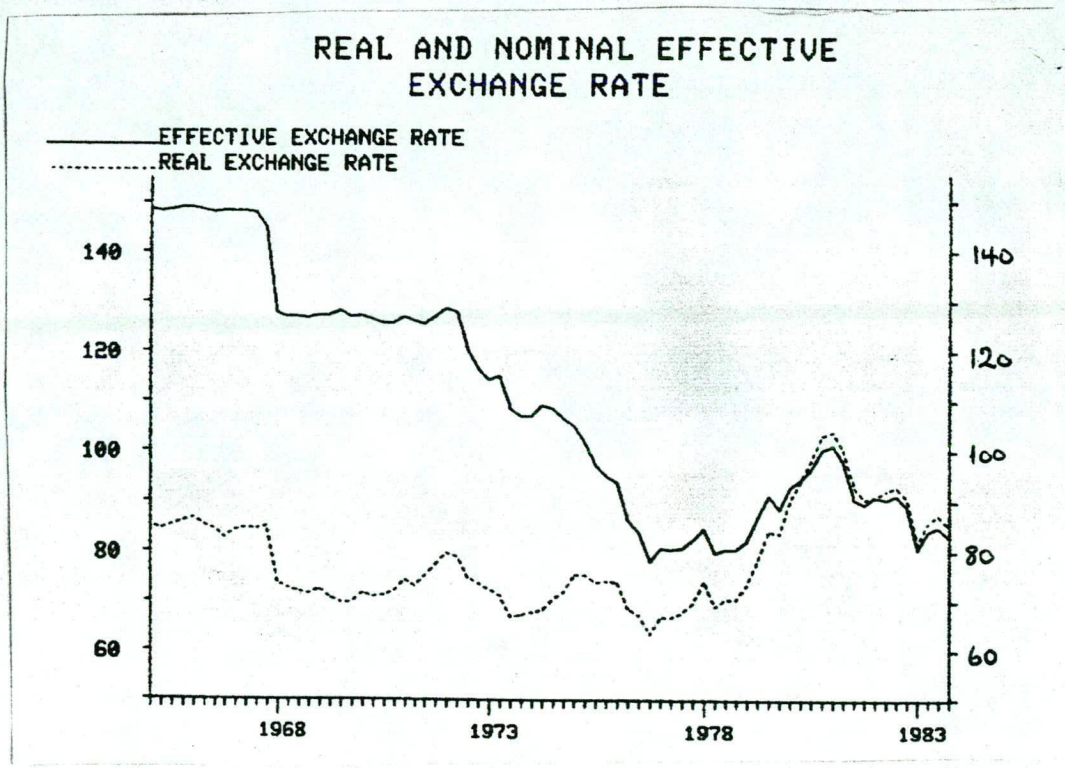
% of GDP	Average 1979-81	1981-82	1982-83	1983-84^{E}
Real PSBR	- 0.4	- 0.5	+ 1.1	+ 1.6
Real PSBR plus asset sales	-	- 0.3	+ 1.6	+ 2.3
Real PSFD	- 1.1	- 1.5	+ 1.0	+ 1.5
Contribution of inflation	- 5.6	- 3.9	- 2.2	- 1.8

E = latest estimate

16. After being raised to 17% in late 1979, and remaining high in 1980, nominal interest rates have been brought down significantly as inflation has fallen, with a temporary interruption in late 1981 reflecting weakness in the exchange market. However real interest rates remain high in both the UK and in other countries. They are as high, or higher, now in the UK as they were in 1980, and on this basis monetary conditions clearly remain tight.



17. The real exchange rate is now some way below its peak in the early months of 1981. Mainly this is due to a lower nominal exchange rate. The factors which drove it up from 1979 - including high nominal interest rates and high oil prices - have been at least partially reversed, but it remains well above the average level of the late 1970s. Pressure on the traded goods sector of the economy remains, though less so than in the first year or so of the MTFS.



Public Expenditure and Taxation

18. An aim of policy at the outset of the MTFS in 1980 was progressively to reduce public expenditure as a share of GDP. In the event this has not been achieved. The share of General Government expenditure has tended to increase, and only this year does it seem likely that there will have been some fall. It has grown faster than forecast over the first two years of each MTFS projection published so far, but the out-turn has been particularly different from the forecast made in the first MTFS in 1980.

Government Expenditure and Receipts*

% of GDP	1979-80	1980-81	1981-82	1982-83	1983-84^{E}
General Government Expenditure**					
1980 MTFS	44.9	45.6	44.5	42.9	41.5
Out-turn	43.5	46.1	46.5	47.3	45.7
General Government Receipts***					
1980 MTFS	39.6	41.3	41.4	42.0	41.5
Out-turn	38.4	40.2	43.1	43.6	42.1

* National Accounts basis

** Including gross interest payments

*** Including gross interest receipts, before fiscal adjustment

E = latest estimate

19. Three major factors have contributed to this. First, social security expenditure has grown more rapidly than expected, partly because of the failure to predict the extent of the rise in unemployment. Second, debt interest payments have been much higher than anticipated, both because of higher interest rates, especially in 1980-82, and also higher borrowing in some years. And local authorities have also consistently spent more than expected. But even this performance on expenditure has been difficult in the face of progressively higher bids from spending departments.

20. In the face of this out-turn for expenditure, taxes were raised sharply in 1981 budget. In spite of net tax reductions in the 1983 budget, general government receipts as a % of GDP are still expected to be higher in 1983-84 than in 1980-81 - and much higher than the figures in the 1980 MTFS, particularly if allowance is made for the fiscal adjustment of around 2% of GDP which was expected at the time. However, to a large extent this reflects higher receipts from the North Sea, which are expected in 1983-84 to be nearly four times the 1979-80 level.

THE PERIOD TO BE COVERED BY THE MTFS

21. The first MTFS in 1980 covered four financial years (1980-81 to 1983-84). The next three covered only three financial years. If the practice of rolling forward by one year only were continued, the 1984 MTFS would cover 1984-85 to 1986-87. However it is worth considering whether to extend this period to four or even five years.

22. The main argument for extending it is that it is appropriate at the beginning of a new Parliament for the Government to indicate its intentions over the whole life of the Parliament. The final year of a five-year period would be 1988-89, the Budget for which could in principle take place under the present Government if it ran its full five years.

23. The MTFS sets out the Government's broad objectives and plans for policy over the medium term. This acts as a constraint on policy in future and thereby contributes to the consistency and stability of policy over time. It also signals to the private sector what the policy framework will be, and hence encourages more efficient decisions. The longer the period of the MTFS the greater are the benefits of this kind that result.

24. There are some potential problems with a 5 year MTFS. Previous MTFSs have set out the assumptions about inflation and money GDP growth rates over the medium term which formed the basis for the financial framework. It would be difficult not to continue to do this. If a five-year period were adopted the assumptions about the end of the period would be interpreted as evidence of the Government's views about longer-term growth and inflation possibilities. It would be necessary to follow a careful line between appearing to be too optimistic and appearing over-pessimistic, while all the time emphasising the uncertainties. Similar difficulties arise with the output growth and inflation assumptions underlying any long-term public expenditure exercise, with which the MTFS would, of course, have to be consistent. The problems of this sort would be less if the MTFS covered a shorter period.

25. Another argument against extending the MTFS is that the figures for the later years carry little credibility because of the likelihood of unexpected developments. The MTFS may not therefore have a significant impact on expectations or behaviour. One aspect of the unreliability of figures for later years is that the Public Expenditure Survey only goes up to 1986-87.

26. The unreliability aspect should not, however, be given too much weight. In the case of public expenditure, the broad intention of holding the total constant in cost terms has already been mentioned in public. Any Green Paper or other document on long-term expenditure would provide the basis on which to prepare projections up to 1988-89. More generally, the later years of the MTFS will not be regarded as unconditioned projections of what fiscal and monetary policies will be - come what may. The discussion of the MTFS in the FSBR has always made clear that policies may have to change if domestic and world developments differ from those foreseen. The purpose of the numbers in the MTFS is to fill out the description in the text of the Government's broad strategy, on one particular set of assumptions about future developments. We have seen in recent years that revisions to monetary targets and PSBR paths have not affected credibility adversely when we have explained the reasons for them.

27. If the MTFS this year was to cover five years, the question arises whether the period should be rolled forward by one year in 1985 and subsequent years or whether one or two years might be dropped off the end. There is a precedent for dropping a year: the 1981 MTFS covered the three years to 1983-84 following a four-year period, also to 1983-84, in the 1980 MTFS. The argument for shortening the period would be that there was no need to go beyond the end of the Parliament. But there is a contrary argument, namly that it is helpful to show how the policy framework will evolve over the medium term, even if that goes into the next Parliament. Even with a shorter period this argument becomes relevant as the Parliament advances through its term. Whatever course might be chosen in 1985 and subsequent years, no problems are likely to be presented that should be taken into account in deciding on the period for the 1984 MTFS.

28. On balance, I favour extending the MTFS to cover five years (1984-85 to 1988-89) even if it is thought that the MTFS in subsequent years should cover only four years. I do not judge the disadvantages of presenting figures for later years that are admittedly subject to considerable revision to be serious beside the advantage of being able to chart a consistent strategy over the whole lifetime of this Parliament.

MEDIUM-TERM OUTLOOK

29. Policy for the medium term has to be set against a background of likely developments in the absence of significant policy changes. This section discusses the outlook in general terms, the next section discusses objectives, and then the remaining sections discuss the financial framework consistent with the achievement of these obectives.

30. Taking inflation first, the central question is whether it will continue to fall over the medium term. Those who argue that it will do so place considerable weight on the depressive effects of the relatively low level of economic activity and low inflationary expectations. Unemployment is expected to remain above the natural rate for some years, and capacity utilisation to be considerably short of full capacity. A further, perhaps substantial, reduction in earnings growth may occur. The low capacity utilisation may limit the extent to which companies are able to raise profit margins, and it may stimulate them to make further improvements in productivity.

31. On the other hand, others place more emphasis on the effects of changes in the level of economic activity. They draw attention to the pressure that rising activity tends to place on costs and prices: commodity prices and wages would tend to rise more rapidly, the exchange rate might come under pressure, and companies would take the opportunity of the growing demand to restore some of the reduction in their profit margins that they have suffered in recent years.

32. Another way of posing the question about whether inflation will come down further is to ask whether the labour market will continue to adjust. Labour market adjustment can be thought of as a situation in which real wages grow significantly less rapidly than productivity. In this situation, profit margins will increase, as they have been doing over the last couple of years, without necessarily preventing a continued downward movement in inflation.

33. The argument that the low level of activity will contribute to a further downward movement in inflation relies to a considerable extent on the expectation that there will be continued adjustment in the labour market. This could be reflected either in lower growth in real wages without much change in productivity growth, or in a continuation of the relatively rapid productivity growth of the last 2-3 years without much slowdown in real wage growth (or a combination of the two). Those who emphasise the inflationary impact of the rise in level of activity tend not to expect much adjustment in the labour market.

34. The extent of labour market adjustment is also critically important to an assessment of likely developments in output and unemployment. So also is the type of adjustment, namely whether it takes the form of slower growth in real wages or faster growth in productivity. Both types improve profitability and hence contribute to faster output growth. Real wage adjustment is likely to lead to a faster fall in unemployment than productivity adjustment. Indeed the latter may well involve some temporary rise in unemployment if the productivity gains were especially sharp. However, productivity adjustment would produce more rapid output growth than real wage adjustment, because it represents a larger rise in the rate of growth of productive potential. The real incomes of those in work would also grow faster.

35. Thus an assessment of the extent and nature of future labour market adjustment is central to the view that one takes of medium and longer-term developments. The evidence from the past provides some pointers:

- there has been considerable adjustment during the last two or three years, especially in manufacturing: profitability has risen sharply, albeit from a low level;

- this has occurred almost entirely on the productivity side: on average we have not seen markedly slower growth in real wages than had been achieved in the past;

- in general, companies have reacted to the financial pressure on them by improving productivity rather than by striking tougher bargains over real wages, by contrast with what has been occurring in the US; and on the union side there has apparently been a willingness to see jobs lost as long as the real wages of those in work were maintained.

36. Looking to the future, this sort of pattern may well continue. The low levels of productivity in the UK, especially in manufacturing, compared with those in other European countries, show that there is still plenty of scope for productivity adjustment, even without any new investment. Furthermore, the historical relationship between

productivity growth and investment suggests that only a small rise in the share of investment in GDP over the next few years would be necessary to sustain faster productivity growth of, say, an extra 1 percentage point a year, assuming that the new investment is at least as productive as it was in peace-time periods up to the late 1960s.

37. Thus some labour market adjustment on the productivity side can probably be expected. There may also be some on the wage side. It is difficult to see the present higher unemployment and changes in labour market institutions not leading to some increase in flexibility , including a greater responsiveness of real wages. But the effect may not be dramatic and it may be most significant in non-manufacturing. The emphasis in manufacturing is more likely to be on high than on low wages and productivity.

38. There may therefore be some tendency for productivity growth to fall over the course of the next five years, with diminishing scope for further catching up on our competitors and with the growth of some relatively low productivity employment. In considering the growth of productive potential it is also necessary to take North Sea oil and labour supply into account. Production in the North Sea may begin to decline later in the MTFS period, tending to pull down the growth of output per head in the economy as a whole. There may also be some decline in the growth of labour supply. Since all three components of potentive potential may tend to decelerate, it is likely that potential growth at the end of the period will be considerably less than it is now, at perhaps about 1½% a year.

39. Some tentative conclusions can be drawn about the medium-term outlook, assuming a broadly unchanged stance of policy. Some relatively slight decline in inflation from the present 5% may occur. There should also be some fall in unemployment, again possibly not very large. Output growth should remain better than in the 1970s but not necessarily as high as in the most recent period.

MEDIUM-TERM OBJECTIVES

40. The medium-term objective of fiscal and monetary policy, as set out in the Mansion House Speech, is to continue to reduce inflation gradually with the ultimate aim of price stability. Of course the policies that may be required to achieve price stability and the associated movements in output and employment are inherently uncertain as they depend on the performance of the economy and how much adjustment takes place in the labour market. Generally speaking, the more adjustment there is, the more favourable are output and unemployment developments for a given inflation objective. The assessment that follows is based on the assumption that a moderate amount of adjustment will occur.

41. The difficulty with a determined move to achieve price stability within five years on this assumption of performance, is that there would have to be a major deceleration of money GDP growth fairly early in the period. The pattern of the 1980-83 disinflation suggests that with such a sharp deceleration output growth would be initially affected more than inflation, although after a time the split of money GDP growth would become more favourable: output growth would rise again and inflation would fall. Unemployment would be adversely affected in the early years unless rapid adjustment occurred in the labour market. To achieve the objective of

price stability within this period would mean a sharp reduction in the PSBR as a percentage of GDP and in monetary growth. Even with a tight fiscal stance there would probably be a rise in interest rates and they would stay higher for a time; nominal interest rates would also be temporarily higher. It is difficult to see any room for tax cuts, unless significant reductions in expenditure could be achieved, or the disinflationary pressures in the economy turned out to be greater than seems likely.

42. The Mansion House Speech explained that a slightly less rapid movement towards price stability might be a preferable strategy. Inflation would still be kept on a downward path, but price stability would not be reached within five years. This would be consistent with bringing the growth of money GDP down significantly to, say, 5-6% a year over the period from the present rate of about 8%. The eventual movement of inflation and output growth will depend on the overall performance of the economy, and especially on labour market adjustment. If the sort of developments discussed earlier occur, and there is continued adjustment on both the productivity and real wages sides, inflation might be of the order of 3-4% after five years, and output growth average around 2½% a year over the period. There would be a reasonable expectation of some fall in unemployment assuming that productive potential was growing at about 1½% a year at the end of the period.

43. If the economy performed less well than this with little labour market adjustment and a poor supply response, inflation might not come down so far and output growth would tend to be lower for a given growth of money GDP. There would be little prospect of a fall in unemployment. On the other hand a better performance associate mainly with better labour market adjustment and improved supply conditions might see further progress being made towards price stability and output growth being somewhat better. Unemployment then might be expected to fall decisively. The objective of "supply side" policies is to improve the chance of rapid adjustment occurring.

44. If it became evident that the economy was performing better or worse than assumed then in future years it might be desirable to alter the objective for money GDP. For example, if there were a marked absence of adjustment and inflation showed little sign of falling there would be a case for aiming for greater deceleration

and tightening policy. However it would also be possible to argue that slow adjustment implied that there were substantial costs in bringing down inflation that much further. We therefore need to reconsider from time to time the judgment about the appropriate path for money GDP. For the moment our analysis points to assuming some moderate adjustment and gearing fiscal and monetary policy towards a growth of money GDP of 5½% by the end of the period.

ASSUMPTIONS FOR THE MTFS

45. Although there is considerable uncertainty about the way that the economy will develop we have to state the assumptions for output and inflation that underlie the projections for revenue and borrowing in the MTFS. It is necessary to consider the kind of figures that we might publish if it were decided to pursue the thrust of policy as outlined in the previous paragraphs. The table shows average and final year inflation and output growth associated with the reduction in money GDP to 5½% in the final year, assuming moderate adjustment.

Assumptions for the MTFS

(per cent a year)

	Output growth	Inflation	Money GDP growth
Period average	2½	4	6½
Final year	2	3½	5½

46. The assumption of moderate adjustment and average money GDP growth of 6½% a year is probably the appropriate basis to carry out the financial arithmetic. It does not show the pessimistic picture frequently observed in outside forecasts in which little adjustment takes place. But it also avoids the risk of raising doubts about the plausibility of the numbers. As we have seen recently, it is much easier to present policy when the outcome for inflation and output turns out to be better than assumed rather than the reverse.

MONETARY POLICY

47. Monetary policy will continue to be directed to the achievement of targets for monetary growth. For present purposes we assume the targets are set consistent with an objective for money GDP growth falling to 5-6% by 1988-89. Unlike previous years, however, it is the intention to have separate ranges for broad and narrow money. For broad money, the focus of attention might continue to be £M3 (and PSL2). For narrow money the aim is to focus maybe on MO (and M2).

48. Setting targets for broad money involves a number of difficult judgments. Growth of broad money has exceeded growth of money GDP since 1979-80, and the question is to what extent this downward trend in velocity will continue. Some of the factors reducing velocity in recent years may well be less important in the next five years, and some may even be reversed:

- the effects of financial deregulation should eventually slow down or stop, though how long the process of adjustment will take is not easy to predict.

- some reduction in real interest rates may partially reverse the increase in financial wealth relative to income which has been observed since 1979.

49. Whether it is reasonable to expect a reversion to the upward trend in velocity observed in the 1970s is debateable. It would mark a significant change from recent behaviour. A more cautious approach would be to work on the assumption that the velocity trend flattens off over the period. On this basis it would probably be reasonable to aim for a 1 point annual reduction in target range for broad money over the period of the MTFS from the present range of 7-11%. However this may mean £M3 in the upper half of the ranges and PSL2 near the top end. One possibility is to raise the range to 7-11% in 1984-85, particularly if the range is also to apply to PSL2, and then reduce it steadily in subsequent years. However, this would pose difficult problems of presentation, and may adversely affect confidence in financial markets. An alternaitve which would

partly get around these problems would be to stay with 6-10% for 1984-85 and hold the range at that level in 1985-86 also, before reverting to a downward path. The balance of argument depends on the weight to be given to PSL2.

50. One possible set of assumptions which, of course, will have to be considered in the light of the forecast and the views of the Bank, is illustrated below.

Broad Money Targets

	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89
Money GDP	8	7½	7	6½	6	5½
£M3	11	9	8	7	6	5
PSL2	13	10	9	8	7	6
Target range	7-11	6-10	6-10	5-9	4-8	3-7
		[7/10	6-9	5-8	4-7	3-6]

51. For narrow money the ranges will have to be lower than for broad money. They will have to be based primarily on the behaviour of M0 since we have insufficient data for M2. It is reassuring, therefore, that M0 and M2 growth rates have been broadly similar since M2 data has been collected. The velocity trend for M0 has been upwards at an average about 4% pa in the last 20 years. The acceleration of velocity after 1979 probably owed something to high nominal interest rates - the disinflationary policy bringing down M0 growth ahead of money GDP. There are signs of a deceleration in velocity in the last year as interest rates have come down. The likely effects on velocity of interest rate changes and changes in payments habits are the two main factors to be taken into account when setting the targets.

52. The pace of change in payments habits in the next five years is very difficult to predict. But our research suggests that the effect on M0 velocity has in the past been relatively smooth. We have no reason to expect that the pace of change will differ significantly from the experience of recent years. Some reduction in nominal interest rates is likely to add to M0 growth over the next five years by comparison with previous trends if inflation is brought down further and real interest rates fall to some extent. If interest rates fall

by 4% over the period of the MTFS this might add around 7% to the level of MO relative to income. Since the timing is difficult to predict it makes sense to assume it is spread fairly evenly over the period.

53. This points to a slightly less rapid decline in the rate of growth of narrow money in the next 5 years than for broad money. Given the objective for money income it suggests a path perhaps as below:

Narrow Money Targets

	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89
Money GDP	8	7½	7	6½	6	5½
MO	7	6	5	4	3½	3
Target Range	-	4-8	3-7	2-6	2-6	1-5
		5-8	4-7	3-6	2-5	1-4
		5.9	4.8	3.7	2-6	1-5

FISCAL POLICY

54. Fiscal policy, as noted earlier, appears to have been less restrictive in 1983-84 than intended at budget time. This is part of the reason why broad money growth is near the top of the range in spite of heavy funding. It has led to high real interest rates, which may partly explain the strength of the real exchange rate. It is very difficult to judge what is the appropriate real exchange rate in the medium term. The present level is significantly above the range experienced in the latter part of the 1970s. However, it is not so far above the level of much of the 1960s and the forecasters see no strong pressures pointing to a sharp decline. Even so if anything the balance of interpretation is that a lower real exchange rate and lower real interest rates would provide a better balance for the UK economy in the present phase of adjustment.

55. The present pattern - high real interest rates, real exchange rate, PSBR and broad money growth - points to fiscal policy being relatively lax in relation to monetary policy in 1983-84. Some correction is probably desirable in 1984-85. The approach adopted here is to examine the appropriate longer term size of the PSBR as a percentage of money GDP, and then to discuss the appropriate speed

of adjustment to the chosen level.

(i) The Medium Term

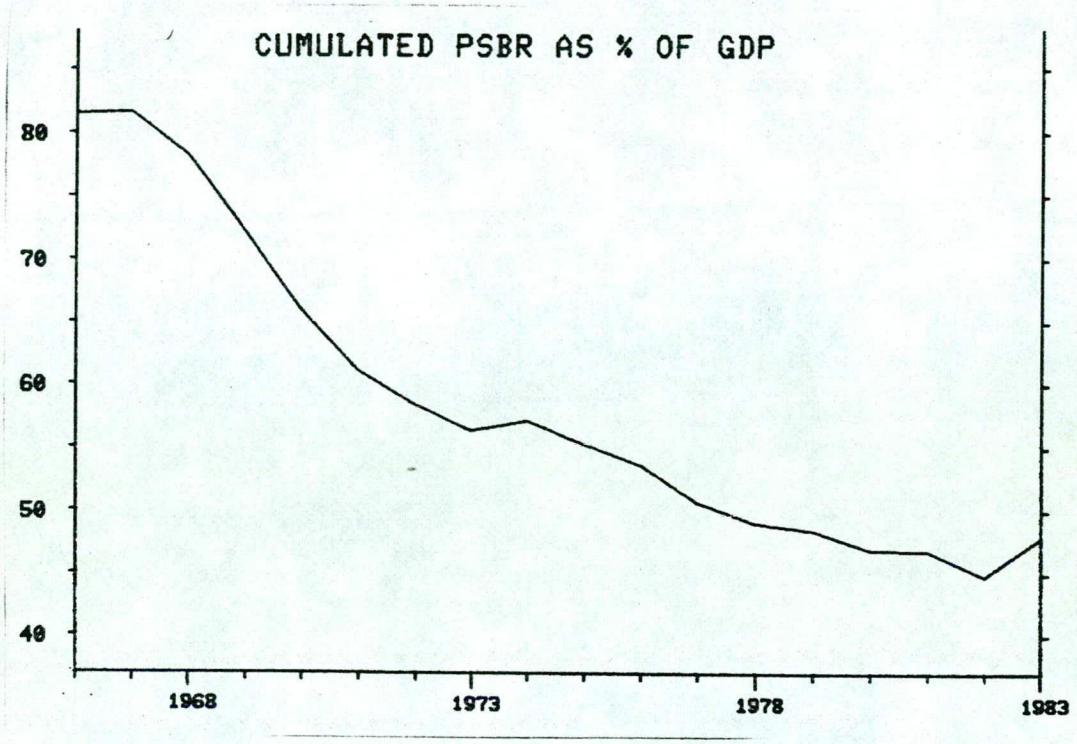
56. The 1983 MTFS assumed a PSBR ratio coming down to 2% per annum in the medium term. This was thought to be broadly consistent with nominal income growth of 8% per annum over the period as a whole. Possible reasons for reducing this figure include:

- lower inflation and money GDP objectives
- higher asset sales/lower net capital expenditure

We therefore need to reconsider the appropriate medium term ratio. The broad aim of fiscal policy is to enable objectives for the monetary aggregates and money GDP to be met at acceptable levels of interest rates. Both these criteria point to a reduction in the PSBR as a share of money GDP by comparison with recent levels.

57. The prospect for real interest rates depends on real rates in the rest of the world, as well as on the stance of fiscal and monetary policy in the UK. The impact of world rates over the next few years is uncertain, with the prospect of rising US rates, but perhaps declining rates elsewhere as the dollar comes under pressure. However adherence to the monetary targets set out above is likely to involve continuing high real interest rates unless the stance of fiscal policy is tightened significantly by comparison with 1983-84.

58. There is considerable uncertainty in choosing the path for the PSBR consistent with monetary objectives. Deriving the appropriate PSBR from a detailed analysis of the monetary counterparts and the demand for money has proved to be difficult, given the behaviour of bank lending. It is therefore also helpful to look at the behaviour of public sector debt - or the cumulated PSBR - relative to money GDP, as in the chart below.



59. The chart shows a downward trend in the ratio of debt to income until the early 1970s, but then a clear flattening off which has become more pronounced in the last two years or so. This has occurred in spite of a high rate of investment in overseas assets in recent years - the counterpart of large surpluses on current account - following the abolition of exchange controls which has led to some substitution in portfolios of foreign assets for public sector debt. One explanation of recent behaviour may be the high level of real interest rates, which appears to have been necessary to induce investors to maintain their holdings of public sector debt relative to income at recent levels. This

implies that if we are to achieve reductions in real interest rates over the medium term it may be necessary to set fiscal policy so as to bring the debt/income ratio back to its trend.

59a. What the trend is likely to be over the medium term is difficult to assess. The argument advanced above suggests that it may still have to be downwards. However, we also need to take into account the flattening off since the early 1970s, which may continue even with lower real interest rates. With the current account now expected to be broadly in balance, and hence little net UK investment in overseas assets, demand for public sector assets may account for a higher proportion of the private sector's net saving. Some commentators have argued that there may be no downward trend by the end of the MTFS period.

60. Against the background of 5-6% growth of money GDP by the end of the period, maintenance of an unchanged debt/income ratio would require a PSBR of roughly 2½% of GDP. If the downward trend were to continue at, say, 2% per annum - close to the average of the last 10 years - a ratio of 1½% would be appropriate. This would imply a greater degree of caution, consistent with the previous versions of the MTFS.

61. This approach merely serves to provide a benchmark against which other factors can be examined. In addition to real interest rates and the cyclical position, it is necessary also to take into account the pattern of capital expenditure, North Sea oil revenues, and other structural factors which affect the appropriate scale of public sector borrowing.

62. A parallel paper on public sector capital expenditure concludes that changes in such spending should be taken into account in assessing changes in the PSBR. Net capital spending has declined from around 5% of GDP in the mid-1960s to nearly zero now; and the figures which underlie the Public Expenditure White Paper, which has asset sales increasing from present levels and a decline in gross investment (excluding defence capital), imply a further fall to minus 1% in 1986-87.* Even allowing for the possibility that some of the capital expenditure in the earlier period was not profitable, and that some current expenditure (eg education) ought

* Part of the fall in the later years is accounted for by the assumed privatisation of BT and BA.

to be treated on a par with capital spending for this purpose, this points to lower public sector borrowing than the 2% of GDP observed in the 1960s.

Public Sector Capital Expenditure

£ billion
(%) of GDP)

	1978-9	1979-80	1980-1	1981-2	1982-3	1983-4	1984-5	1985-6***	1986-7
Gross*	9.9 (5.8)	10.5 (5.1)	12.2 (5.2)	12.1 (4.7)	11.9 (4.2)	12.4 (4.1)	11.0 (3.4)	9.3 (2.7)	9.4 (2.5)
						5	4.6	3.7	3.5
of which:									
asset sales**	-0.4 (-0.2)	-1.5 (-0.7)	-1.1 (-0.5)	-1.3 (-0.5)	-2.5 (-0.9)	-2.7 (-0.9)	-4.2 (-1.2)	-3.7 (-1.0)	-3.6 (-1.0)
Net**	3.1 (1.8)	2.5 (1.2)	2.7 (1.2)	1.7 (0.7)	0.6 (0.2)	0.1 (-)	-2.1 (-0.7)	-2.7 (-0.8)	-3.2 (-0.9)

* Domestic capital formation less special sales of assets
** Gross council house sales plus special sales of assets
*** excluding investment by BT and BA from 1985-86

* based on estimates of capital consumption, after 1982-83

63. The pattern of oil production also points in this direction. We are now close to peak production, and as a consequence, revenues from the North Sea currently exceed the stream of additional tax which is sustainable in the longer term. It can be argued that this should be reflected in reduced public sector borrowing, with saving of debt interest used to compensate for lower revenue as the oil runs out.

North Sea Oil Revenues

	1978-89	79-80	80-81	81-82	82-83	83-84	84-85	85-86	86-87	87-88	88-89
£billion	0.6	2.4	3.9	6.5	7.8	9.0	9.9	9.7	10.1	9.2	9.7
% of GDP	0.3	1.2	1.7	2.5	2.8	3.0	3.0	2.8	2.8	2.4	2.4

64. A further consideration is the pattern of demographic change and pension provision. Higher pension commitments falling due in the next century, associated with rising numbers in retirement relative to those in work and the coming to maturity of the state scheme, point to higher net savings now than is implicit in a pay-as-you-go system. This is a potentially very important consideration for the longer term which will have to be examined further in the context of the Secretary of State for Social Services' inquiry into provision for retirement. But it is a further argument for lower public sector borrowing in current circumstances.

65. These structural factors suggest a PSBR at the bottom end of the range indicated by the debt/income calculations. The aim to reduce inflation by means of balanced fiscal monetary policies points to the same conclusion. It therefore seems appropriate to plan on the basis of a PSBR equivalent to 1½% of GDP by the end of the period. As the period is extended in future versions of the MTFS, it may be appropriate to aim for lower figures at the end as the economy moves towards price stability.

(ii) The Short term

66. We start from a position in 1983-4 in which the PSBR looks like being 3½% of GDP. The key issue is how quickly it is reasonable to get down to the medium term objective of 1½% of GDP.

67. It is quite acceptable to allow for the PSBR to deviate from its medium term 'norm' in response to cyclical factors. That was an important reason why we felt able to allow a rise in the PSBR ratio in the 1981 Budget, How much it should be allowed to vary over the cycle depends partly on the relative efficacy of fiscal policy and interest rates in stabilising the economy. There is no presumption that the stabilisers inherent in the fiscal system should be automatically allowed to operate fully. The combination of PSBR and interest rates appropriate at any stage in the cycle is a matter of choice for the Government.

68. Arguably it makes sense for the Government to bring the PSBR back to its appropriate medium term norm as the economy approaches a cyclically neutral position. However, a gradual move towards lower inflation probably means fiscal policy adjusting ahead of

output and inflation. This suggests it would be appropriate to bring the PSBR down to its appropriate medium term level even while unemployment remains some way above its longer term level.

69. A further consideration is that before the end of the MTFS, the contribution of oil revenues to the PSBR will start to decline as production falls. By comparison with the peak over the next two years, oil revenues may well fall by about ½% of GDP, and for any given PSBR this means higher receipts from other sources. The process of adjustment to a lower PSBR is thus likely to be harder in the later years than the PSBR numbers themselves indicate. This suggests making as much progress as possible in the early years, before the oil revenues start to fall away significantly in 1987-88.

70. A further factor to be taken into account is the profile to asset sales. Relatively high figures in the early years for example would increase the case for a relatively quick reduction in the PSBR. This conclusion is reinforced by the fact that there has been a significant rise in asset sales in the last four years, which has not been fully reflected in a lower PSBR.

71. Against these arguments for bringing down the PSBR quickly in the early years of the MTFS period must be set the fact that the room for manoeuvre on fiscal policy looks to be most limited in the next year or two. On current forecasts it may be necessary to raise taxes slightly next year in order to get back onto the path set in the 1983 MTFS, which envisaged a PSBR of 2½% of GDP in 1984-85. And yet room for manoeuvre during a period of structural tax reform would be very welcome. This argues against attempting to reduce the PSBR too quickly from its present level.

72. As regards 1984-85, there is a clear need to get back onto a downward path after the prospective overshoot this year. With asset sales rising by £1bn next year, we need to cut the PSBR by close to this amount even to stand still. In order to redress the imbalance between monetary and fiscal policy in 1983-84, and enable real interest rates to come down, there is a clear case for a larger reduction.

73. The precise number must await the outcome of the Winter Forecast. On the basis of the Autumn Forecast and the profile for the PSBR, there will probably be little scope for any net tax cuts in the 1984 Budget. To achieve a PSBR of £8 bn some increase may be necessary. I would want to see the forecast details before making a final judgment. There would be a clear case for £8½ bn rather than £8 bn if tax increases prove to be necessary to achieve the lower figure while significant tax reductions appear to be in prospect for the next year. It would be difficult to explain and justify a proposal for tax increases in 1984 to be followed immediately by tax cuts. At the same time we must be aware that this picture - a relatively difficult fiscal position in the next year or so giving way to an easier position later on - has been a feature of most recent forecasts, and in view of recent experience in forecasting public expenditure we should retain a healthy scepticism.

74. Even so, after 1984-85 the room for manoeuvre is likely to be somewhat greater; and there is then a strong case for making fairly rapid progress towards achieving the medium term objective. The medium term path I envisage, and the corresponding paths for the PSFD and GGFD, might look as follows:*

£billion (% of GDP)	1983-84	1985-86	1985-86	1986-87	1987-88	1988-89
PSBR	10 (3¼)	8½ (2½)	7 (2)	6½ (1¾)	6½ (1¾)	6 (1½)
PSFD	10 (3¼)	8¾ (2½)	7½ (2¼)	7 (2)	6½ (1¾)	6 (1½)
GGFD	9½ (3¼)	7¾ (2¼)	6½ (1¾)	6½ (1¾)	6 (1½)	5½ (1¼)

75. This implies sticking to the PSBR figures as a share of GDP in the 1983 MTFS for the first two years, with a gradual decline after that.

* Annex B shows a ready-reckoner for PSBR figures and ratios

76. The PSFD and PSBR move in a broadly similar manner. In the early years, the PSFD is slightly higher, with extra proceeds from special sales of assets being only partially offset by net lending to the private and overseas sectors. In the last two years, the PSFD may decline faster than the PSBR if the asset sales programme slows down. The GGFD, which excludes government loans to Nationalised Industries, is likely to be a little below the PSBR and the PSFD throughout the period.

77. If we succeed in holding public expenditure constant in real terms this should leave room for tax cuts in the years after 1984-5, even in the last two years when oil revenues are falling away. Estimates of the fiscal adjustment must be very speculative at this stage, and extremely uncertain in any event. Again we need to finalise the precise numbers when the new forecast is available, but the qualitative conclusion at this stage points to making significant progress towards a lower PSBR in the early years.

Questions for Discussion

78. There are four broad questions, relating the the period of the MTFS, the medium-term objectives, the monetary targets and the PSBR path.

79. The issue for decision on the period is whether to roll the MTFS forward, by one, two or three years. The main considerations are:

- the impact on expectations
- the effects on future freedom of manoeuvre.

80. The Mansion House Speech provides the starting point for deciding medium-term objectives. It is now necessary to choose particular numbers that can be published as assumptions about medium-term developments.

81. It is not possible at this stage to make firm decisions about monetary targets, especially for the next year or two. Nevertheless a discussion of likely trends in velocity over the short- and medium-term can indicate the sort of monetary paths that are likely

to be consistent with policy objectives.

82. The discussion on the PSBR path should separate the medium-term PSBR target from the speed of the adjustment towards it. Relevant to the medium-term question are:

- the need to reduce real interest rates
- whether the downward trend in the ratio of public sector debt to money GDP will continue and, if so, at what rate
- the low level of net capital expenditure, resulting in part from the high level of asset sales
- the fact that North Sea revenues are near their peak
- the rise in future pension commitments

The issues that should be taken into account in deciding the speed at which the PSBR is to be moved down include:

- the stage of the cycle
- the lags in the response of money GDP and inflation to fiscal policy
- the pattern of North Sea oil revenues
- the pattern of asset sales
- the room for manoeuvre on fiscal policy in 1984-85 and 1985-86.

ANNEX A

COMPARISON OF MTFS FIGURES WITH OUTTURN

GDP/deflator (market prices)

% changes	1979-80	1980-81	1981-82	1982-83	1983-84
1980 MTFS		19.5	12.1	8.2	7.5
1981 MTFS			10.8	8.0	7.2
1982 MTFS(1)				7.8	6.9
1983 MTFS(1)					5.4
Latest estimate	16.8	18.6	10.0	6.7	5.2

(1) Annual projections of the GDP deflator were given in 1982 and 1983 MTFS, but nothing in earlier years.

RPI(2)

% changes	1980 Q4	1981 Q4	1982 Q4	1983 Q4
1980 MTFS	16.5	10.2	8.7	7.5
1981 MTFS		10.2	7.5	7.4
1982 MTFS			9.0	7.1
1983 MTFS				5.8
Latest estimate	15.3	11.9	6.2	5.1

(2) Not published in MTFS; 18 month ahead forecasts given in short term prospects.

Money GDP (Market prices)

% changes	1979-80	1980-81	1981-82	1982-83	1983-84
1980 MTFS		17.1	12.0	9.6	10.7
1981 MTFS			10.5	9.6	9.7
1982 MTFS(3)				9.7	9.7
1983 MTFS(3)					7.9
Latest estimate	19.9	13.7	9.7	9.2	8.3

(3) Annual money GDP projections were given in 1982 and 1983 MTFS, but not in earlier years.

Real GDP(4) (factor cost)

% changes	1979-80	1980-81	1981-82	1982-83	1983-84
1980 MTFS		-2.2	-0.2	+1.4	+2.8
1981 MTFS			- 0.4	+1.3	+2.3
1982 MTFS				+1.7	+2.6
1983 MTFS					+ 2.4
Latest estimate	+2.6	-4.1	-0.1	+2.3	+2.8

(4) Projections for real GDP at factor cost have been given in all published MTFS. However the annual path has not been made explicit and an average figure has always been given.

£M3(5)

% changes	1979-80	1980-81	1981-82	1982-83	1983-84
1980 MTFS		9.4	8.0	7.0	6.0
1981 MTFS			8.0	7.0	6.0
1982 MTFS				11.6	9.2
1983 MTFS					9.0
Latest estimate	11.5	21.2	12.0	11.5	10.0

(5) Illustrative ranges for £M3 were published in all MTFS. The figures for the outturn are on a mid-April to mid-April basis, MTFS figures are Q1 on Q1.

M1(6)

% changes	1979-80	1980-81	1981-82	1982-83	1983-84
1980 MTFS		16.8	17.5	0.8	9.0
1981 MTFS			14.1	14.8	14.5
1982 MTFS				10.8	13.4
1983 MTFS					11.8
Latest estimate	3.3	12.4	3.9	14.9	12

(6) Illustrative ranges for narrow measures of money were published in the 1982 and 1983 MTFS. These were the same as for broad money though the text made clear that higher numbers were possible as inflation and interest rates came down.

General Government Expenditure[7]
(including interest payments)

% of GDP	1979-80	1980-81	1981-82	1982-83	1983-84
1980 MTFS	44.9	45.6	44.5	42.9	41.5
1981 MTFS			47.7	46.1	43.9
1982 MTFS				47.0	45.0
1983 MTFS					46.4
Latest estimate	43.5	46.1	46.5	47.3	45.7

General Government Receipts[7]
(including interest receipts, before fiscal adjustment)

% of GDP	1979-80	1980-81	1981-82	1982-83	1983-84
1980 MTFS	39.6	41.3	41.4	42.0	41.5
1981 MTFS			43.1	43.2	42.7
1982 MTFS				43.4	42.3
1983 MTFS					43.3
Latest estimate	38.4	40.2	43.1	43.6	42.1

(7) Annual figures. General government expenditure and receipts and money GDP were both published in 1982 and 1983 MTFS. In 1980 and 1981 MTFS levels of government expenditure and receipts were given in cost terms. In addition figures for public expenditure as a proprtion of GDP in first and last years of the MTFS were given in 1980, 1981, 1982 MTFS.

PSBR as a proportion of GDP(8)

	1979-80	1980-81	1981-82	1982-83	1983-84
1980 MTFS	4¾	3¾	3	2¼	1½
1981 MTFS			4¼	3¼	2
1982 MTFS				3½	2¾
1983 MTFS					2¾
Latest estimate	4.8	5.6	3.4	3.3	3.4

(8) Projections of the PSBR ratios have been given in all MTFS.

ANNEX B

EQUIVALENT PSBR FIGURES AND RATIOS

£ billion

% of GDP	1984-85	1985-86	1986-87	1987-88	1988-89
1	3.3	3.5	3.7	3.9	4.1
1¼	4.1	4.3	4.6	4.8	5.1
1½	4.9	5.2	5.5	5.8	6.1
1¾	5.6	6.1	6.4	6.7	7.2
2	6.5	6.9	7.3	7.7	8.2
2¼	7.3	7.8	8.3	8.7	9.2
2½	8.1	8.7	9.2	9.6	10.2
2¾	9.0	9.5	10.1	10.6	11.2
3	9.8	10.4	11.0	11.6	12.3

FROM: F CASSELL
11 January 1984

CHANCELLOR

cc - Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Littler
Mr Bailey
Mr Battishill
Mr Kerr
Mr Ridley
Mr Lord
Mr Portillo

Sir Lawrence Airey, IR
Mr A M Fraser, C&E

CHEVENING: PERSONAL BORROWING

I attach a paper on the recent growth of personal borrowing and its implications.

F CASSELL

PERSONAL BORROWING

This note looks at the recent behaviour of personal borrowing and the extent to which it has changed since the mid-1960s. It then considers the resulting issues of analysis and policy - which bear on such questions as the appropriate targets for broad money and the role of over-funding.

2. With the removal of the corset in mid-1980 (and the preceding abolition of exchange controls) the banks were not only freed from a direct constraint on total lending, but also had much greater freedom over its composition. As a result total bank lending rose very rapidly, and within this total there was a high growth of lending to persons, particularly for house purchase. Partly reacting to the competition from the banks, but also responding to the authorities' acquiescence in the banks' incursion into mortgage lending, the building societies dramatically stepped up their lending, and increased the range of financial services offered to depositors and borrowers. Between mid-1980 and mid-1983 the stock of lending by banks and building societies to the personal sector rose by £47 billion, or 82 per cent.

3. The high growth in lending has not been accompanied by a commensurate growth in broad money, whether measured by £M3 or any of the PSLs. Overfunding, accompanied by money market assistance, together with rising non-resident balances and non-deposit liabilities have produced a marked difference between the growth of money and the growth of credit to the private sector. One strand of monetarist analysis stresses that the importance of high monetary growth derives from the potential for the private sector to spend currency and highly liquid deposits. On this view it does not matter how fast credit grows provided monetary growth is under control. Prima facie the experience of the past three years accords with this view. Prices and nominal GDP have decelerated. Indeed there is some difficulty explaining the extent of their deceleration against the background of relatively rapid growth of broad money; these difficulties apply a fortiori to potential explanations of economic behaviour that attribute a significant role to credit.

4. There are, however, misgivings that the recent growth of personal credit could have unwanted implications for spending and prices in the future. This paper examines the arguments that give rise to these misgivings. This first part of it summarises the recent development of personal borrowing and the debt/income ratio. The second part seeks to explain these developments and assesses whether they are likely to continue. The third part assesses the extent to which the additional borrowing has increased expenditure. The final part sets out some possible conclusions.

I. THE BEHAVIOUR OF PERSONAL SECTOR BORROWING

(i) Gross debt/income ratios

5. Most discussion of personal sector debt concentrates on a few prominent constituents of it - HP, bank lending and building society lending. Panel 1 of Chart I shows how these have moved in relation to personal disposable income since the mid-1960s, and how they are forecast to move over the next few years[1]. It shows that most of these debt/income ratios are now above their previous peaks, of the early 1970s, and are forecast to rise still further.

6. This familiar story is, however, misleading. Liberalisation and the more competitive spirit it has unleashed have enabled banks and building societies to win back business from other lenders (such as local authorities, insurance companies, solicitors etc) and to displace trade credit. The lower panel of Chart I shows the effect on the debt/income ratio of adding various categories of borrowing, the top line showing the total financial liabilities of the personal sector.[2] The striking feature is the extent to which the rise in the debt/income ratio over the whole period since 1966 is lower the wider the coverage of debt. Whereas on the narrower measure - HP, bank, and mortgage lending - the debt/income ratio was above its previous peak by early 1982 this has only recently been the case with total financial liabilities.

7. The debt/income ratio in Britain is of course still far below that in the United States. There are major institutional differences between the two countries - for one thing all consumer debt interest is tax deductible in the US, whether for housing or other purposes. While there is no reason why British consumers and lending institutions will eventually converge on American debt/income ratios, these ratios provide a benchmark against which developments here can be assessed. Chart II shows one common measure of the US household debt/income ratio since 1950, and also shows equivalent measures of the household[3]

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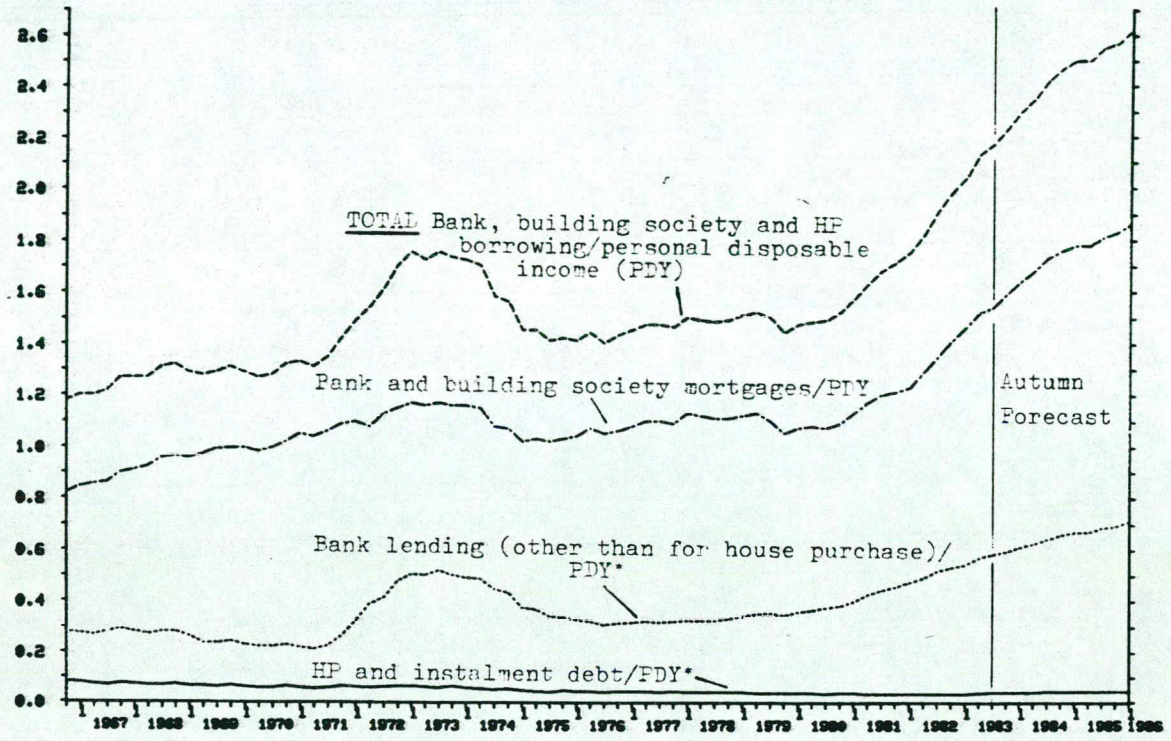
[1] The changeover from the banking to the monetary sector in 1981(4) produced a discontinuity in the series for HP debt and bank lending because the majority of finance houses were thereafter in the monetary sector and their lending became a constituent of total bank lending to the personal sector. Chart I adjusts the series for both of these to take account of this discontinuity, so that before 1981(4) the series for both are comparable with their present definitions.

[2] Annex 1 describes in detail the various components of total personal sector liabilities and gives the absolute (£b.) amount and share (%) of total liabilities for end 1978 and the beginning of 1983.

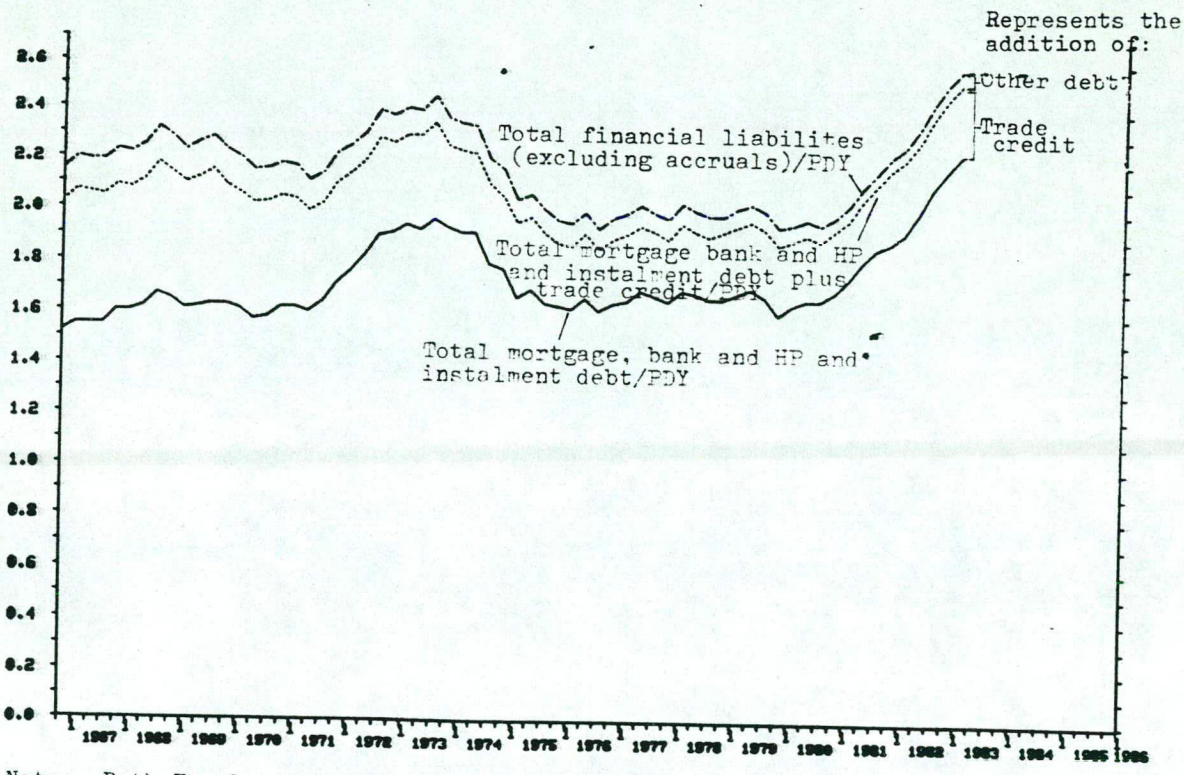
[3] The household sector excludes unincorporated businesses (which are in the personal sectors). (It is only possible to to make this adjustment in the UK for the time period shown in Chart II and for this particular definition of the debt/income ratio.)

CHART I: DEBT INCOME RATIOS OF THE PERSONAL SECTOR

PANEL 1



PANEL 2

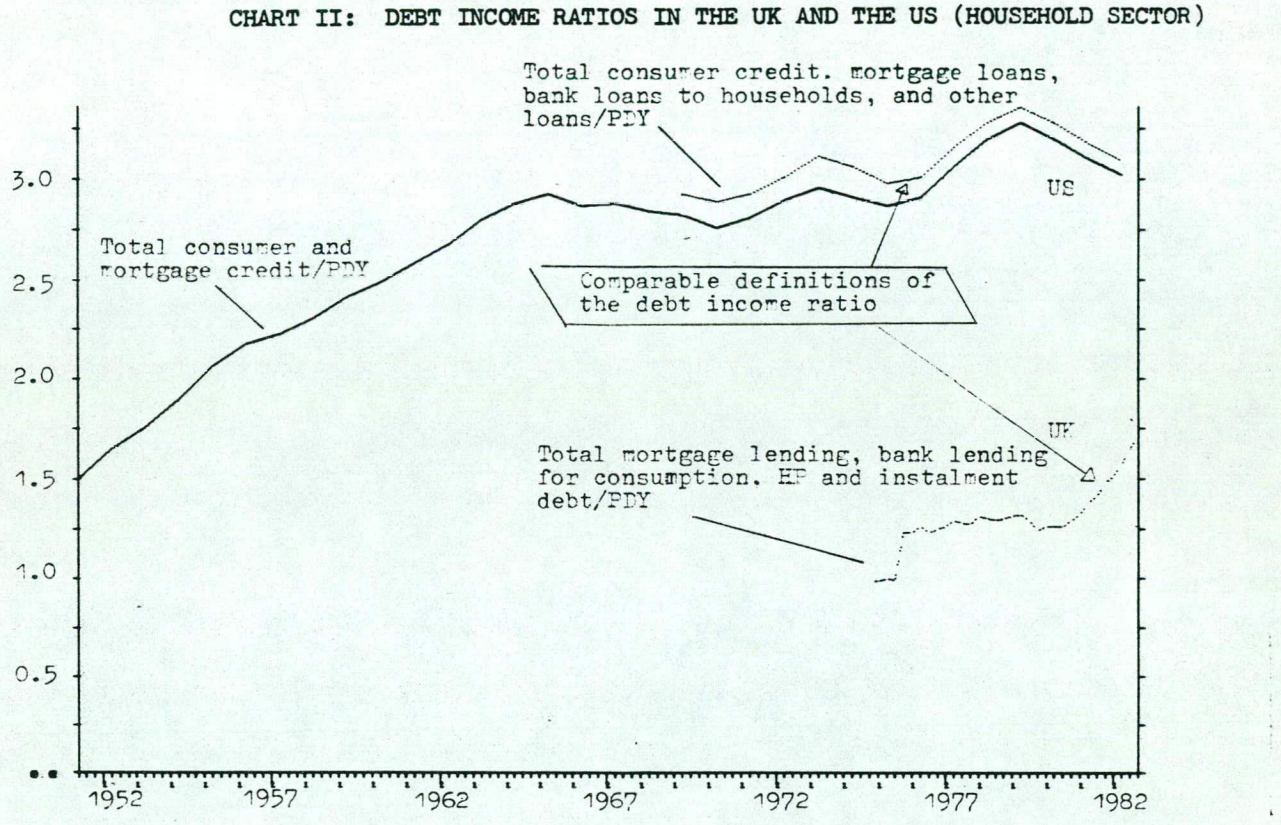


Note: Both Panels show the ratio of the stock of debt outstanding at end-quarter to the quarterly flow of personal disposable income.

*These series are rescaled before 1981Q4 to allow for the break in series, caused by the switch from the banking to the monetary sector.

debt/income ratio for the US - since 1969 - and the UK - since 1974. The US ratio has been significantly higher, but the gap has narrowed in the last few years.

CHART II: DEBT INCOME RATIOS IN THE UK AND THE US (HOUSEHOLD SECTOR)



(ii) Net indebtedness

8. The adjustment of personal sector finances since 1979 has involved substantial increases not just in borrowing from banks and building societies but also in deposits with these institutions and in national savings instruments. Chart III shows gross and net debt/income ratios for the personal sector. There is inevitably some arbitrariness both about the measure of gross credit used here - which covers only HP, banks, and building societies (because only data on these is readily available) - and about the liquid financial assets deducted from it - deposits with banks, building societies and national savings. Nevertheless this information on net credit gives a useful insight into recent developments. The net debt/income ratio of the personal sector rose sharply between 1971 and 1973, but since then there has been a fairly steady rise. In the context of this historical experience there is nothing odd about the accumulation of net liquid financial assets in the last few years, or the continuation of that accumulation expected by the forecasters.

CHART III : PERSONAL SECTOR DEBT/INCOME RATIOS

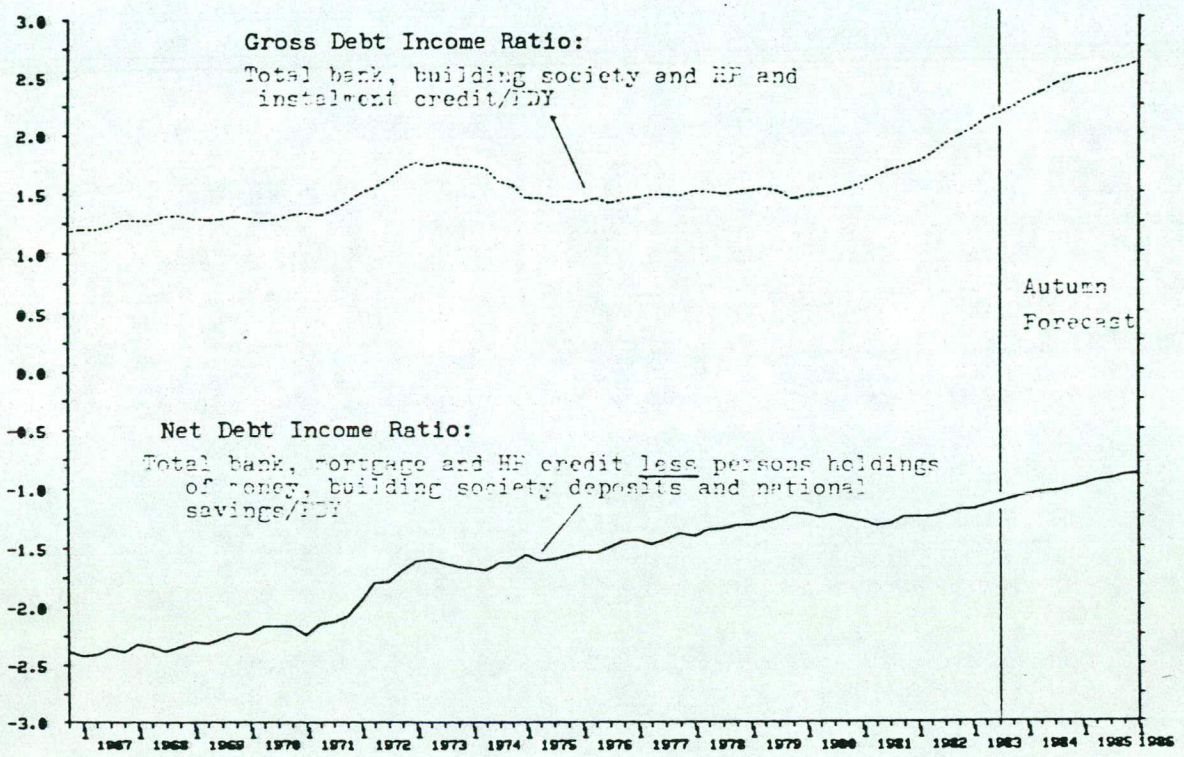
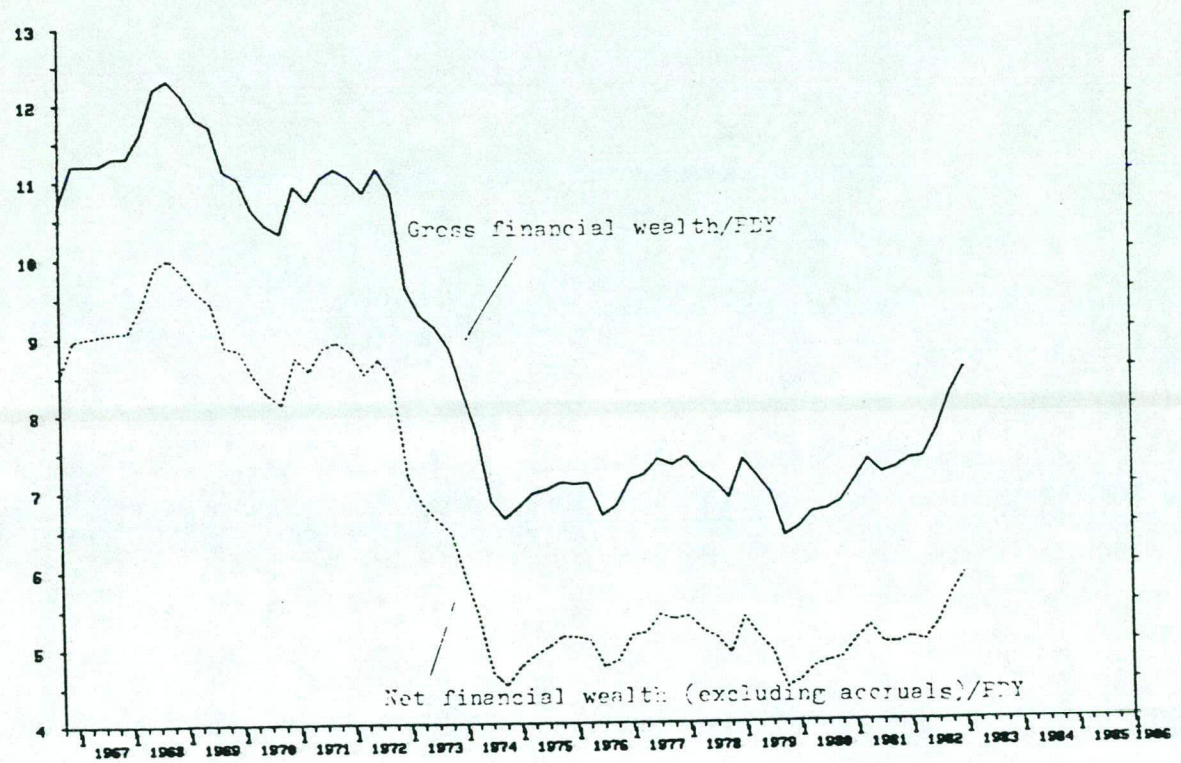


CHART IV PERSONAL SECTOR FINANCIAL WEALTH/INCOME RATIOS



9. The substantial rise in personal borrowing has been partly matched by accumulation of interest-bearing liquid assets (much of it in forms of National Savings and building society deposits that lie outside PSL2). Chart IV shows the ratios of the familiar measures of total gross and net financial wealth to disposable income. These are both dominated by the sharp falls that occurred in the early 1970s (mainly as a result of falls in the market value of gilts and equities). In the very recent past the gross ratio has risen more than the net ratio and the gap between them is higher than it has been before.

10. Since we do not measure separately personal sector payments and receipts of interest it is difficult to form clear ideas about the behaviour of net and gross income gearing. It looks as if the ratio of gross interest payments to income has tended to rise since the mid-1960s, but also to display sharp cycles around this rising trend as nominal interest rates have fluctuated. Of course a fall in interest rates, and therefore in income gearing, does not in itself mean that borrowing has been prudent. The latest forecast suggests that gross interest payments will be a lower share of income than in 1980 or 1981, though considerably higher than the average for the 1970s.

II. EXPLANATIONS FOR THE RECENT GROWTH OF BORROWING

11. The recent surge in personal borrowing needs to be seen in a longer time perspective. One would expect the debt/income ratio to rise in a society in which owner-occupation is increasing and, with higher incomes, more and more people are looking good credit risks for bankers. In fact, however, it fell sharply in the mid-1970s and did not begin rising again until the end of the decade. It seems plausible to attribute much of the recent rise to an unwinding of the developments - high inflation, squeezed real incomes, financial controls - that depressed the ratio in the 1970s. To some extent, at least, persons have been trying to get back to the desired debt/income ratios that were denied them in the long period of financial regulations. Helped by council house sales. They have also been adding rapidly to their stock of real wealth.

(i) The reaction of the banks to de-control

12. It seems likely that in this freer environment not only have persons wanted to borrow more from banks, but the banks themselves have wished to have a higher share of their lending going to persons. Lending to companies and, still more, sovereign lending abroad have become riskier in recent years.

13. Though comparison of profit margins on various categories of lending may suggest that lending for house purchase is not very attractive to the banks currently, such lending is

virtually risk-free. Moreover, for any personal lending the banks are likely to have a detailed and accurate picture of the individual's finances if his or her account is with them and can therefore readily judge the security of the loan. In HP or trade credit the lender often has little knowledge of the borrower.

(ii) Substitution of cheap for expensive credit

14. One obvious explanation for the fast growth of personal borrowing from banks and building societies is that the liberalisation of financial markets has led to the operation of something analogous to Gresham's law. Relatively cheap, market-determined, credit is now the marginal source of credit and has displaced other forms. It is unlikely that this process is yet complete. Chart V shows how much cheaper bank and building society credit is than other forms of credit (HP; credit cards).

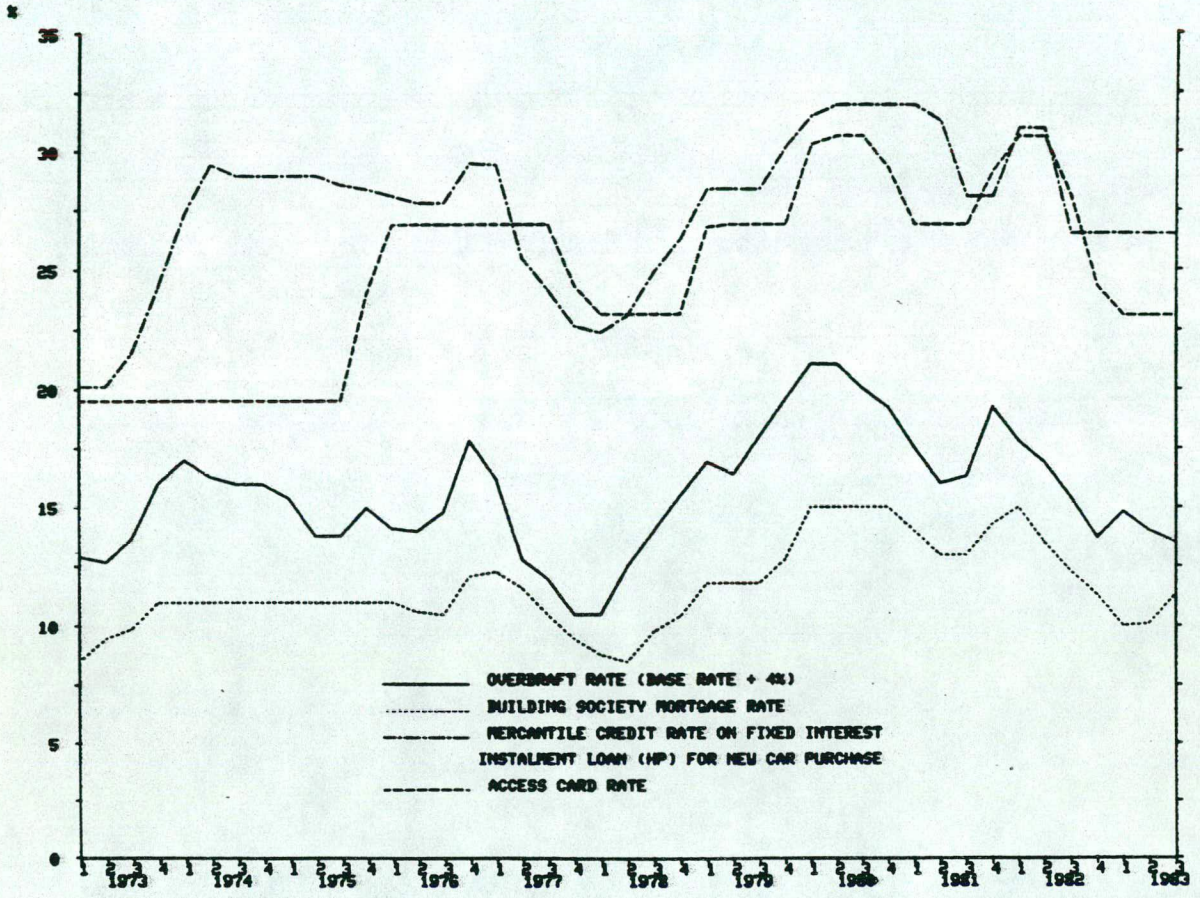
(iii) Reduced Cost of Holding Financial Assets

15. As noted in Part I, while gross debt/income ratios have risen sharply in recent years there does not appear to have been a similar rise in the net debt/income ratio, which has risen at much the same rate as in the past.

16. The reasons for this simultaneous rise in financial assets and liabilities are not clear. Because the cost of credit normally exceeds the return on financial assets it is often assumed that it is not rational for an individual to increase both simultaneously. Much of the recent increase in lending to persons may have gone to people who previously made little use of high-cost consumer credit, while it has been other parts of the personal sector that have been accumulating financial assets.

17. However, it seems likely that many people have simultaneously increased their stocks of both credit and financial assets. One effect of the removal of the curb on bank lending and the associated end of mortgage queues at building societies has been to reduce to only a few percentage points the difference between the rate of interest at the margin on personal borrowing and the net return on financial assets - because it is no longer HP or Access that is the marginal source of finance. This interest rate differential can be viewed as the "cost" of holding precautionary financial balances. If persons could readily borrow at market rates - in the way that large companies can - there would be no obvious reasons why they should want to hold large precautionary balances. Most, however, cannot do so, and without a cushion of liquid assets they might be forced to dispose of other assets if they were faced with an unexpected payment. It is quite possible, therefore, that many people have taken advantage of the substantial reduction in the marginal cost of credit to them to increase their liquid assets.

CHART V: INTEREST RATES FOR PERSONAL BORROWING



*These are average interest rates over the quarter expressed as an annual percentage rate of increase (APR).

18. One obvious instance in which the cost borrowing is low in relation to the rates available on financial assets is lending for house purchase, because this attracts tax relief on the interest on mortgages up to £30,000[1]. There is still a substantial stock of unused mortgage tax relief. It would be rational for individuals to have as much as possible of their borrowing in the form of mortgages (up to the point at which they exhaust the tax relief), and probably to increase their total borrowing as well. It may thus be some time before the personal sector as a whole fully adjusts to the opportunities open to it now that there are no significant queues at building societies or restrictions on bank lending. There are important constraints - such as the cost of moving house - on the full exploitation of potential opportunities in the short run. But over time the availability of mortgage interest relief on the present scale within a very liberal financial system could lead to major distortions both of resource allocation and of the financial structure.

III. BORROWING AND EXPENDITURE

(i) Increased lending for house purchase

19. The increased supply of mortgage credit has undoubtedly been a major factor in the recovery in house-building. However, the growth of mortgage debt has far out-stripped the growth of the privately-owned housing stock. A significant part of the additional mortgage debt has been used for other purposes.

20. One possible, and much discussed, way in which the increase in gross borrowing has probably helped to bolster consumption is through equity withdrawal from mortgage lending. The table below shows estimates of this. It is clear that equity withdrawal is currently much greater than in the mortgage boom of the early 1970s.

EQUITY WITHDRAWAL
(£ billions)

1971	0.6	1978	1.5
1972	1.1	1979	1.8
1973	0.7	1980	1.5
1974	0.5	1981	3.4
1975	1.1	1982	6.1
1976	1.0	1983	[6.0]
1977	1.2		

---

[1] Before 1969 and between 1972 and 1974 interest on personal sector bank borrowing was similarly tax-deductible.

21. The greater the extent of equity withdrawal for a given amount of mortgage lending the less likely is that lending to generate house price booms such as occurred at the beginning and end of the 1970s. Lending for house purchase may contribute to the build up of personal sector financial assets or to higher consumption, particularly of durables, or to some combination of the two. There are no specific indicators of the extent to which equity withdrawal is increasing consumers' expenditure, and maybe inflation. The effect of equity withdrawal on consumers' expenditure is one of numerous factors that will influence judgement on monetary and fiscal policy, even though it is not directly observable.

(ii) **Lower Saving**

22. The recent rise in borrowing has been associated with a steep fall in the personal saving ratio. After being flat for two years, consumers' expenditure in total rose by 5¼ per cent in the five quarters to the third quarter of 1983. Spending on durable goods, which is more directly dependent on borrowing than other forms of consumption, rose by 25½ per cent over the same period. The saving ratio peaked at 15½ per cent in the third quarter of 1980 and has since fallen to 8½ per cent in the third quarter of 1983. (See Chart VI).

23. It is not easy to determine whether the rapid increase in borrowing was in part at least a cause of the increase in consumption or whether it merely represented a means of financing it. There have been few satisfactory empirical estimates of the influence of the availability of credit on consumers' expenditure. The main explanatory variables in empirical work have been real personal disposable income, and financial infuences such as liquidity, financial wealth, real and nominal interest rates, inflationary expectations and perhaps some proxy for uncertainty such as movements in unemployment.

24. The relationships embodied in the Treasury model suggest that increased real personal disposable income and the reduction in inflation explain much of the recent increase in consumption. However, there remains a significant element both of the earlier rise and the more recent fall in the saving ratio for which there is no adequate explanation. Chart VII shows that at the beginning of the recession, when the saving ratio rose sharply, the path of consumers' expenditure was lower than predicted. Over the past eighteen months, however, this increase has been much more than predicted (though, given the previous over-prediction, the current level of consumer spending is much as predicted). It is difficult to believe that the more ready availability of credit has not been an important factor in this.

CHART VI PERSONAL SAVING RATIO (per cent)

Annual data 1970-79
Quarterly data 1980(1)-86(4)

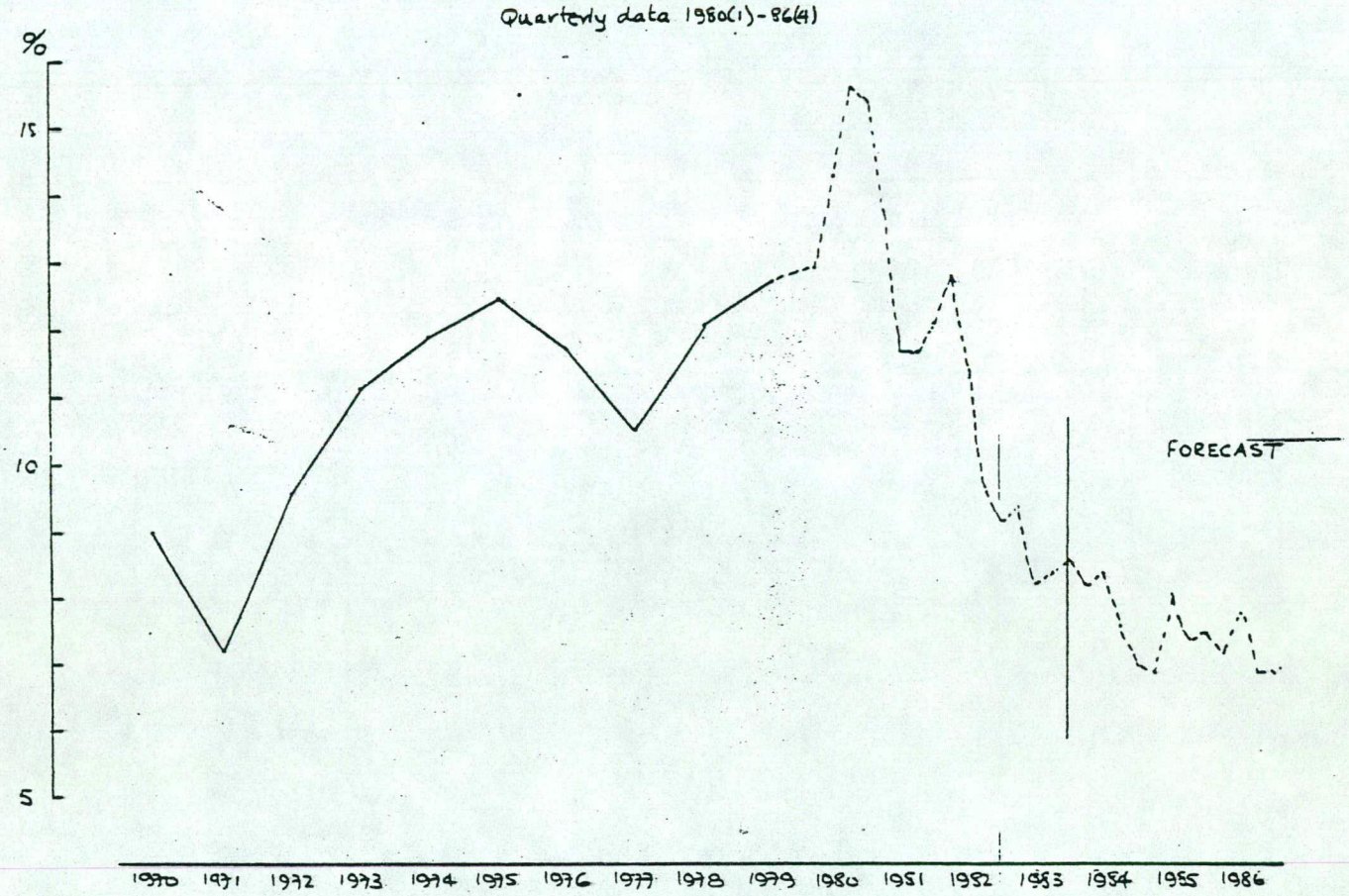
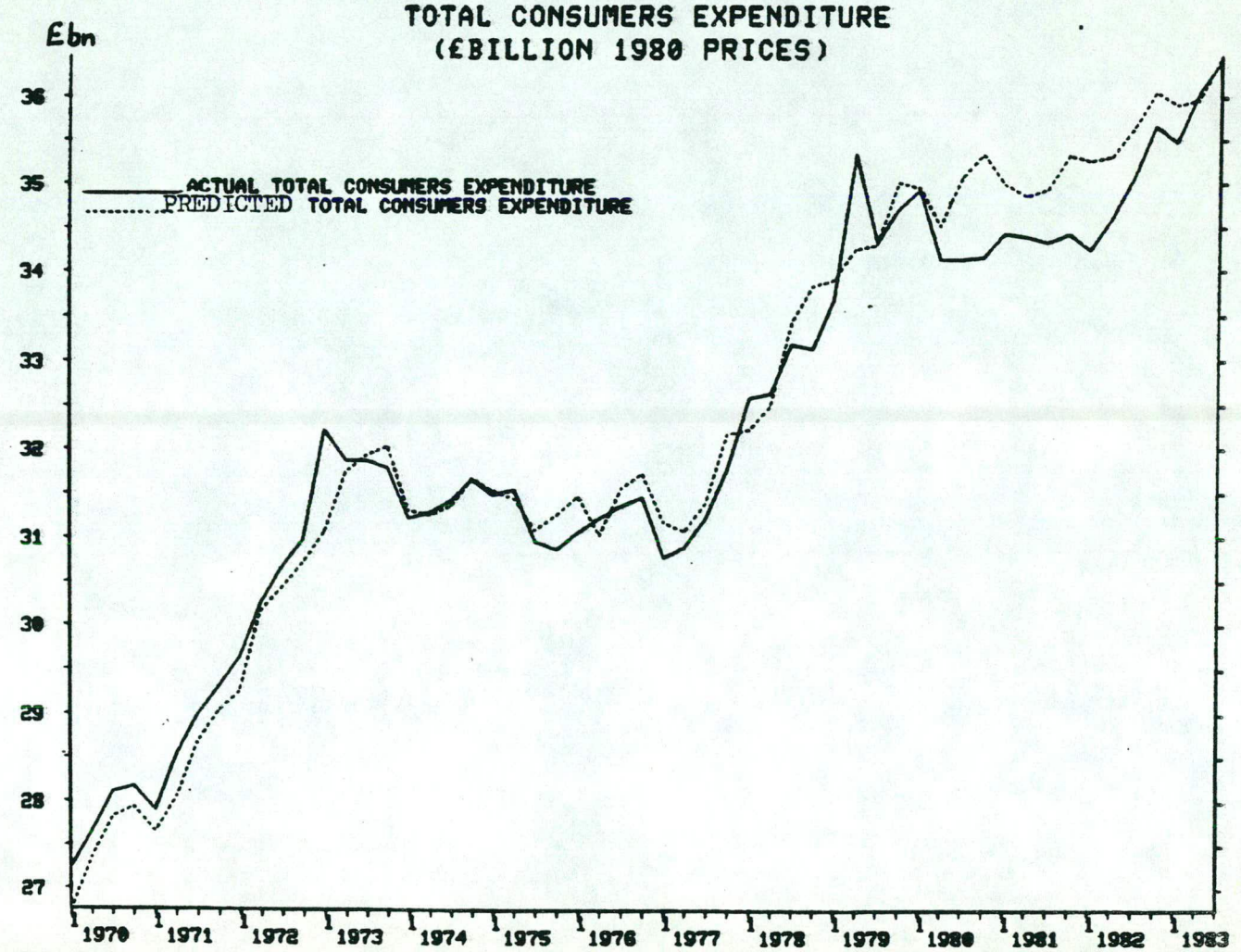


CHART VII

TOTAL CONSUMERS EXPENDITURE
(£BILLION 1980 PRICES)



25. Consumers are now taking up credit that was previously unavailable, or very expensive. This means that expenditure that might in the past have been postponed until sufficient savings had been accumulated is now going ahead. It may be some time yet before persons reach their desired debt/income ratios and levels of income gearing and the adjustment is complete. So there could be for some time to come higher levels of borrowing accompanying higher levels of consumption than would have been the case before liberalisation.

IV. CONCLUSIONS

26. Explanations of the recent behaviour of personal borrowing are too tentative to permit firm conclusions for future policy. However, some implications can be drawn from this assessment:-

(i) The ready availability of credit over the past two years has almost certainly played some part in the strong growth of consumer spending. The fact that expenditure on durables has increased so much faster than would have been expected from past relationships with movements in income, certainly points in that direction. However, it is easy to exaggerate the independent part that credit has played. Most of the decline in the personal saving ratio can be plausibly explained by changes in real income, real wealth and interest rates.

(ii) The recent trends in borrowing could go on for some time. The evidence reviewed in this paper does not support the view of some outside forecasters that the debt/income ratio is now so high that persons will be unwilling to let it rise further, and in consequence consumption will decelerate sharply. But while it is not difficult to find plausible reasons why the debt/income ratio has risen, and could continue to rise, it is much harder to assess how <u>stable</u> the present ratio might be. This is a major uncertainty in the forecast, and for policy. So it is not easy to judge whether the present level of borrowing gives cause for concern. The pace of consumer spending foreseen in the autumn economic forecast (on the assumption that borrowing continues on its upward trend) looks compatible with the Government's objectives for the economy. But there is a wide margin of error, both ways, around that forecast.

(iii) The strength of personal demand for credit could give rise to serious monetary problems if there were a marked resurgence in company demand for credit. The growth of bank credit would then create problems for monetary control, which would compel us to over-fund the PSBR or to accept a faster growth of broad money.

(iv) These risks will need to be carefully assessed in setting the monetary targets for 1984-85. The fact that persons have been borrowing heavily from banks and at the same time building up their financial assets raises the question whether it would be acceptable to accommodate the demand for credit by setting a somewhat higher range for the growth of broad money than the 6-10 per cent previously envisaged - on the argument that the additional money balances would be willingly held (ie idle balances). How far this would be acceptable would depend partly upon what was happening to narrow money. However, there are considerable risks in allowing the economy to become highly liquid. This may have no immediate effect on inflation, but it creates conditions in which spending and inflation could accelerate rapidly if some factor (eg a fall in real interest rates) led the private sector to want to spend more or, more generally, if expectations turned.

(v) If, to guard against these risks, it was desired to restrain the growth of personal borrowing, the instruments to hand are not extensive. The most effective one would be to remove or reduce tax relief on mortgage interest. If that is ruled out, it might be possible to move a little in that direction by defining more tightly the rules for eligibility (which in practice would mean confining the relief to loans for house purchase, not improvements) or, more radically, by some form of quantitative restriction on the relief on second purchases (perhaps related to a proportion of the purchase price of the house). Such restrictions would create unfairnesses and anomalies. However, if we are genuinely worried about the growth of personal borrowing they need to be considered. A consumer credit tax - covering mortgages as well as other credit - could have some <u>marginally</u> helpful effect in restraining credit. Beyond that, if we are seriously concerned about the risk of excessive consumer spending developing in the coming year, we need to look again at the possibility of devising a regulator for personal taxes that is available for use within the fiscal year.

(iv) Another aspect to be considered is the implication of the strong growth in personal borrowing for the proposals afoot for liberalising the lending activities of building societies. The societies would like to be free to make personal loans for purposes other than house purchase (they envisage only a limited amount, though in aggregate the sum could be large). A widening of their powers would be consistent with the Government's general stance on market forces and competition. However, the analysis in this note suggests that we should be very cautious in moving in this direction (at least while we

have so little influence over the total volume of their lending) even though this may be seen as an arbitrary form of quantitative restriction.

ANNEX

PERSONAL SECTOR FINANCIAL LIABILITIES

The following table shows the published personal sector financial liabilities.

	£bn		% of total liabilities	
	1978Q4	1983Q2	1978Q4	1983Q2
HP and other instalment debt	3.0	2.9	4.9	2.2
(Adjusted* to allow comparison with 1983Q1)	(2.2)		(3.6)	
Bank lending other than for house purchase	8.8	27.9	14.5	21.1
(Adjusted* to allow comparison with 1983Q1)	(9.6)		(15.9)	
Bank lending for house purchase This includes trustee savings bank mortgages	1.8	12.5	3.0	9.4
Building Society lending for house purchase	31.7	62.8	52.4	47.4
Insurance company and pension fund lending for house purchase	1.7	2.2	2.8	1.7
Local Authority and other public sector lending for house purchase	3.4	5.9	5.6	4.5
Trade Credit This is primarily trade credit of unincorporated businesses but also includes unpaid household gas and electricity bills, and trade credit of non-profit making bodies. No precise breakdown is available.	7.7	14.3	12.8	10.8
Other financial liabilities The largest component is other domestic long term loans (£3bn in 1983Q2 of which about half should be consolidated). This is a catch-all category which includes among other items long term debt of stockbrokers and jobbers long term debt of charities, mortgages not included elsewhere, and several items of long term debt within the personal sector, which are not netted out of the published figures. Other financial liabilities also includes accruals of taxes, rates and interest (£0.7bn in 1983Q2) and domestic liabilities not covered elsewhere (£0.3bn in 1983Q2).	2.3	4.0	3.8	3.0
Total financial liabilities of the personal sector	60.4	132.5	100	100

*From 1981Q4 onwards the introduction of the monetary sector in the statistics reallocates a substantial part of HP and other instalment debt to banking lending. This adjustment rescales the earlier figures to allow comparison across the break in series.

MR. KERR

CONFIDENTIAL

FROM: A M W BATTISHILL
DATE: 11 January 1984

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Bailey
Mr Littler
Mr Cassell
Mr Ridley
Mr Lord
Mr Portillo
Sir Lawrence Airey - IR
Mr A Fraser - C & E

CHEVENING

I attach a paper entitled "The FSBR: Handling the PSBR", which considers inter alia the idea of converting the PSBR path in the MTFS from a financial year to a calendar year basis.

2. An annotated agenda will follow later in the week.

A M W BATTISHILL

CONFIDENTIAL

CONFIDENTIAL

THE FSBR: HANDLING THE PSBR

Note by the Central Unit

This note considers possible ways of dealing with the PSBR figures in the FSBR when the Budget takes place before the PSBR outturn is known.

2. The problem is essentially one of reconciling the need for decisions in February or early March on the fiscal stance for the coming year with the absence until mid-April of firm indications of the PSBR outturn for the year just ending, and an average forecasting error over that short period of some £1 billion or more in recent years. There are two aspects to this. First it is important to have the firmest possible baseline against which to decide the policy stance on the PSBR for the coming year. Second, it can be embarrassing if the outturn for the current year subsequently proves to be substantially different from the Budget estimate, particularly if (as was the case last year) the main cause of the difference is expected to continue to influence subsequent years.

3. In looking at possible new arrangements, we have tried to consider how far they would help to meet these two difficulties, without introducing new problems which do not exist at present. Where necessary, the note also looks briefly at any wider implications of change.

OPTIONS

4. We have looked at the following possibilities:

(a) dropping revised forecast PSBR figures for the current year in favour of firm outturn figures for the first 10 or 11 months only;

(b) converting to calendar year figures for the PSBR:

(c) reducing the information about the PSBR given in the FSBR.

The note concludes with a brief discussion of the prospects of holding the Budget after the PSBR outturn is known in years after 1984.

5. The first of these possibilities - giving an outturn for 10 or 11 months -was looked at in the summer but rejected then by the Chancellor (Mr Norgrove's minute of 9 September and Mr Kerr's of 13 September). We have re-examined the idea but confirm that it should continue to be dismissed. It would be indefensible to publish a forecast for the coming year but not one for a year which was already 10 or 11 twelfths over.

CALENDAR YEAR BASIS

6. The Chancellor asked for this to be examined. In its simplest form, it involves converting the PSBR path in the MTFS from a financial year to a calendar year basis. But given the interlocking fiscal and monetary framework, it would also make sense to move the monetary target periods onto a broadly consistent basis. We look at this further in paragraph 22 below.

7. In looking at the operational possibilities of this kind of approach we have made a number of assumptions. First, the intention is <u>not</u> to change the financial year to the calendar year as such. Nor is it to change the

public expenditure planning year; or the basis period for the annual taxes so that they run from 1 (or 6) January instead of 6 April. Changes of this kind (which have been examined before) would be far more sweeping, and could not be contemplated at all quickly. Indeed, moving the expenditure year and the financial year to the calendar year would defeat the purpose of the exercise if it also meant bringing the Budget forward to November: uncertainty over the PSBR outturn would simply then be moved back four months. The proposition examined here is a more limited one applying to the PSBR path in the MTFS and to the monetary targets, though it is still quite a significant change.

8. It would probably have to work something like this. The MTFS would be re-drawn on a calendar year basis from 1984 onwards. This would mean translating the present financial year forecasts of general Government expenditure, general Government receipts and public sector borrowing into forecasts for calendar years. The fiscal adjustment would also have to be put onto the same basis. Performance against forecast would be judged on the calendar year rather than the financial year figures. Public expenditure planning and control would continue to apply to the financial year, as would decisions on most taxes. But in setting fiscal and monetary policy in the Budget, the main focus would be on the effects over the calendar year already started. And the principal information base would be the calendar year ended on the preceding 31 December.

Operating it in practice

9. There are perhaps three main aspects to this:

(a) the effect on forecasting accuracy;

(b) the effect on the need and scope for in-year action;

(c) less important than the other two, the relationship between the first and second years of the MTFS.

The discussion below assumes that the change from a financial year to a calendar year basis would be made in the 1984 Budget.

(a) **Effect on forecasting accuracy**

10. The annex below sets out past PSBR figures by financial year and by calendar year. The calendar year figures have been more variable than the financial year figures. This greater variability is however partly accounted for by the effects of the Civil Service dispute and figures adjusted for this show a smoother profile.

11. It is not possible to say whether forecasting accuracy would be improved by moving to forecasts of calendar years, whilst maintaining the present financial year for control and accounting purposes. Examination of the past forecasting record is unlikely to provide strong evidence one way or the other, since until recently the quarterly profile has not been given a great deal of attention by ourselves or by Departments. The main emphasis has been on a forecast for the financial year as a whole. Moreover the timing of expenditure within the year could be affected if we moved over to calendar years for forecasting purposes. So the comparison of past calendar year forecasts with outturns would not be a very good guide to the future if we did decide to move over to calendar years as the main focus for the level of borrowing.

12. A priori arguments also lead to no clear conclusions. On the one hand it would help to know the PSBR outturn for 1983 (but only for borrowing itself and not for all the income and expenditure components) in making a

forecast for 1984, as opposed to having to forecast 1984-85 before the 1983-84 outturn is known. At the time of the March 1984 Budget we would also have some figures for the first two months of the next calendar year. On the other hand, the figures for the 1983 outturn would be difficult to interpret because:

- the control mechanisms for expenditure relate to financial years not calendar years;
- we would not know all the components of income and expenditure used in forecasting;
- Christmas and the beginning of the new calendar year would introduce a new source of uncertainty into the end year revenue and expenditure figures (as the latest December CGBR figures suggest).

13. In any event moving to a calendar year focus does not remove the problem of March uncertainty altogether. The kind of end-year surge in expenditure and borrowing last year - representing lower shortfall, not just a timing difference - would still be a problem and indeed, arguably more so, because it would throw out the Budget forecast for the calendar year already under way. The task of forecasting the end year figure should be a little easier to handle with the improvements being made to end-year monitoring, but we do not yet know how effective the new arrangements will prove to be. But to the extent that there is real improvement it will help with the present situation, as well as any new calendar year arrangement.

14. We conclude there is little reason to suggest that a switch to calendar year borrowing figures would lead to a significant improvement in forecasting accuracy. This applies both to expenditure and to revenue

forecasts. There would be some awkward transitional problems in switching the focus of attention from financial years to calendar years, especially if, as seems likely, we should be pressed to publish borrowing figures for both. And some of the snags could well persist (see below).

(b) **The effect on the need and scope for in-year action**

15. Even if a switch to calendar years were to improve forecasting accuracy, it would not be enough in itself to eliminate any possibility of error in forecasts of the PSBR - and sometimes the error could be substantial. But, more important, the effects of the PSBR going wrong could be more pronounced and the problem of corrective action made more difficult.

16. With the Budget in March and the MTFS based on financial years, problems arise first in relation to any significant departure from the forecast for the year just ending. A major difference between forecast and outturn is a source of embarrassment and inevitably tends to undermine confidence in the forecast for the year ahead - and in the Budget judgement. But, as in the spring this year and last, the forecast still retains some credibility. The Budget judgement stood and the Finance Bill was not changed despite the error in the estimate of the outturn for the previous year. The autumn measures in 1982 and last year's July measures were both based on an assessment provided by new forecasts prepared under the usual timetable.

17. With the MTFS - and fiscal policy and the PSBR - related principally to the calendar year, it seems likely that attention (and any potential concern) would focus more, rather than less, sharply on the outturn for the

March quarter of the year. For this would no longer be part of the story of last year: it would be the first instalment of the current year. So any significant departure from forecast in that quarter would have an immediate implication for the overall forecast for the current calendar year and might well increase expectation of early corrective action. The precise effects are difficult to judge; but there must at least be a presumption that the shorter timescale for action would mean that the March outturn would come to hold a greater significance for confidence in the Budget judgement.

18. At the same time, the scope for effective corrective action in the Budget would be reduced. This is because Budget changes could affect tax rates only for the remaining 9 months of the calendar year MTFS period, instead of the 12 months of the financial year, as at present. (The problem would be rather greater because the biggest tax-gathering quarter is the last one of the tax year, and this would of course fall outside the calendar year MTFS period). Such a result is bound to follow if the period applying to the financial path in the MTFS is changed, while that applying to the principal means of achieving that path - variations in tax or public expenditure - remains unchanged. Though, as noted at the outset (paragraph 7 above) without that separation the problem is simply shifted backwards in time.

19. In practice there is a risk either that bigger changes in tax rates or public spending would be needed to correct for divergences from forecast within the calendar year, or that a greater burden of adjustment for current financial conditions would have to fall on monetary policy.

20. This potential difficulty with calendar year PSBRs might be reduced if the Government declined to publish in the FSBR any estimate for the PSBR outturn in the financial year then ending. In that case the Treasury's estimate for the first quarter PSBR could not be calculated. The Industry Act forecast, Part V of the FSBR and probably also the revenue effects of tax changes and the like would in that case similarly all need to be put on a calendar year basis. But the result would not sit easily for example with a PEWP published a few weeks earlier on a financial year basis, and it would be difficult to refuse a request from the Treasury Committee for an estimate of the financial year outturn. Indeed, so long as the Government accounts were on a financial year basis, it is difficult to see how financial year figures could easily be dropped at all.

21. Finally, in this context, a switch to calendar years might tend to increase the importance of the autumn forecast and announcements. With the Budget not taking place until some way into the new MTFS calendar year the autumn PSBR forecast would acquire even greater significance and there could be more pressure to offset a prospective negative fiscal adjustment through changes in NIC. There could also be a temptation to try to validate a particular PSBR figure for the year in progress by adjusting the timing of payments and receipts between December and January.

(c) **The relationship between the first and second years of the MTFS**

22. Under the present system the figures are firm only for the first year of the MTFS; other figures are "indicative". But with a PSBR on calendar years the figure for the second year would not be set until the Budget 2½ months or so after the year had begun. This would not seem to be a

serious problem and could probably be overcome by giving the second year an intermediate status somewhat firmer than the purely indicative figures for later years. Indeed there might be an advantage in this, in that it would represent a further step away from annuality towards a greater emphasis on the medium term.

Implications for the monetary targets

23. It would not make much sense to switch to calendar years for the PSBR without also making a corresponding change to the periods for the monetary targets. Indeed not to do so would seriously weaken the coherence of the MTFS and obscure the connections between monetary and fiscal policy. So we conclude that the monetary target periods would have to be changed, too. The target period would need to run as now for 14 months in order to avoid a gap in the targets between the end of the calendar year and the following Budget. For the coming year, therefore, the target period would run from January 1984 to March 1985.

24. Although there is no necessary connection between this change and switching the monetary statistics from banking to calendar months, it would be tidy if the two changes could be made together. This is unlikely to be possible for the 1984 Budget. But we ought to be in a position to announce our intention to make the switch as from the 1985-86 target period.

Conclusion

25. To construct the MTFS on calendar year PSBR figures appears to provide a firmer base for the Budget and reduce the risk of embarassment when the financial year outturn is substantially different from the Budget

forecast made only a matter of days or weeks before. But we believe these gains would be largely illusory. For unexpected movements in the March PSBR outturn would impact directly on the current calendar year Budget forecast. Arguably the perceived need for corrective action would be greater than now, whilst the scope for it would be reduced (from 12 months to 9). This is a major obstacle to a calendar year solution which, in other respects, is at best no more attractive than present arrangements.

REDUCING PSBR DETAIL IN THE FSBR

26. This is a third option. It assumes that we stick to financial year figures for the PSBR; but try to reduce the potential impact of unexpected differences in outturn.

27. In September (Mr Kerr's minute of 13 September to Mr Norgrove) the Chancellor agreed that the aim should be to minimise the extent to which the estimated outturn is broken down in the FSBR. The Chancellor also said that the FSBR should include a point estimate, but that the Budget speech might try to avoid highlighting the precise figure either by hedging it about a bit or by instead giving a range. The following paragraphs (which need to be read alongside the 1983 FSBR) discuss in more detail how these points might be met on the assumption that financial year PSBR figures are retained.

28. Figures for the outturn year and for the future in the MTFS and IAF are already rounded to the nearest £½ billion. There does not seem to be scope for further rounding or for omitting information from these sections.

29. Part 5, covering details of Public Sector Transactions, has been considerably simplified in the past year or two but may still offer further scope for shortening and rounding.

30. Figures in the text of Part 5 are rounded to the nearest £½ billion, expressed as a fraction. It would be difficult to go beyond that, to round to the nearest £1 billion unless the MTFS figures were rounded to the same degree. But this could be awkward since the change from year to year may sometimes be only £½ billion or less in cash terms.

31. Tables 5.1 to 5.4 are summaries based on table 5.8, and, in turn, provide more detailed analysis of the figures in the MTFS and IAF.

32. Table 5.1 at least probably has to be retained. One option would be to round to the nearest £½ billion rather than, as at present, to the nearest £0.1 billion. But this would look odd for the smaller numbers in the table. It might help instead to emphasise the uncertainties by including a line at the bottom of the table which would explicitly repeat the margin of error on the PSBR, for both estimated outturn and forecast. A footnote would draw attention to the recent EPR article on the track record of PSBR forecasts. There may also be scope, though probably not for the 1984 Budget, to set out the margins of error on the components.

33. Tables 5.2 to 5.4 would be easier to drop than table 5.1, but to do so would not help to reduce embarrassment if the PSBR turned out differently from forecast; and it would attract criticism. Alternatively, the components of these tables could perhaps be taken into an expanded

table 5.1, showing for central government, local authorities and public corporations the totals of expenditure and revenue, but without all the detail. Again, there seems little to commend this: the totals for expenditure and revenue have little meaning without a statement of how they are derived. And we conclude that there is quite a good case for keeping these three tables as they are.

34. Table 5.5 was introduced in 1982 and has been generally welcomed. The TCSC and Procedure Committee were specially pleased with it. Its emphasis is on where the money comes from and where it goes, in a way designed to show relative magnitudes. There seems to be no harm in leaving this too as it is.

35. Any role it has in adding to the PSBR problem could however be reduced by incorporating it in a new section in the FSBR devoted to public expenditure. This could take account of any new decisions on public expenditure in the Budget; and update, as necessary, the White Paper figures. The section might also take in paragraphs 4.19 to 4.24, 5.15 to 5.18, 5.21, 5.22 and tables 5.6, 5.7 and 5.10 (which could well be rounded to the nearest £0.1 billion). The present Part 5 (probably to become Part 6) would then be left to express expenditure and income only in terms of national accounts and central funds and accounts.

36. The ability to provide detailed further analysis of any Budget expenditure decisions depends on how early such decisions are taken. But there may in any case be enough material scattered around the FSBR to provide the basis for a separate expenditure section. The first draft of the

FSBR could include a section on these lines if the Chancellor wishes. If it does not work in practice it would be easy enough to go back later to the 1983 format.

37. Next there are tables 5.8 to 5.12. These are very detailed, and of interest only to the most expert. One possibility would be to drop all or some of them from the FSBR, though in that case it would probably be necessary to provide them on request. On the other hand, this would be likely to arouse suspicion and lead to even more concentration on the detailed figures than if they were published as usual. Another possibility would be to round the figures in general to the nearest £0.1 billion, subject to a review of whether any of the more detailed figures are needed for reporting purposes during the year. Rounding in this way would be helpful. It would markedly change the appearance of the tables and reduce the detail.

38. Finally, the Budget speech could emphasise the uncertainties even more strongly than usual, stating the margins of error. This would probably be better than stating a range, which could complicate the presentation of the decisions on the PSBR path.

FUTURE YEARS

39. The obstacle to a Budget in April this year is the date of Easter, April 22. To wait for the 1983-84 PSBR outturn means deferring the Budget until 17th April; but it is not then possible to complete the Budget debates before the Easter recess. For the next few years Easter falls as follows:

1985 April 7

1986 March 30

1987 April 19

1988 April 3

1989 March 26

In 1985 the first estimate of the PSBR outturn should be available by Friday 12 April, and might perhaps be brought forward a day or two although the figures would be less firm. Budget Day might then be on Tuesday 16 April assuming the Easter recess ends before then as seems likely. Or it might be on 23 April to give more time to take the PSBR outturn into account. The Budget could be a few days earlier than that in 1986, 1988 and 1989, though an April Budget is probably not possible in 1987 for the same reasons that prevent it this year.

40. A later Budget is not, of course, wholly advantageous. The main advantage is that the PSBR outturn would be known before final Budget decisions are taken. The main disadvantages would be the loss of time for the Parliamentary stages of the Finance Bill (though there would be longer to draft the Bill) and the loss of revenue from the excise duties. (5 per cent revalorisation of these this year brings in a little over £10 million per week.) An immediate post-Easter Budget also has implications for work over the Easter period.

41. Nevertheless, in principle, it looks as though the Chancellor need not be constrained to an early Budget, if he prefers a later date, for 4 of the next 5 years. For next year the options can be considered in more detail when the timetable to the 1985 Budget is drawn up.

11 January 1984

PSBR Figures

	£ billion		% GDP			£ billion		% GDP
1978-79	9.2		5½		1978	8.3		5
1979-80	9.9		4¾		1979	12.6		6½
1980-81	13.2	(12.6)	5¾ (5½)		1980	12.2		5¼
1981-82	8.8	(8.2)	3½ (3¼)		1981	10.8	(7.8)	4¼ (3)
1982-83	9.2	(9.7)	3¼ (3½)		1982	5.5	(7.7)	2 (2¾)
1983-84*	10		3¼		1983+	12		4

Figures in brackets are adjusted for the direct revenue effects of the Civil Service dispute

*Autumn Statement figures

+Q4 forecast, Q1-3 actual

CONFIDENTIAL

FROM: A M W BATTISHILL
DATE: 12 January 1984

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Littler
Mr Cassell
Mr Kerr
Mr Ridley
Mr Lord
Mr Portillo

Sir Lawrence Airey, IR
Mr A M Fraser, C & E

CHEVENING

I attach a suggested annotated agenda for the weekend discussions at Chevening covering the papers already circulated.

A M W BATTISHILL

CONFIDENTIAL

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CHEVENING; 14, 15 JANUARY 1984

Papers and Agenda

Papers

1.	Policy Background to the MTFS	:	Sir Terence Burns
2.	Personal Borrowing	:	Mr Cassell
3.	The FSBR: handling the PSBR	:	Mr Battishill
4.	Tax Issues	:	Mr Cassell
5.	Assets, public expenditure, and borrowing	:	Mr Bailey and Sir Terence Burns
6.	Additional material on public expenditure	:	To follow

[Also relevant: Personal taxation: Background to Budget decisions: Mr Monger (22.12.83)
Financial Statement and Budget Report 1983-84
Autumn Statement 1983; Part 1 of the draft 1984 Public Expenditure White Paper]

Agenda

SATURDAY 14 January

1. MACRO-ECONOMIC STRATEGY AND THE MTFS

[references are to paper 1 except where otherwise specified]

(a) Policy background: paragraphs 1-20 review policy and performance since 1980. Is this accepted? Any points arising?

(b) MTFS period - paragraphs 21-28

(i) Is it agreed that the MTFS should continue to be based on financial years rather than changed to calendar years? [Paper 3: paragraphs 6-25]

(ii) For what period should the MTFS be rolled forward - by one year (to 1986-87), two years (to 1987-88) or three years (to 1988-89)?

The 1980 MTFS covered four years, those in 1981-83 covered only three years. The main considerations are the impact on expectations and the effects on future freedom of manoeuvre. The greater difficulty of making realistic assumptions (and their relationship to any public expenditure exercise) for later years needs to be taken into account. Also:

(iii) Are the implications likely to be acceptable when the MTFS is rolled forward next year, and in later years (paragraph 27)?

Note that the MTFS even if covering five years in 1984 could be shortened for later years, as in the last Parliament. No.

(c) Medium term outlook. (paragraphs 29-39). Although the split of money GDP between output and inflation cannot be pre-determined by Government, the MTFS objectives must reflect the potential performance of the economy. Over the next 4-5 years, without any major change in policies, is it reasonable to expect

(i) inflation on average to continue to fall gently from 5 per cent?

(ii) better output growth than in the 1970s but not necessarily as high as most recently?

(iii) growth in productivity and productive potential to decelerate a bit?

(iv) some labour market adjustment on productivity and wages, with some fall in unemployment?

(d) Medium term objectives. (paragraphs 40-46). The Mansion House Speech provides the starting point. It is now necessary to consider particular numbers that can be published as assumptions about medium-term developments.

(i) On inflation is it enough to aim for something less than price stability in 4-5 years time; or should there be a tougher (or easier) objective?

(ii) Are the likely implications for output and employment acceptable?

(iii) Is it reasonable to look forward to a fall in money GDP from about 8 per cent to 5-6 per cent over the period (subject to periodic review)?

(e) Money (pargraphs 47-53 and tables on pages 22 and 23). Firm decisions cannot yet be taken, but a decision of likely trends in velocity over the short and medium term can indicate the sort of monetary paths likely to be consistent with the policy objectives. In particular:

(i) Broad money. What are the considerations bearing on the 1984-85 target? Do those tend still to point towards lowering the target as in the MTFS? Or are there reasons for deferring a move down to 6-10 per cent. Is the broad shape of the path suggested in paragraph 50 satisfactory?

(ii) Narrow money. Presumably there should be a lower range than for broad money? Should the target range decline more slowly than that for broad money to reflect the expected behaviour of velocity? Does a lower growth rate argue for a narrower range or is it safer to keep a 4 per cent band? Is the broad shape of the path suggested in paragraph 53 satisfactory?

(iii) Personal borrowing. Are the conclusions of paper 2 on personal borrowing acceptable? Are any steps necessary to restrict personal borrowing - December bank lending figures were on high side?

(iv) Next steps after Chevening? Need for note on more detailed monetary issues? [Timetable assumes first draft MTFS first week of February.]

(f) PSBR (paragraphs 54-77). The discussion needs to separate the medium-term PSBR target from the speed of adjustment towards it.

(i) Medium term objective: considerations include:

- the need to reduce real interest rates
- whether the downward trend in the ratio of public sector debt to money GDP will continue and, if so, at what rate
- the low level of net capital expenditure, resulting in part from the higher level of asset sales
- the fact that North Sea revenues are near their peak
- the rise in future pension commitments

What weight should be given to these factors?

(ii) Speed of adjustment: considerations here include

- the stage of the cycle
- the lags in the response of money GDP and inflation to fiscal policy
- the pattern of North Sea oil revenues
- the pattern of asset sales

- the room for manoeuvre on fiscal policy in the next two years.

Note paragraphs 74-77, including the table on page 29.

(g) Implications for 1984-85

There are a number of issues:

(i) Firm decisions on next year's PSBR must await the forecast. But, for immediate working purposes, is it reasonable to assume no scope for net tax cuts next year?

(ii) The Autumn forecast suggested a small negative fiscal adjustment for 1984-85 with a significant positive adjustment in 1985-86. Is it more sensible to look at 1984-85 and 1985-86 together?

(iii) What does this mean for the likely general shape of the Budget? And for the balance between tax increases and tax reductions? And for the balance between the personal and business sectors?

2. TAX ISSUES

[references are to paper 4]

A Income tax (paragraph 5)

(a) Is the priority to increase tax thresholds? Should indexation be regarded as an overriding minimum requirement? Should we aim in the Budget arithmetic at a target increase above indexation? If so, what might that be?

(b) Should the increase in personal allownces also apply equally to

(a) all allowances (including the elderly)

(b) higher rate bands

or would differential increases be possible? Are there more complicated packages related to the interaction of NIC and income tax which should be looked at?

(c) What priority should be given to raising the Investment Income Surchrage threshold this year? Nil.

(d) What about child benefit? Because of the distributional implications should decisions on CB uprating be considered alongside those on personal allowances? If so, how should this be taken forward?

B **Corporation Tax and NIS** (paragraphs 7 and 10-14)

(a) Is a reduction this year in (i) the main corporation tax rate (ii) the small companies rate a high priority? (This needs to be considered alongside structural changes - below)?

(b) Is abolition (or reduction) of NIS a high priority this year?

C **Are there other direct tax candidates for relief next year?**

(a) a reduction in stamp duty on equities financed by ending the exemption of gilts from stamp duty and CGT (paragraphs 19-21)?

(b) Share options?

(c) Mortgage interest ceiling?

(d) Capital taxes?

(e) Others?

D **Specific duties** (Annex 3)

(a) Are these to be increased at least in line with inflation? Is it possible to consider doing more than indexation? Across the board, or for particular duties?

(b) What about the Community wine: beer problem. How is that to be approached?

(c) What about the future of VED?

E **VAT etc**

What is the scope for raising extra revenue from:

- extending the VAT base (paragraphs 27-32);
- ending the postponed accounting system for VAT on imports;
- imposing a licence duty on personal credit (paragraph 18);
- any other changes?

What are the main constraints?

- RPI effects: how much could we stand this year?
- effects on business; balance between services and manufacturing?
- staffing considerations?

- practicability for 1984-85?

F Tax reform

Could and should "tax reform" be adopted as a major theme for the Budget? A number of issues already under consideration: composite rate for banks; changes in building society taxation (paragraphs 16-17). Beyond these what should be the other priority areas for tax reform?

(a) Company taxation: do we proceed with the stock relief and capital allowances package (paragraphs 7 and 10-14)? If so:

(i) on the basis proposed by the Financial Secretary?

(ii) what if anything should be said about reducing CT rates in later years?

(iii) is it better to compensate companies by reducing CT rates or abolishing NIS, if the resources are not available to achieve both?

(iv) how explicit should the Government be at this stage about its longer-term intentions for company and reform?

(v) how can the problems of gainers and losers (eg much of manufacturing industry, unincorporated businesses and leasing operations) be overcome? Do they matter?

(b) pensions and life assurance (paragraphs 22-26): work is in hand on taxing lump sums and pensions funds' investment income; and various changes in the treatment of qualifying life assurance policies:

(i) How is this work going?

(ii) Are there possibilities for action this year? With what kind of revenue consequences (presumably not for 1984-85)?

(iii) On pensions, does Mr Fowler's review preclude early action?

(c) North Sea (paragraph 15): is it right to rule out any further structural changes in the North Sea regime at this stage (beyond limited action on "farmouts")

(d) VAT (paragraphs 27-32): Should the longer term aim be to extend the VAT base even further? By applying a reduced rate to some (or all) remaining zero-rated items? Are there any clear "no-go" areas?

G **Next Steps**

(a) How should we proceed on outstanding items?

(b) Would it be now sensible to draw up a programme of meetings, with papers, for the next month?

(c) The timetable envisages a Budget speech outline by 3 February; and the first draft of the speech by 17 February. Is this confirmed?

(d) Consultations with other Ministers?

(e) Are the suggestions in paper 3 (paragraphs 26-38) for trying out a new expenditure section in the FSBR and for more extensive use of rounding acceptable?

(f) Any other issues?

SUNDAY 15 JANUARY

3. ASSETS, PUBLIC EXPENDITURE AND BORROWING

[references are to paper 5]

The central issue here is about the implications of public expenditure capital transations for appropriate levels of public sector borrowing. Issues for discussion are:

(a) Is it right to consider decisions to undertake public sector investment separately from decisions about how it is to be financed? Is the analysis in paragraphs 4 and 5 agreed?

(b) Is it agreed that micro-economic arguments in paragraph 6 point to a "target" level of public borrowing which allows for the net acquisition of assets? If so is there any dissent from the conclusions in paragraph 7?

(c) Decisions on the PSBR need also to reflect wider policy objectives for interest rates, money GDP and money supply. These will not necessarily point to the same level of PSBR in every case. How far, therefore, should the conclusions in paragraph 7 be modified by the macro economic arguments in paragraphs 12-14. In particular is it agreed that:

- the essential choice is between higher interest rates and higher taxes;

- that in financing one-off capital projects the general presumption might be in favour of some higher borrowing (and higher interest rates) rather than higher taxes;
- in the case of a change in trend in public expenditure the analysis needs also to consider the reasons for the change;
- there is a potential difference between financing transactions in existing assets and investment in new assets (since purchase of existing assets does not necessarily put pressure on interest rates);
- the closer substitutes the assets are for gilts the smaller the effect on interest rates (for any given nominal framework).

(d) Should the target for the PSBR be adjusted to take account of movement in asset sales (paragraph 19)? To what extent should any additional adjustment be made for fluctuations in other net capital expenditure (paragraph 20)?

(e) Should the public expenditure planning total be adjusted to exclude

- special sales of assets?
- other capital transactions?

or (for the reasons in paragraph 23) left as it is?

[Additional material to follow on public expenditure]

FROM: HUW EVANS
24 February 1984

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr Bailey
Sir T Burns
Mr Littler
Mr Anson
Mr Cassell
Mr Monck
Mr Battishill
Mr Lankester
Mr Monger
Mr Odling-Smee
Mr Scholar
Mr Riley
Mr Shields
Mr Stibbard
Mr Ridley
Mr M Hall
Mr Lord
Mr Portillo
Mr Norgrove
Miss Roach

Sir L Airey - I/Rev
Mr Fraser - C & E

PSBR FORECASTS

We have now reviewed the forecast of the PSBR, taking account of the latest information.

The PSBR in 1983-84

2. GEP have now received an excellent response to the new F10 expenditure returns, designed to provide additional information on the outturn for spending by departments. We have taken these returns, with only very minor amendments, into the forecast. The result is a figure for total Supply expenditure of £86.7 billion, about £½ billion lower than in the January forecast. Almost half of the reduction was social security; the remainder was spread over many Votes. (The most recent February monthly note on the PSBR incorporated much of this reduction.) Other changes since the January forecast include higher Inland Revenue receipts, mainly corporation tax and income tax. There have been no further changes

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on local authorities or public corporations for this year. The results of the two CIPFA surveys, on local authority spending and borrowing, are of questionable quality. After careful interpretation we have concluded they are broadly in line with our own expectations.

3. The net effect is to reduce our estimate of the PSBR by £½ billion this year. The details are as follows:

	£ billion			
	PSBR	Made up of:		
		CGBR(O)	LABR	PCBR
April-January (estimated outturn)	7.5	6.4	0.6	0.4
February-March (forecast)	1.9	1.1	0.7	0.2
1983-84 Financial year total	9.4	7.5	1.3	0.6

4. In the FSBR a precise number (rounded to the nearest £0.1 billion) will be shown in the tables in Parts 5 and 6; but a rounded number in the text and in Parts 2 and 3 (and in the Speech).

5. There are the usual uncertainties for 1983-84: in particular end-year spending by departments, and end-year borrowing by local authorities. As presently drafted Part 3 of the FSBR, table 9, shows (for the first time) an average error from past forecasts equivalent to £1 billion, or ¼ per cent of GDP. This figure emerged from the analysis of budget forecasts since 1967-68 published in the September 1983 EPR. You will recall that in both March 1982 and March 1983 the budget forecasts of the PSBR for the year just finishing had (above average) errors of, respectively, £1.8 billion and £1.7 billion (in opposite directions). The lessons learned from analysis of these errors, and additional information being gathered this year, should reduce the chances of such errors; but there is inevitably a sizeable margin of uncertainty about borrowing in March. There are also problems with

the provisional estimates of public corporations' borrowing so far this year which contribute to the uncertainty of the full-year estimate.

6. The figure of £9.4 billion continues to assume that the PSBR benefits from the £½ billion EC refund by 31 March, even though this now looks very unlikely. An error attributable to this assumption being wrong, while easily defensible on its own, could (if the error on the rest of the PSBR went the same way) compound the total error.

7. In coming to a view on the 1983-84 PSBR you will wish to take into account:- our latest central forecast; the margin of uncertainty; the strong probability of the EC refund not being received before 31 March - and whether you prefer to take risks on the side of the published estimate being shown to be too high (or the reverse). There are arguments for not changing the forecast of £10 billion published in the Autumn Statement. The likelihood that we will not get the £½ billion EC refund tends to reinforce the arguments. But we assume that in any case you will want us to include in the detailed tables the EC refund within the current financial year. A provisional estimate for 1983-84 will be published on April 17.

The PSBR in 1984-85

8. The pre-budget forecast of the PSBR, with indexation but no fiscal adjustment, was £6.9 billion (new definition). On the basis of the latest package with a net PSBR cost in 1984-85 of £0.1 billion, our forecast of the 1984-85 PSBR is only a little changed, at £7¼ billion.

9. Within this total, and before taking account of the effects of the budget, central government tax revenues have been revised up since the January forecast:

(i) £0.3 billion more on income tax, partly reflecting higher receipts in 1983-84.

(ii) £0.25 billion more on PRT, because of higher oil production and prices.

(iii) £75 million more on Capital Gains Tax from the Furness v Dawson case (the remainder benefiting later years).

(iv) £80 million more stamp duty, reflecting a higher forecast of land and stock market prices.

(v) Nothing from the change in the tax treatment of building societies on the assumption that they will appeal and that the receipts will not reach the exchequer until 1985-86.

10. Offsetting this, we now think local authority borrowing will be higher in 1984-85 with rates rising more slowly, as a result of reviewing the likely effects of legislative changes. Limited information suggests that rate increases in April 1984 will be a little lower than previously anticipated. In addition, debt interest payments have been revised up (not reflecting any change in interest rates).

11. The main uncertainties on 1984-85 include:

(i) Asset sales. We continue to assume £1.9 billion. If BT and BA are sold, then the total will almost certainly be higher, probably by around £½ billion. If they are not sold, the total will be less.

(ii) EC refunds. We continue to make the conventional assumption of a two-thirds EC refund.

(iii) The impact of legislation on local authority borrowing is highly uncertain; as is the outcome for rate increases.

(iv) Corporation tax receipts are forecast to rise rapidly as a result of the big rise in profits in 1983. The scale of the rise is uncertain (though less than for later years).

(v) The precise level of public spending is very difficult to forecast: in this forecast a planning total is emerging a little lower than in the White Paper (by perhaps £¼-½ billion), implying a similar underspend on the reserve

Margins of error

12. Over the sixteen-year period 1982-83, the average error on PSBR forecasts at budget time was 1.4 per cent of GDP (see September EPR for details). In 1984-85 this is equivalent to £4½ billion, the figure shown in table 9 in the draft Part 3 of the PSBR.

13. But as the EPR article also showed, years after 1977-78 (and before 1974-75) displayed smaller errors, averaging 0.9 per cent, equivalent to £3 billion in 1984-85. Given the more settled economic climate (especially for inflation) compared with the mid seventies, and the greater efforts now being put into PSBR measurement, monitoring and forecasting, the £3 billion average error is probably a better yardstick.

14. One implication is that, if we are now right about the estimated outturn, the error in 1983-84, after allowing for the July 7 measures, was not far from average. Another implication is that, with a central forecast of £7¼ billion for 1984-85, even an average error could take us to one end of (or outside) the £5-10 billion range.

15. In the FSBR we quote figures of up to £200 billion for the flows on either side of the public sector account. This is made up of the planning total (£126 billion); debt interest (£15 billion); and costs and capital expenditure of public corporations (£50-60 billion). Thus a 1 per cent error on one side of the accounts alone can be worth up to £2 billion.

16. In coming to a view on the PSBR for 1984-85 you will want to take account of our central forecast, of the general margin of uncertainty, of the particular risks identified including the likelihood that asset sales will be higher than expected and of the possibility and desirability of making in-year corrections.

17. On the basis of our central forecast the past, present and forecast PSBR trends would be as follows:

PSBR, £ billions (per cent of GDP in brackets)

	Outturns/ Forecast	Average errors quoted in FSBR, Part 3
1980-81	13.1 (5.6)	
1981-82	8.8 (3.4)	
1982-83	9.2 (3.3)	
1983-84	9.4 (3.1)	1 ($\frac{1}{4}$)
1984-85	7.25 ($2\frac{1}{4}$)	$4\frac{1}{2}$ ($1\frac{1}{2}$)
1985-86	7 (2)	-

18. For 1984-85, a PSBR of $2\frac{1}{4}$ per cent of GDP is equivalent to £7.3 billion precisely; or to anywhere in the range £6.9-7.7 billion.

Further revisions

19. A limited amount of further information will become available before the budget and FSBR are finalised:

(i) further returns from departments who choose to update their FIO returns (GEP are taking in information up until 2 March).

(ii) February CGBR, available in aggregate on 2 March. (The first news of the February PSBR as a whole is due on 9 March, too late to be of much use; the figures will be published on 16 March, three days after the budget).

In addition analyses of budgetary measures and the forecast will continue. All this could yield changes to this year and perhaps to next. If there are clear reasons for making a change we will advise you. But it would be best to regard the present estimates of the overall PSBR numbers as the basis for final decisions, and, probably, for publication. Then, within the broad constraints of an overall PSBR for both years, further work can continue on improving the estimates for individual items.

HPE

H P EVANS

BUDGET SECRET

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FROM: COLIN MOWL
DATE: 27 February 1984

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns —
Mr Littler
Mr Bailey
Mr Cassell
Mr Evans
Mr Battishill
Mr Odling-Smee
Mr Sedgwick
Mr Lankester
Mrs Lomax
Mr Riley
Mr Shields
Mr Ridley
Mr Lord
Mr Portillo

PROVISIONAL POST-BUDGET FINANCIAL FORECAST

We have taken another look at the Financial Forecast in light of later information and the proposed Budget measures. A note describing our latest thinking is attached. The forecast is based on the PSBR figures in Mr Evans' note of 24 February. The general message is of little change since the forecast reported at the end of January, although forecasts of overfunding have been increased and new money market assistance could still be over £1 billion a year.

Colin Mowl

COLIN MOWL

BUDGET SECRET

PROVISIONAL POST-BUDGET FINANCIAL FORECAST

Although most of the key numbers for the economic forecast to be published in the FSBR are fairly firm, the internal forecasting process is not yet complete. New information is still coming in and we are still in the process of absorbing the financial implications of the latest forecast of the PSBR (Mr Evans's minute of 24 February on PSBR Forecasts). This note gives, therefore, only a provisional assessment of the post-Budget financial forecast. Compared with the January forecast it takes into account subsequent decisions on fiscal and monetary policy, the latest view of the "underlying" PSBR, new monetary data for the last two calendar quarters of 1983 and for banking January.

The January Forecast

2. The financial outlook as portrayed by the January forecast can be summarised as follows. Against a background of little change in the current account and no major imbalance on capital account the exchange rate was expected to remain steady. This, together with better progress on inflation than expected by most outside forecasters, provided the environment for the small fall projected for nominal interest rates, of the order of one point through 1984-85. This was thought to be consistent with £M3 growth in 1984-85 of 9 per cent, following 11 per cent in 1983-84. PSL2 was forecast to grow 1 per cent faster than £M3 in both 1984-85 and 1985-86. The M0 forecast was 6½ per cent for 1984-85 and 6 per cent for 1985-86.

3. The forecast envisaged further increases of just over £1 billion in the outstanding stock of money market assistance in both 1984-85 and 1985-86. Overfunding of £½ billion was implied for 1984-85, although net sales of gilts to the non-bank private sector were expected to fall from £9¾ billion in 1983-84 to £6 billion in 1984-85.

Summary of the Post-Budget Outlook

4. The outlook for the next two financial years, as we now see it, is little different from January. The forecast of those non-financial factors, such as real expenditure, inflation and the current account, which are important influences on the financial variables has changed very little. Compared with the January forecast, however, the PSBR is now lower this year, and in 1984-85 and 1985-86. The PSBR is £¾ billion lower in 1984-85 mainly bacause the Budget is broadly revenue neutral, whereas the January forecast assumed tax cuts of £1 billion. The lower PSBR and a higher national savings target than previously assumed both reduce £M3, other things being equal. As usual, however, there are partially offsetting effects in the form of higher bank lending and lower debt sales, some of which are associated with Budget measures, primarily PAS and the corporate tax package. In addition we have changed our view of local authority debt sales since January. The net effect is that £M3 growth in 1984-85 is still put at 9%, the same as in the January forecast, and 8% in 1985-86. The latest forecast of the main aggregates is shown in the table below. M0 is now forecast to rise slightly less than in January. The forecast of PSL2 growth relative to £M3, on the other hand, has been revised upwards.

Monetary Aggregates Growth Rates (Target period at annual rate)

	M0	M2	Narrow Target Range	£M3	PSL2	Broad Target Range
1983-84	5½	10½	-	10½	12½	7-11
1984-85	6¼	10	4-8	9	10½	6-10
1985-86	5¼	9	3-7	8	9½	5-9

5. Our view is that because M0 and £M3 are forecast to be within their target ranges, and because our forecast of other indicators of monetary conditions such as the exchange rate and inflation do not indicate any easing, the overall picture is still consistent with a small fall in interest rates, despite PSL2 growth above the top of the broad range. This is subject to the qualification that

new money market assistance is forecast at over £1 billion a year, the same as in the January forecast. The forecast now also incorporates rather more overfunding but it would be difficult to eliminate this without lower long rates and faster £M3 growth.

Budget Effects

6. As well as taking account of the implications of the Budget for the economy as a whole and the PSBR, the financial forecast also allows for the direct effects of the Budget on the financial system, as discussed in Mr Cassell's note of 24 February (The Effects of the Budget on the Financial Sector). The quantitatively most important of these measures are the composite rate for the banks, life assurance premium relief, the corporate tax package, PAS and NIS.

7. We have assumed that the direct effect of the introduction of the composite rate for the banks is to divert deposits from the banks to other financial institutions, primarily the building societies, to the tune of £½ billion in 1984-85 and £1 billion in 1985-86. The effect of this at unchanged interest rates is to boost PSL2 relative to £M3 - it should be noted however that the absolute effect on £M3 is very small relative to the direct outflow from bank deposits because much of the money transferred to building societies is re-lent to the private sector through mortgages. Ultimately funds only leak out of the private sector, and therefore out of £M3, to the extent that there are more purchases of public sector debt, either by individuals or building societies, or less bank lending. The forecast assumes that while banks do not increase interest rates on bank loans as a result of this measure, building societies reduce their deposit rates slightly in 1985-86, compared with what otherwise would have happened, as a result of higher net receipts.

8. The loss of new business by life assurance companies due to abolition of premium relief is assumed to be £250 million in 1984-85 and £800 million in 1985-86. While this will reduce these institutions' purchases of gilts, possibly by £250 million in 1985-86, individuals and other institutions will increase their purchases and the net effect is a small fall, which only partially offsets the effect of the lower

PSBR on £M3.

9. The main direct effect on the financial system over the next two years of the other measures mentioned in paragraph 6 is on bank lending. Companies are assumed to finance £400 million of the additional £1200 million of VAT payments associated with abolition of PAS from higher bank lending. The corporate tax package is also expected to increase bank lending, primarily to finance pre-payment of investment goods bought overseas. This effect is now put at £500 million, rather higher than the one in Mr Cassell's note on financial institutions. Abolition of NIS, on the other hand, tends to reduce bank borrowing by companies. The net effect on bank borrowing of these three measures may be to increase it in 1984-85 by £700 million (¾ per cent of the private sector's outstanding £ borrowing from banks), other things being equal.

The Exchange Rate and Interest Rates

10. The table below sets out our latest view of interest and exchange rates.

	£/Dollar Rate	Effective Exchange Rate	Eurodollar Interest Rate	World Basket Interest Rate	UK 3 Month Interest Rate	UK 20 Year Gilt Interest Rate
1983-84	1.50	83.7	9.8	9.3	9.7	10.5
1984-85	1.52	83.5	10.0	8.6	8.7	9.3
1985-86	1.64	83.4	10.6	8.2	7.8	8.7

11. Little has happened since January to change our view of the effective exchange rate, which has strengthened slightly over the last week. UK 3 month interest rates are currently just under 9½ and 20 year rates just below 10½. The annual averages in the table imply a fall of just over one point in short rates over the next year. Despite the projected fall, nominal interest rates at the end of 1985-86 are still expected to be, at the short end, 3½ points above, and at the long end, 4½ points above the rate of inflation.

£M3 and its Counterparts

12. The table below summarises the post-Budget Forecast of £M3 and its counterparts.

£ billion	1983-84	1984-85	1985-86
PSBR	9.4	7.3*	7.0*
Net sales of public sector debt to non-bank private sector			
(a) Gilts	9.8	6.0	5.3
(b) National Savings	3.1	3.5	3.5
(c) Other	-2.1	-1.1	-0.6
Changes in £ bank lending to the private sector	13.9	14.6	14.4
Net external adjustments	-0.7	-1.6	-1.9
Increase (-) in net non-deposit liabilities	-2.9	-2.4	-2.2
Change in £M3	8.9	9.4*	9.1*
(a) financial year (%)	9.1	9.0*	7.9*
(b) target period (%)	10.4	9.0*	7.9*

* New definition of the PSBR and £M3

13. As always, there is a wide margin of error surrounding these forecasts. On the figure shown in the table for the PSBR in 1983-84 it looks as if the prospective £M3 growth in the current target period is slightly below the top of the target range. However there can be large differences between calendar quarter and banking month data, and we can adjust only approximately our calendar quarter/financial year forecast on to a target period/banking month basis. A firm assessment of monetary growth in the current target period is best left therefore until the next monthly forecast.

14. As in the January forecast we are projecting gilt sales to the non-bank private sector of £6 billion in 1984-85, a long way below the 1983-84 level of nearly £10 billion. Our forecasts of private sector financial wealth and the relative rates of return on money and gilts have changed little since January. We are now assuming, however, larger inflows into national savings, £3½ billion compared with £3 billion. Sales of other public sector debt are expected to be negative because local authorities are switching to borrowing from the central government, instead of from the market. Since January we have increased our estimate of the extent to which this occurs, offsetting the effect of higher national savings on money.

15. Our forecast of bank lending has been revised upwards since January mainly on account of Budget effects discussed earlier. Our current forecast of lending by sector is shown below.

Bank Lending in Sterling to Private Sector - £ billion

	House Purchase	Other Personal Borrowing	Industrial and Commercial Companies	Other Financial Institutions	Total
1983-84	3.5	5.4	2.3	2.7	13.9
1984-85	3.6	5.2	4.1	1.8	14.6
1985-86	3.6	5.0	4.2	1.6	14.4

The Building Societies

16. Building societies' liabilities form a large proportion of M2 and PSL2. The societies have been competing aggressively for funds recently and will also receive money diverted from the banks as a result of the introduction of the composite rate for the banks. Our forecast is summarised in the table below:

	Recommended Interest Rates		Net Receipts*	Advances	
				Gross	Net
	Net Share	Mortgage	£ billion	£ billion	
1983-84	7.0	11.0	12.1	19.4	11.1
1984-85	6.9	10.9	11.4	22.2	12.5
1985-86	5.8	9.4	11.0	22.4	11.7

*excludes wholesale money

This assumes that the mortgage rate is reduced by ½% in July, ¼% less than we previously assumed because of the narrowing of the societies' margins as a result of the changed tax treatment of their profit on gilts. We have now also allowed for a larger cut in their interest rates in general in 1985-86 due to the introduction of the composite rate on the banks. Despite only a modest cut in building society interest rates in 1983 and some rundown in liquidity we think that the societies' inflow will not be large enough to sustain gross lending of £23 billion in 1983, the figure the BSA have recently been talking about.

M2 and PSL2

17. As emphasised in earlier papers we are not in a position to make a properly considered forecast of M2. This part of the forecast should be treated with particular caution therefore. We assume that 60% of building society inflows count as M2. The numbers for M2 below are slightly different from those in Mr Johnston's note on M2 of 22 February but the broad picture is unchanged.

% Change over Target Periods

	M2	PSL2
1983-84	10½	12½
1984-85	10	10½
1985-86	9	9½

Money Market Assistance and Overfunding

18. Our forecast of money market assistance and overfunding is given below.

£ billion

	1983-84	1984-85	1985-86
Overfunding	1.6	1.2	1.3
Market Assistance	3.0	1.1	1.7

Overfunding is now expected to be higher than envisaged in the January Forecast mainly because the PSBR is lower. The market assistance forecast is slightly lower for 1984-85 but up over £½ billion in 1985-86.

LK45

BUDGET SECRET

AS9

FROM: A M BAILEY
DATE: 29 February 1984

CHIEF SECRETARY

cc PPS
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Littler
Mr Cassell
Mr Evans
Mr Odling-Smee
Mr Monger
Mr Scholar
Mr Ridley
Mr Battishill
Mr Norgrove
Mr Hall
Mr Riley
Mr Stibbard
Mr Shields
Mr Collinson
Mr Martin

PUBLIC EXPENDITURE IN THE FSBR

Your main question (Mr Gieve's minute of 28 February) relates to the run of cost-terms figures for public expenditure shown in table 5.6 of the draft FSBR.

2. Table A attached shows a revised version of this, discussed with GEP and the forecasters. You will see that the profile is now a good deal flatter, anyway for forward years, though it does not altogether avoid the presentational problem. There are a number of points to make:

i. The table is not necessarily our final view - some marginal changes to the figures might still be needed, and in particular Sir T Burns will be submitting to the Chancellor tomorrow his recommendations on the PSBR figures in the MTFS, which will have to be reconciled with the figures for public expenditure and taxation. But in agreeing on this table we have taken account of the Chancellor's PSBR preferences as so far expressed.

1759/2

ii. For 1983-84, the forecasters now expect about £½ billion of shortfall below the White Paper planning total of £120.3 billion, in the light of the latest monitoring returns. You will remember that departments have been asked to make a special effort to provide reliable up-to-date forecasts for end-year out-turn on supply, which are published in detail in your memorandum on Budget Day. So we must take the results seriously; it would be particularly embarrassing to ignore them, stick to the White Paper figure and then be shown in a few months time to have been £½ billion too high for no respectable reason. However, the Chancellor will probably want to show a PSBR figure of £10 billion, as against a current "realistic" expectation of £9.4 billion (excluding any slippage of EC receipts, which cannot be acknowledged publicly), consistent with the present public expenditure forecast. This PSBR figure could if necessary be reconciled on the tax side. But in the table we have added back £0.2 billion to the 1983-84 public expenditure total to give the figure of £120.0 billion, and suggest that this adjustment could be absorbed somewhere outside the supply figures. This increase also, of course, helps the cost terms profile.

iii. There is a similar reduction of £½ billion in the forecasters' latest view of the planning total for 1984-85. It reflects a number of marginal changes to demand-led and other programmes (social security benefits, nationalised industries, local authorities) since the latest forecast; plus the NIS change. On past precedent, it is clearly right to deduct the NIS change for all years, and this accounts for the reductions below White Paper totals for all forward years shown in the FSBR line of Table A. It will be shown separately in the FSBR for 1984-85, (ie no change in the Reserve), and Treasury Ministers will be invited to propose to the Budget Cabinet that programme totals and cash limits should be adjusted later. But we have not reduced the planning total any further to bring it into line with the forecasters' view - that is, we have adopted course (a) rather than course (b) in my minute of yesterday. The safety margin thus introduced into the planning total might also help justify a higher PSBR than the central forecast and provide the Chancellor with a safety margin there as well if he is still so minded.

iv. There are two arguments against this course and in favour of course (b). There is a case for publishing our central forecasts (as for the current year), as the firmest basis for subsequent monitoring; but we will look carefully at the

detailed figures in the rest of the FSBR to minimise this disadvantage of course (a). The other argument is presentational - there is still a considerable step up, in cost terms, from £114.3 billion in 1983-84 to £115.0 billion in 1984-85 which then establishes a plateau for the later years. But nearly all of this increase (£0.6 billion) reflects the lower GDP deflator (4½% instead of 5%). It is a consequence of planning in cash terms that lower inflation leaves more room for increased real spending. The balance of the increase reflects lower spending now expected in the current year. Where we are comparing a planning figure with a more accurate estimate of end-year out-turn, there is always liable to be some exaggeration of the real difference - or in other words, the Reserve is quite likely to be underspent, and we can say so if asked (though we might be less ready to admit that the PSBR is above the "central" forecast).

3. Table B attached is a fuller explanation, as requested, of the differences between the present figures, 1983 FSBR and 1984 White Paper. Mr Odling-Smee tells me that the difference in 1984-85 general government expenditure of £1½ billion on Table 2.7 has been revised and is now £1 billion (cf £1.1 billion in first line of Table B). But the general government figures in Table B could still change as quality checks continue.

4. We still need to look out for other presentational difficulties as the detailed figures are filled in. And we will now calculate revised public expenditure/GDP percentages, using the latest figures for the planning total on net debt interest.

5. Paragraph 3 of Mr Gieve's minute lists some more detailed queries on the draft FSBR:

MTFS paragraph 19 - "real terms" is the phrase approved by the Chancellor to refer to cost terms, here and elsewhere ("volume" is banished!)

Part 5, page 1 - I suggest some further redrafting to replace the first two paragraphs:

"The Government's expenditure plans for 1984-85 to 1986-87 were published in the White Paper (Cmnd 9143) on 16 February. This section relates the Budget figures published elsewhere in this document to those plans. The measures announced in the Budget will directly affect public expenditure in two ways."

Paragraph 3 - amend as proposed.

Paragraph 4 - the reference to "public expenditure programmes", as opposed to "the public sector", is correct here, because it leads on to the reference to "programmes" in the next sentence.

Table 5.1 - see explanation in paragraph 2(iii) above.

Page 3, paragraph 3 - when we have firm figures (paragraph 2 above), we will look again at the description of changes from the 1983 FSBR and February White Paper, taking account of your comment.

Table 5.6 - see paragraph 2(iv) above.

Part 6, table 6.3 - we have not finalised the figures for local authority spending for 1983-84 and 1984-85. As you imply, these will need to be considered carefully to decide how far we can go towards providing fully "realistic" figures (I understand that the corresponding "realistic" figures in table 5.3 last year did not appear to attract any comment).

Table 6.5 - the present intention is not to show shortfall separately but to allocate it among the various economic categories.

6. There is one other presentational point on this section of the FSBR to which I should draw your attention. Table 5.6 only shows cost-terms figures for the planning total, not for programmes. Last year we published a cost-terms programme table separately in answer to a written PQ the day after the Budget, carrying the White Paper table (now 1.14) through into the two later years on the basis of Budget forecasts for the GDP deflator. We can do this again (it is a matter of arithmetic, given the GDP deflators already in Table 5.6) - either in a Parliamentary answer or in the FSBR. After discussion I accept that such a detailed table (in £ millions instead of £ billions as elsewhere - the latter would be of little use for individual programmes) would not fit easily into the FSBR and would be better published separately.

7. Finally, your last point on the different definitions of public expenditure is of course a general one. Sir Peter Middleton's submission of 22 February on the Anson report said that as soon as resources allow we need to look at this systematically to see if it can be simplified and improved. Meanwhile there are definitions in Part 5 of the White Paper (paragraph 32). But I will let you have a note on all this at more leisure - as you say, we cannot make changes for this FSBR.

A M BAILEY

PLANNING TOTAL, CASH AND COST: CMND 9143 AND FSBR CURRENT VIEW COMPARED

TABLE A

	1982-83	1983-84	1984-85	1985-86	1986-87
Cmnd 9143					
Planning total: cash (£b)	113.4	120.3	126.4	132.1	136.7
GDP Deflator (year on year percentage increase)	1.0	1.0500 (5)	1.1025 (5)	[1.1499* (4¼)]	[1.2005* (4½)]
Planning total: cost (£b)	113.4	114.6	114.6	[114.9]*	[113.9]*
FSBR (Current view)					
Planning total: cash (£b)	113.4	120.0	126.2✓	131.7✓	136.3✓
GDP Deflator (year on year percentage increase)	1.0	1.0500 (5)	1.0973 (4½)	1.1443 (4¼)	1.880 (3¾)
Planning total: cost (£b)	114.0	114.3	115.0	115.1	114.7

*Not published

✓Figures lower than Cmnd 9143 because of NIS abolition

CHANGES IN VIEW ON EXPENDITURE:

TABLE B (1983-84)

£ billion

	1983 FSBR	1984 PEWP	Current view	Current view compared with: 1983 FSBR	Current view compared with: 1984 PEWP
	(1)	(2)	(3)	(3) - (1)	(3) - (2)
General government expenditure in national accounts terms	137.7		138.6	0.9	
Less:					
Interest payments	14.2		14.8	0.6	
Other national accounts adjustments	3.7		3.7	-	
Plus:					
Public corporations net market and overseas borrowing	-1.0		-0.5	0.5	
Capital expenditure of certain public corporations	0.5		0.4	-0.1	
Equals:					
Public expenditure planning total	119.3	120.3	120.0	0.7	-0.3
Underlying 'plans'[1]	120.5	120.6[2]	120.6[2]		
Implied longfall(+)/shortfall(-)[3]	-1.2	-0.3	-0.6		
GDP deflator (1982-83=1.0)	1.054	1.05	1.05	-0.004	-
Public expenditure planning total in cost terms	113.2	114.6	114.3	1.1	-0.3

[1]The 'plans' shown here are not comparable - column 1 is Cmnd 8494 plans incorporating Budget changes while columns 2 and 3 are departments views of outturn at the time Cmnd 9143 was being prepared

[2]The previous published plan was £119.8 billion, in the Autumn Statement

[3]Only columns 2 and 3 are comparable - see note 1

CHANGES IN VIEW ON EXPENDITURE

TABLE B (1984-85)

£ billion

	1983 FSBR	1984 PEWP	Current view	Current view compared with: 1983 FSBR	Current view compared with: 1984 PEWP
	(1)	(2)	(3)	(3) - (1)	(3) - (2)
General government expenditure in national accounts terms	145.2		146.3	1.1	
Less:					
Interest payments	14.2		15.4	1.2	
Other national accounts adjustments	5.6		4.2	-1.4[1]	
Plus:					
Public corporations net market and overseas borrowing	-0.6		-1.0	-0.4	
Capital expenditure of certain public corporations	0.7		0.5	-0.2	
Equals:					
Public expenditure planning total	125.5[2]	126.4	126.2	0.7	-0.2
Underlying 'plans'	126.4	126.4	126.2	-0.2	-0.2
Implied longfall(+)/shortfall(-)	-0.9	-	-	0.9	-
GDP deflator (1982-83=1.0)	1.113	1.1025	1.0973	-0.0157	-0.0052
Public expenditure planning total in cost terms	112.8	114.6	115.0	2.2	0.4

[1]The change in view here reflects the different treatment of BT privatisation in the accounts

[2]Implicit in FSBR Table 2.3

SECRET

Folder

~~A66~~

FROM : T. BURNS

DATE : 1 MARCH 1984

CHANCELLOR

cc Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir P Middleton
Mr Littler
Mr Bailey
Mr Cassell
Mr Monck
Mr Battishill
Mr Evans
Mr Monger
Mr Odling-Smee
Mr Scholar
Mr Barber
Mr Hall
Mr Riley
Mr Shields
Mr Stibbard
Mr Ridley
Mr Lord
Mr Portillo

PSBR FOREASTS

Mr Evans' minute to you of 24 February reported latest estimates for 1983-84 and 1984-85. Your response (John Kerr's minute to Mr Evans of 27 February) was to hold to the £10 billion figure for 1983-84; and for 1984-85 publish a prudent £7 1/2 billion. This minute explores further the main issues of substance and presentation. It assumes no significant changes as a result of further information eg from February's CGBR, available tomorrow.

2. For 1983-84 a (rounded) figure of £10 billion would be our best guess assuming that the EC refund is unlikely to accrue in 1983-84, which conventionally was included in Mr Evans' arithmetic. However the detailed tables in parts 5 and 6 will continue to assume that the EC refund is credited to the PSBR before the end of this year. We will find offsetting change, or changes, elsewhere in the public sector accounts.

SECRET

3. For 1984-85 the forecast of the PSBR in Mr Evans' 24 February minute was £7.3 billion on certain assumptions on asset sales and EC refunds. In coming to a final judgement on the published figure for 1984-85, we also also need to take into account:

(1) PE's working assumption on asset sales is for receipts of £2.5 billion on the assumption that both BT and BA are sold, instead of the £1.9 billion assumed, although all items in the programme of asset sales are subject to considerable uncertainty over timing and receipts.

(2) A view on the timing of EC budget refunds relative to the figures assumed in the forecast. There is the possibility of this year's refund being delayed until next year, and I am advised by EC that next year's assumed refund could well be delayed. There are other possible outcomes that leave us with less refunds in respect of 1984-85 than is currently incorporated in the forecast. Obviously the outcome is very uncertain, but it could go either way.

(3) Last year's budget forecast for oil revenues in 1983-84 of £8 billion looks like turning out £1 billion or so too low. This is because oil production in 1983 was 10 million tonnes higher than expected. We have accepted the Department of Energy's view that oil production in 1984 will be 121 million tonnes (oil and NGLs) an increase of 6 million tonnes over 1983 . Nevertheless the production forecast is probably on the conservative side and it would not be difficult for production to be 4 million tonnes higher (worth over £1/4 billion extra on revenue). However uncertainty about the future course of the dollar is at least as important source of error as the forecast of oil production. Outside forecasts of oil revenues are generally and unusually, a little lower (by an average of £0.4 billion) than ours.

(4) Allowing for both asset sales and oil, but not EC refunds would give a central estimate for 1984-85 of under £6 1/2 billion. This would be consistent with a planning total of under £125 1/2 billion.

4. Some safety margin for 1984-85 would be prudent after this year's overshoot which has inclined you to publish a figure of £7 1/2 billion. But:-

(i) There may be benefits to be gained from announcing a lower PSBR especially if it looks as if it can be reached without a struggle;

(ii) A large undershoot of the PSBR also gives rise to criticism and, as in 1982-83, to pressure to "infill";

(iii) The recent record of budget forecasts of the PSBR is of an overshoot in 1983-84, following two years of undershoot in both 1981-82 and 1982-83 (in the latter case of £1/2 billion, which would have been £1 1/2 billion or more had it not been for infilling in autumn 1982).

5. The size of the safety margin is one issue; another is where it should be shown. Mr Bailey's minute to the Chief Secretary of 29 February ("Public expenditure in the FSBR") envisaged showing a planning total in the FSBR of £126.2 billion. I agree with this view.

6. Although I am not closely in touch with the odds on the possible EC budget outcome, my judgement is that there is sufficient safety margin in a forecast of £7 1/4 billion. With the planning total shown as £126.2 billion (including asset sales of £1.9 billion) and EC refunds as in the forecast, the extent of the safety margin could be regarded as £3/4 billion, most of which would be on expenditure, without allowing for EC refunds additional to those in the existing (public) assumption.

7. If you decide to have a £7 1/4 billion PSBR we could incorporate a slightly high oil revenue figure at the same time as adjusting upwards the planning total to reach the adjusted PEWP figure of £126.2 billion and the existing (public) assumption for EC refunds.

8. If you decide to go for £7 1/2 billion the simplest approach is to take the existing (public) assumption for EC refunds, the £126.2 billion planning total and the old oil revenues.

9. If you do decide to go for £7 1/4 billion, the unrounded figure could be £7.2 billion rounding - if you wished - to £7 billion. We normally round to the nearest half in the MTFS and speech.

10. Finally, it would be worth waiting for tomorrow's CGBR figure for February and its interpretation. There might be some implication for 1983-84 and for the change between the two years.

C. A. Ryding

PP T BURNS

CONFIDENTIAL

~~A66~~

FROM: H P EVANS
DATE: 1 March 1984

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr Bailey
Sir T Burns
Mr Littler
Mr Anson
Mr Cassell
Mr Monck
Mr Battishill
Mr Lankester
Mr Monger
Mr Odling-Smee
Mr Scholar
Mr Riley
Mr Shields
Mr Stibbard
Mr Ridley
Mr M Hall
Mr Lord
Mr Portillo
Mr Norgrove
Miss Roach

PSBR FORECASTS

You asked how the latest figures for the public expenditure planning total in 1983-84 differ from earlier estimates. Successive forecasts for the estimated outturn of the planning total have been as follows:-

35/3

Planning Total, 1983-84, £ billion

Forecasts made in:

March 1983 (FSBR)	119.3
June (internal)	121.5
July (internal, after July 7 measures)	120.2
September forecast	120.1
PEWP, and January internal forecast	120.3
End-February internal forecast	119.8
Proposal for FSBR (Mr Bailey's minute of 29 February)	120.0

2. The July 7 measures totalled £1.3 billion (cash limits reduction, asset sales, and an allowance for end-year flexibility).

3. The overall position has changed relatively little since July, though there is still a wide margin of error around the eventual outturn.

4. Without the July 7 measures, our latest estimate suggests that the budget estimate would have been too low by nearly £2 billion, nearly half being higher than expected overspending by local authorities, and a little over half higher than expected spending by central government: overruns on some demand-led programmes and a lower allowance for shortfall on cash limited programmes. With the July 7 measures, the potential overrun on central (but not local) government expenditure has been offset fully (or a little more than fully) by extra asset sales and cash limit reductions.

5. A full brief on the changes between the 1983 and 1984 FSBR forecasts of the Planning Total will be included in the budget brief.

6. You also asked about the reference in my minute of 24 February to an upward revision of debt interest payments in 1984-85. Our forecast of interest payments in 1983-84 has gone up since January because of new information from ECGD on interest support costs on

non refinanced export credit; and because of an upward revision to the - difficult to predict - interest payments on CTDs. These revisions, amounting to about £0.2 billion have been broadly carried through into 1984-85, and in addition we have reduced our estimate of some interest receipts after further consultations with the Bank of England and others. The total effect is to reduce (net) interest receipts* in 1984-85, by comparison with the January forecast, by £0.3-0.4 billion. None of these changes reflect a change in view on interest rates, which are little changed from the January forecast.

LIPE

H P EVANS

* ie increase (net) interest payments

LK58

BUDGET SECRET

A59

Talk to HPE about PSBR dinner

FROM: A M BAILEY
DATE: 2 March 1984

MR SCHOLAR

cc PPS
Sir P Middleton
Sir T Burns
Mr Evans
Mr Battishill
Mr Stibbard
Mr Norgrove

PUBLIC EXPENDITURE IN THE PSBR

F

on your desk

We had a word about Mr Gieve's minute of today giving the Chief Secretary's views on this.

2. I understand that on the 1983-84 figure, the Chancellor is minded to round down the PSBR to £7 billion. In that case, a planning total as high as £120.3 billion (before taking any explicit account of the EC repayments slippage) may be on the high side. But we agreed that you would discuss with Mr Stibbard how best to accommodate it, and let me know if there are any serious problems.

3. You will also aim to arrange the cost terms PQ for answer on the afternoon of the Budget itself.

4. On the Chief Secretary's final, drafting point, though it is a bit awkward to say that nationalised industry costs arising from the wider VAT base will be "absorbed within existing programmes", I think we should accept the Chief Secretary's preferred drafting.

5. This leaves Mr Gieve's paragraph 5, which relates back to the whole question of the separate national accounts classification of public expenditure. Since we are not going to be able to "simplify the exposition" for this MTFS, I think we can, as Mr Gieve agrees, discuss this in more detail at leisure. We have agreed that you or Mr Stibbard will produce a draft note for the Chief Secretary on the lines requested in paragraph 4 of Mr Gieve's earlier minute and promised in the final sentence of my note of 29 February.

AMB

A M BAILEY

77/3

Copy No 7 of 29

A59

FROM: JOHN GIEVE
DATE: 2 March 1984

MR BAILEY

cc PPS
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Littler
Mr Cassell
Mr Evans
Mr Odling-Smee
Mr Monger
Mr Scholar
Mr Ridley
Mr Battishill
Mr Norgrove
Mr Hall
Mr Riley
Mr Stibbard
Mr Shields
Mr Collinson
Mr Martin

PUBLIC EXPENDITURE IN THE FSBR

The Chief Secretary was grateful for your minute of 29 February.

2. He agrees that for 1984-85 and later years we should stick to the planning totals less the IS adjustment.

3. However he thinks that we should stick to the figure of £120.3 billion for 1983-84. This would have the advantage of smoothing the trend in cost terms. It should also be consistent with the PSBR figure to be published for 1983-84. Moreover, as he understands it, we do in fact expect expenditure to come out at £120.3 billion taking account of the likely slippage of the EC repayments. Of course, the programme breakdown must not undermine our EC bargaining position, but he thinks the advantages of getting the total right outweigh the disadvantages of getting the programme breakdown a little wrong.

4. He is content to publish a cost terms table for individual

62/3

programmes in answer to a written PQ but wonders why this cannot be answered on the afternoon of the Budget itself.

5. While he agrees that we can consider the different definitions of public expenditure at leisure, he is not sure why the MTFS section of this FSBR should not derive the PSBR from the White Paper totals. He thinks that it is a bit clumsy presentationally to have to include in that section a separate table relating general Government expenditure to the Public Expenditure planning totals. Sticking to the latter would simplify the exposition.

6. On a point of detail, he still prefers the phrase "the Public Sector" in paragraph 4. It is departments, local authorities, nationalised industries that will have to pay the additional bills although they will have to meet these from within their existing programmes.

JG

JOHN GIEVE

SECRET

A59

FROM: A P HUDSON
DATE: 5 March 1984

PRINCIPAL PRIVATE SECRETARY

cc Chief Secretary
Minister of State
Economic Secretary
Sir P Middleton
Mr Littler
Mr Bailey
Sir T Burns
Mr Cassell
Mr Monck
Mr Battishill
Mr Evans
Mr Monger
Mr Odling-Smee
Mr Scholar
Mr Barber
Mr Hall
Mr Riley
Mr Shields
Mr Stibbard
Mr Ridley
Mr Lord
Mr Portillo

PSBR FORECASTS

1. The Financial Secretary has seen the 1 March minute from Sir Terence Burns.

2. His own view is to go for a PSBR of £7 billion.

TB This mornings minute expressing a preference for £7½ bn was withdrawn!

APH

A P HUDSON

1AR

SECRET

A59

FROM: M E Corcoran
DATE: 5 March 1984

PS/CHANCELLOR OF THE EXCHEQUER

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Littler
Mr Bailey
Mr Cassell
Mr Monck
Mr Battishill
Mr Evans
Mr Monger
Mr Odling-Smee
Mr Scholar
Mr Barber
Mr Hall
Mr Riley
Mr Shields
Mr Stibbard
Mr Ridley
Mr Lord
Mr Portillo

PSBR FORECASTS

The Minister of State has read Sir Terence Burns' minute of 1 March. He would still prefer not to go below £7½ billion for the PSBR in 1984-85.

M E CORCORAN
Private Secretary

SECRET

BUDGET SECRET

A59

CH/EX REF NO B84/507

FROM: J O KERR

DATE: 6 March 1984

MR CASSELL

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Lankester
Mrs Lomax
Mr Riley

1984-85 PSBR

As you know, Ministers this morning discussed the decision on the 1984-85 forecast PSBR, in the light of Sir T Burns' minute of 1 March, and Mr Evans' minute of 24 February. It was noted that Sir T Burns thought that, with the planning total shown as £126.2 billion, including asset sales of £1.9 billion, and with EC refunds handled as in the forecast, a PSBR of £7.25 billion would allow a safety margin of some £0.75 billion, which was thought to be sufficient. The question therefore was whether it would be better to publish £7.2 billion, rounded to £7 billion, or £7.3 billion rounded to £7.5 billion. On Budget Day, the emphasis would be on the rounded figure: in the markets, and in monitoring performance over the year, attention would shift to the unrounded figure.

2. It was agreed that the market arguments pointed to £7.2/£7 billion, particularly in view of the asset sales arguments, and the introduction on imports. It was suggested that the political arguments went both ways - £7.5 billion would be well received by most Government supporters, £7 billion would be very well received by some, but would strike others as arguably too tight. The lower figure would also marginally increase the risk of an overshoot - but it was noted that any over/undershoot would be measured from the precise, rather than the rounded figure, and that the extra measure of assurance gained by

2003.

BUDGET CONFIDENTIAL

I would recommend sticking to £10b for the rounded figure. I am not convinced that we gain anything from giving an unrounded one; but if you would like to indicate that our expectation is that the out-turn is slightly more likely to be below £10b than above it, £9.8b looks a bit less contrived than £9.9b.

From: P J Stibbard
6 March 1984

1. MR CASSELL
2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr Bailey
Sir T Burns
Mr Littler
Mr Anson
Mr Monck
Mr Battishill
Mr Lankester
Mr Monger
Mr Odling-Smee
Mr Scholar
Mr Riley
Mr Shields
Mr Ridley
Mr Norgrove
Miss Roach
Mr H Evans

PSBR IN 1983-84

Mr Evans sent you a note on 24 February including an assessment of the PSBR in the current year. The central estimate at that time was £9.4 billion but FSBR drafts since then have included a figure of £10.0 billion. The difference takes into account the uncertainty over whether the EC refunds will materialise; for the same reason the FSBR is currently showing a planning total of £120.3 billion rather than the central estimate of £119.8 billion.

2. We now have available the central government borrowing outturn for February; preliminary estimates were reported by Miss Roach on 2 March. The figures are still showing an undershoot on last month's forecast for February of £0.4 billion on million own account - CGBR(O). This is made up of about £130/higher Inland Revenue and £20 million higher Customs and Excise and £230 million lower Supply expenditure - mainly on Defence and NCB grants.

3. This afternoon we have discussed the implications of the February outturn with Inland Revenue and Customs and as a result the March whole year forecast for Inland Revenue receipts has been raised slightly

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but this is offset by other small adjustments and lost in the rounding.

4. We also have considered the Supply outturn figures for February carefully alongside the forecasts sent in by departments on the F10 forms (including the amendments they were invited to telephone to us up to the end of last week). Our view is that the figure in the FSBR for the year as a whole (£86.7 billion) - which was very largely based on F10 returns sent in earlier - need not be revised. This implies that the March surge will be rather greater than we previously forecast, but still not as great as last year.

5. Our current view then of the PSBR has scarcely changed from Mr Evans' note of 24 February:-

£ billion

	PSBR	of which		
		CGBR(O)	LABR	PCBR
24 February	9.4	7.5	1.3	0.6
6 March	9.5	7.5	1.3	0.7

6. With the presentational adjustments mentioned in paragraph 1 above, the arguments still point to publishing a figure in the FSBR of £10.0 billion or thereabouts. At present we are using a figure in the Part 5 tables (where we round to the nearest £0.1 billion) of £10.0 billion. You may prefer to show a figure of £9.9 billion elsewhere (rounded to £10 billion/in the document), particularly as the risk on EC refunds is likely to be closer to £0.4 billion than £0.5 billion - because we may well have to make a contribution of £0.1 billion towards the refund.

See attached note

7. If you would like to show a figure other than £10.0 billion it would be helpful to know this before lunch-time tomorrow to meet the printing timetable.

8. First news of the full PSBR for February should be known on Friday and I will pass it on as soon as possible.

9. Next week we will circulate the usual note on outturn and forecasts, putting on record our implied forecasts for March - ie the difference between the February outturns and the FSBR figure for the full year.

P J STIBBARD

BUDGET CONFIDENTIAL

From: P J Stibbard
7 March 1984

MR CASSELL

cc Principal Private Secretary
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Mr Bailey
Sir T Burns
Mr Littler
Mr Anson
Mr Monck
Mr Battishill
Mr H Evans
Mr Lankester
Mr Monger
Mr Odling-Sme
Mr Scholar
Mr Riley
Mr Shields
Mr Ridley
Mr Norgrove
Miss Roach

PSBR IN 1983-84

In the note I sent up last evening there were two small errors. Bearing in mind the margin of uncertainty still surrounding this year's PSBR outturn they do not affect the presentational choice between £10.0 billion, and £9.9 billion or £9.8 billion rounded up to £10 billion. However, for the record the corrections are as follows.

2. In paragraph 3 the reference to the increase in the Inland Revenue receipts forecast should have applied to the whole year rather than just March (in fact March was reduced slightly).

3. In the last part of paragraph 6 the logic on EC refunds was rather tangled. The correct position, under various assumptions, is as follows:-

Central estimate, assuming refund of £0.5 billion	= £9.5 billion
Central estimate, assuming refund of £0.5 billion is only achieved by paying a contribution of £0.1 billion	= £9.6 billion
Estimate assuming no refund	= £10.0 billion

P J STIBBARD

2043

CH/EX REF. NO. B(84)506.

FROM: J O KERR
DATE: 7 March 1984

cc Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Battishill
Mr H Evans
Mr Lankester
Mr Odling-Smee
Mr Ridley
Mr Scholar
Mr Riley

MR STIBBARD

1983-84 PSBR

The Chancellor has seen your minute of 6 March, on which Mr Cassell commented that he still recommended showing £10 billion as the rounded figure for the forecast 1983-84 PSBR outturn.

2. The Chancellor accepts Mr Cassell's advice.

3. Mr Cassell also noted that he was not convinced that anything would be gained by giving an unrounded figure as well. The Chancellor agrees with that too. If, but only if, we have to publish an unrounded figure in the FSBR, he would see nothing wrong with £9.9 billion.

J O KERR

199/3

B(84) 514

BUDGET - SECRET

A59

Seen by Chancellor

10 DOWNING STREET

From the Private Secretary

7 March 1984

Dear John.

At their meeting yesterday and again this morning the Prime Minister and the Chancellor discussed his minute of 6 March. It was agreed that the detailed tables should ~~show a PSBR~~ in 1984-85 of £7.2 billion, rounded down to £7 billion in the summary tables, around 2¼% of GDP.

The Chancellor explained that, as a result of changes in the terms of building society deposits, the behaviour of M2 was now less predictable. It was less likely that it could be accommodated within the same range as M0. He therefore proposed to apply the two target ranges to M0 and sterling M3, with M2 and PSL2 being mentioned in the text as further indicators of monetary conditions. This was agreed.

Yours sincerely

Andrew

Andrew Turnbull

John Kerr, Esq.,
HM Treasury.

CHANCELLOR
- 8 MAR 1984
INFO.
CST, FST, MST, GST
Sir P. Middleton
Sir T. Burns
Mr Battishill
Mr Cassell
Mr Lankester

BUDGET - SECRET

25/3

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COPY NO 6 OF 23 copies

FROM: COLIN MOWL
DATE: 8 March 1984

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Littler
Mr Bailey
Mr Cassell
Mr Evans
Mr Battishill
Mr Odling-Smee
Mr Sedgwick
Mr Lankester
Mrs Lomax
Mr Riley
Mr Shields
Mr Ridley
Mr Lord
Mr Portillo

PROVISIONAL POST-BUDGET FINANCIAL FORECAST

You asked what proportion of total life assurance business was represented by the loss of new business stemming from the abolition of premium relief (Miss O'Mara's minute of 6 March). The assumption we used was that 40 per cent of that part of new business which currently qualifies for tax relief (known as "qualifying" business) is lost. However as emphasised in Mr Cassell's note on the Effects of the Budget on the Financial Sector this proportion is no more than a guess. The proportion lost of <u>total</u> new life business would be much less, possibly about 15 per cent. The reason for the uncertainty about this latter figure is that we do not have up to date information on non-qualifying business.

2. From Inland Revenue information it is estimated that new qualifying business in 1983-84 was equivalent to <u>full year</u> premium income of £1500 million. This included however a one-off boost associated with the switch from repayment to endowment mortgages following the introduction of MIRAS and, in the absence of any change in tax relief, new qualifying business was assumed to fall back in 1984-85 to about £1200 million.

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3. New business obtained in 1984-85 will not give a full year's premium income on average in 1984-85 because not all of it is obtained at the beginning of the year. Reflecting this we have assumed that new business in 1984-85 would have generated only £600 million premium income in that year. If 40% of this is lost as a result of the abolition of relief then this implies a loss of £250 million. In subsequent years, of course, the life companies will lose the full year's equivalent of the premium income lost in the first year, plus for the reason just explained part of new business that would have been gained in the later years, so the loss will be rather greater.

4. Apart from Inland Revenue information on qualifying business, the latest information on life assurance relates to 1982. In 1982 total new premium income was £2.7 billion on a full year basis, an increase of over 20 per cent on the previous year. Of this about £0.9 billion qualified for tax relief.

Colin Mowl

COLIN MOWL

COVE[illegible]IAL

IMMEDIATE

FROM: A BENNETT
DATE: 16 March 1984

SIR T BURNS

1. Merry Christmas

2. Do we have similar reports for other aspects of the fiscal?

3. Do we keep Treasury informed?

cc Mr Cassell
Mr Lankester
Mr Evans
Mr Odling-Smee
Mrs Lomax
Mr Pirie
Mr Sedgwick
Mr Shields
Mr Riley
Mr Peretz
Mr Mowl (O/R)
Mr Vernon
Mr Hood
Mr O'Donnell
Mr Fisher

FSBR/1984 FINANCIAL FORECAST

I attach a note outlining the financial forecast consistent with the FSBR forecast. For reference, I also attach a track record of forecasts of some of the key variables in this area made at the time of the FSBR 1983 forecast round. This is included in Annex A.

Alan Bennett

A BENNETT

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FINANCIAL FORECAST - PSBR 1984

Introduction

This report discusses the financial aspects of the economic forecast connected with the financial statement and Budget Report of 1984. The forecast was prepared in consultation with the Bank, as appropriate.

2. The rest of the forecast, particularly those variables which are important influences on financial developments, is summarised and compared with the January forecast in the table overleaf. The outlook for the next two financial years, as we now see it, is little different from January. GDP is forecast to grow by 3% in 1984/85, falling slightly to 2½% in 1985/86, the same as projected in January. Inflation is projected to fall in 1985 from its current level of 5% to stabilise around 4½% over the next two years.

3. The PSBR projection, revised down for this year, has also been lowered in later years. The 1984/85 figure is now put at £7.2 billion instead of £8 billion. About half of this change is due to the fact that the fiscal adjustment assumed in January was not used in the budget and the remainder is due to a reduction in the expected underlying PSBR. The current account forecast shows a modest improvement relative to January. This is, however, mainly due to a change in the treatment of gold which has been shifted from the current account to the capital account. The effect on the balance of payments is neutral. The private sector surplus is little changed but there has been a small reallocation away from persons to companies, partly reflecting the removal of the fiscal adjustment which had been assumed to apply to persons.

Policy Assumptions

4. The PSBR forecast for 1984/85, which represents 2¼% of GDP, reflects the assumed effects of the budget measures and the expected underlying borrowing requirement. For 1985/86 and 1986/87 it has been assumed to be set at 2% of GDP. The path of short term interest rates has been chosen with reference to a number of monetary conditions such as the exchange rate, but chiefly with the objective of ensuring that the monetary aggregates fall within the recommended target ranges. These

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THE REST OF THE FORECAST: SUMMARY TABLE

Inflation (TFE deflator, % change on a year earlier)	January 1984	FSBR 1984
1983 Q1	6.7	6.7
1984 Q1	5.2	5.3
1985 Q1	4.3	4.3
1986 Q1	4.1	4.4
1987 Q1	4.6	4.2

Output (GDP, % change on previous year)		
1982-83	2.3	2.3
1983-84	3.0	2.5
1984-85	3.1	3.2
1985-86	2.3	2.4
1986-87	1.5	2.0

PSBR (£billion)		
1982-83	9.2	9.5
1983-84	10.5	9.9
1984-85	8.0	7.2
1985-86	7.8	7.0
1986-87	7.4	7.0

Current Account (£billion)		
1982-83	5.3	5.5
1983-84	2.1	2.1
1984-85	1.4	1.3
1985-86	0.8	1.7
1986-87	-0.6	0.4

ICCs Financial Surplus (£billion)		
1982-83	4.1	4.1
1983-84	7.8	7.0
1984-85	3.2	4.0
1985-86	0.9	1.1
1986-87	0.7	-0.8

Persons' Financial Surplus (£billion)		
1982-83	8.8	8.8
1983-84	7.0	6.6
1984-85	7.1	6.5
1985-86	9.5	8.4
1986-87	8.3	7.8

Real TFE % change on previous year	January 1984	FSBR 1984
1982-83	2.9	2.9
1983-84	3.4	3.2
1984-85	3.8	3.8
1985-86	2.6	2.7
1986-87	2.0	2.4

Nominal GDP (market prices, % change on previous year)		
1982-83	9.2	9.6
1983-84	8.3	8.0
1984-85	8.1	7.9
1985-86	6.7	6.8
1986-87	6.0	6.1

Personal Disposable Income (% change on previous year)		
1982-83	7.5	7.8
1983-84	7.7	7.4
1984-85	7.8	7.1
1985-86	8.0	7.5
1986-87	6.3	7.6

Private Sector Net Financial Wealth (% change on a year earlier		
1983 Q1	28.4	28.4
1984 Q1	11.0	11.1
1985 Q1	10.3	11.8
1986 Q1	7.1	6.8
1987 Q1	5.1	9.7

Private Sector Gross Financial Wealth Denominated in £ (% change on a year earlier)		
1983 Q1	13.2	13.2
1984 Q1	13.0	13.2
1985 Q1	11.2	11.8
1986 Q1	8.8	8.9
1987 Q1	7.5	10.5

ranges are:

	1984/85	1985/86	1986/87
MO	4-8	3-7	2-6
£M3	6-10	5-9	4-8

The Exchange Rate

5. Sterling's effective exchange rate ended 1983 at 82.9. Much of the fall from the pre-election peak of 88 was associated with the decline in UK interest rates relative to the rest of the world, particularly the US. In the first two months of 1984 sterling had a stable look about it and traded in the range 81½-83½. However, in the first two weeks in March it has fallen some 2½ points and is currently trading at 81, reflecting several factors such as prospective interest rate cuts, anxiety about a miners strike, budget uncertainty and apprehension over the EEC summit. It has, however, strengthened appreciably against the dollar which has weakened reflecting inflationary fears, a huge trade deficit and widespread views that the dollar is overvalued.

6. Over the forecast period no major change is expected for the nominal effective rate. In the short term we assume a slight appreciation as the dollar is expected to weaken further and fears about the oil price recede. This is consistent with current forward rates which imply a small appreciation of sterling. Though projections of the nominal rate are for a fairly flat path from 1984 Q2 onwards, good UK inflation prospects relative to the rest of the world imply a small fall in the real exchange rate. We believe this exchange rate path to be consistent with no major imbalance in the UK current and structural capital account positions. There may therefore be scope for further falls of UK rates relative to world rates, particularly the Euro-dollar without exerting significant downward pressure on sterling especially as we expect further falls in the dollar. Factors thought to influence the market's view of exchange rates such as UK real money supply relative to the world and the dollar oil price are broadly flat in the projection and are not expected to generate large destabilising outflows. Though the forecast decline in North Sea production could exert some downward pressure in the longer term this may already be discounted in current rates.

7. Though our forecast nominal rate of 83.5 by 1984 Q4 is slightly higher than the consensus of outside economic forecasters it is within the range of such forecasts and compares with projections by 'specialist currency forecasters' of 84 by Phillips and Drew, 85 by Lloyds Bank and 81 by LBS Exchange Rate Outlook.

8. The projection of sterling cross rates is shown below. These are always subject to great uncertainty particularly when, as in the forecast, we expect sharp overseas currency movements. They show that within the broad pattern of a flat sterling rate in effective terms, sterling is expected to appreciate against the dollar and French Franc but depreciate against the Yen and Mark.

Sterling Exchange Rates

	Nominal Effective Exchange Rate	£/$ Rate	£/DM Rate	£/FF Rate	£/Yen Rate	Real Effective Exchange Rate (1980/81=100)
1982/83	88	1.67	4.08	11.4	417	90
1983/84	84	1.49	3.94	12.0	354	86
1984/85	84	1.54	3.80	12.1	322	85
1985/86	83	1.64	3.63	12.1	306	84

Interest Rates

9. Eurodollar rates have remained fairly stable since January and are expected to remain so throughout most of 1984. UK short term rates, having settled around 9½% for most of the last six months, declined to 9% shortly before the budget in anticipation of base rate cuts. A small part (¼%) of this actually occurred before the budget (Barclays and Royal Bank of Scotland). The remaining banks followed the budget with more sanguine cuts (½%). The next base rate cut will probably not occur until the New Year, but wholesale rates of sufficient maturity should continue to gently decline, as this is foreseen. There are now signs, albeit faint, that the banks are preparing to stiffen the competition for retail deposits. Barclays, for instance, did not lower their 7 day deposit rates when they announced a ¼% cut in base rates and the others have maintained a similarly narrowed differential. Building Society rates look certain to come down soon, possibly by ½%* in April,

*See footnote to paragraph 19.

the change in the (gross) deposit rate probably being larger reflecting the lower post tax return available to building societies on their reserves of gilts. Long term interest rates are expected to decline gradually, and 20 year rates should fall below 10% this year, possibly before the summer. 10 year rates may take longer to reach this level owing to the concentration of funding at this maturity in the recent past.

	Eurodollar Interest Rate	World Basket Short Rate	UK 3-month Interbank Interest Rate	UK 20 year Long Term Interest Rate	Inflation (final expenditure prices)
1983/84	9.8	9.3	9.7	10.5	5.3
1984/85	10.0	8.6	8.7	9.3	4.3
1985/86	10.3	8.1	7.8	8.7	4.4

Sectoral Flow of Funds

10. The pattern of financial surpluses and deficits is shown below. The main difference from the January forecast is a shift from persons to companies (ICCs and FCs), resulting from the change in the fiscal adjustment, as noted above.

Sectoral Financial Surplus' and Deficits and the PSBR (£bn)

	Persons	ICCs	Financial Cos	Total Private	Overseas*	Public Sector	PSBR
1983/84	6.6	7.0	0.8	14.4	-2.1	-10.7	9.9
1984/85	6.5	4.0	0.4	10.9	-1.3	- 8.9	7.2
1985/86	8.4	1.1	0.2	9.7	-1.7	- 6.6	7.0

* The overseas financial surplus is the negative of the current account surplus

Overseas

11. The reduction in the current account surplus from the 1982-83 level is expected to result in a substantial decline in net non bank private sector outflows, which will tend to moderate the effects of the current account on domestic wealth. Compared with a net outflow of £8.8 billion in 1982-83, we are expecting net outflows of £2.8 billion in 1983-84

and £3.0 billion in 1984-85. Net direct investment outflows persisted in 1982-83 but they were much reduced from the previous year and in 1983/84 the prospect is for a small inflow. These inflows are expected to persist over the forecast period due to good prospects for UK profitability but may decline as world growth strengthens. Gross outward portfolio investment is expected to decline in 1983/84 and in subsequent years though it should still remain at substantial levels, as institutions continue to acquire overseas securities. The overseas capital account forecast is summarised below.

External Flows (£ bn)

	Current Account	Net Direct Investment	Outward Portfolio Investment	Private* Inward Portfolio	Sterling Balances	Other** Items
1982/83	5.4	-0.6	-6.4	-3.5	2.0	3.2
1983/84	2.3	0.1	-6.1	0.8	2.5	0.3
1984/85	1.3	1.1	-5.7	-0.3	3.5	0.2
1985/86	1.7	0.5	-5.2	-0.3	3.3	-0.1

* Including the balancing item

** Oil investment, trade credits, company borrowing, deposits overseas, banks FC liabilities, intervention

OFIs (excluding building societies)

12. Total sources of funds available to OFIs for investment are forecast to remain broadly similar in 1984/85 to those available this year. Whilst life assurance inflows will fall due to the abolition of tax relief this is likely to be offset by higher personal post tax income and by the fact that the institutions will be the chief beneficiaries of the reduction of stamp duty. Whilst there may be some forestalling of capital investment in response to the changes in capital allowances, this is likely to be financed by bank borrowing and thereby offset in their sources of funds. With purchases of overseas assets slowing down and a reduction in their take up of gilt edged, OFIs should have no problem absorbing a high proportion of public sector assets due for sale in 1984/85 and 1985/86. The continuing repayment of local authority debt also helps in this respect, and indeed leaves room for a further build up of bank deposits.

OFIs Excluding Building Societies (£bn)

Sources of funds

	Bank Borrowing	Unit Trust Inflows	Life Ass., Pension Fund Inflows	Other	Financial Deficit	Total Sources
1983/84	3.6	0.8	13.4	-0.2	-2.7	14.9
1984/85	2.7	0.9	13.4	-0.5	-1.5	15.0
1985/86	2.0	0.8	13.5	-0.5	-1.6	14.2

Uses of Funds

	Bank Deposits	LA Temp Debt	LA Long Debt	Gilts	UK Company Securities	Overseas Assets	Other Assets
1983/84	2.8	-0.5	-0.4	7.0	2.1	4.6	-0.7
1984/85	2.7	-0.3	-0.6	5.3	3.8	4.0	0.1
1985/86	1.7	-0.2	-0.4	4.7	4.0	3.7	0.7

Industrial and Commercial Companies

13. Forecasting flow of funds for ICCs remains a hazardous task owing to the large discrepancy that still remains between the very substantial surplus recorded in the national accounts and the rather smaller identified net accumulation of financial assets measured in the financial accounts. In practice we have assumed that this discrepancy will diminish with the projected shrinkage of ICC's surplus, but by a smaller amount, so that their net borrowing requirement is forecast to increase. The changes in the collection of VAT on imports announced in the budget are expected to increase ICCs borrowing requirement as is the widening of the VAT base. The corporation tax package should, however, increase their surplus, notwithstanding the expected forestalling in expenditure and this combined with the abolition of NIS and the removal of stock relief (which should discourage stockbuilding) should more than offset the VAT effects. Such forestalling as ICCs undertake themselves is likely to be financed partly by bank borrowing, partly from stock of financial assets and partly by intra ICC transactions.

14. Despite the rise in public sector asset sales, the new equivalence of the tax treatment of debentures vis a vis equities and the halving of stamp duty on equity transactions should more than offset this. We therefore expect new issues to rise from £2.3 billion this year to £2.8 billion in 1984/85 and £2.7 billion in 1986/87. Sterling bank borrowing, which has already recovered strongly in recent quarters, should maintain its momentum over the forecast period in line with the increased borrowing requirement. This, along with continued borrowing from overseas (inward investment) and buoyant capital issues, should enable ICCs to continue to accumulate financial assets. However, as the cycle develops, we expect that in relation to nominal expenditure, their holdings will decline.

Persons

15. Although the personal sector surplus benefited in sum from the various budget measures, the removal of the fiscal adjustment assumed in January has left them with lower surpluses vis a vis the January forecast. Despite this, they are expected to remain in a comfortable position. Inflows into building societies, which have reached record levels recently, are likely to continue apace, especially in view of the composite rate ruling for banks. These in turn should finance a continuing brisk demand for mortgages that has still to be fully satisfied, boosted as it will have been by the raising of mortgage interest tax relief ceilings. Bank lending to persons both for consumption and house purchase, should also grow rapidly, although as the stock rises, the rate of growth will show continuing deceleration.

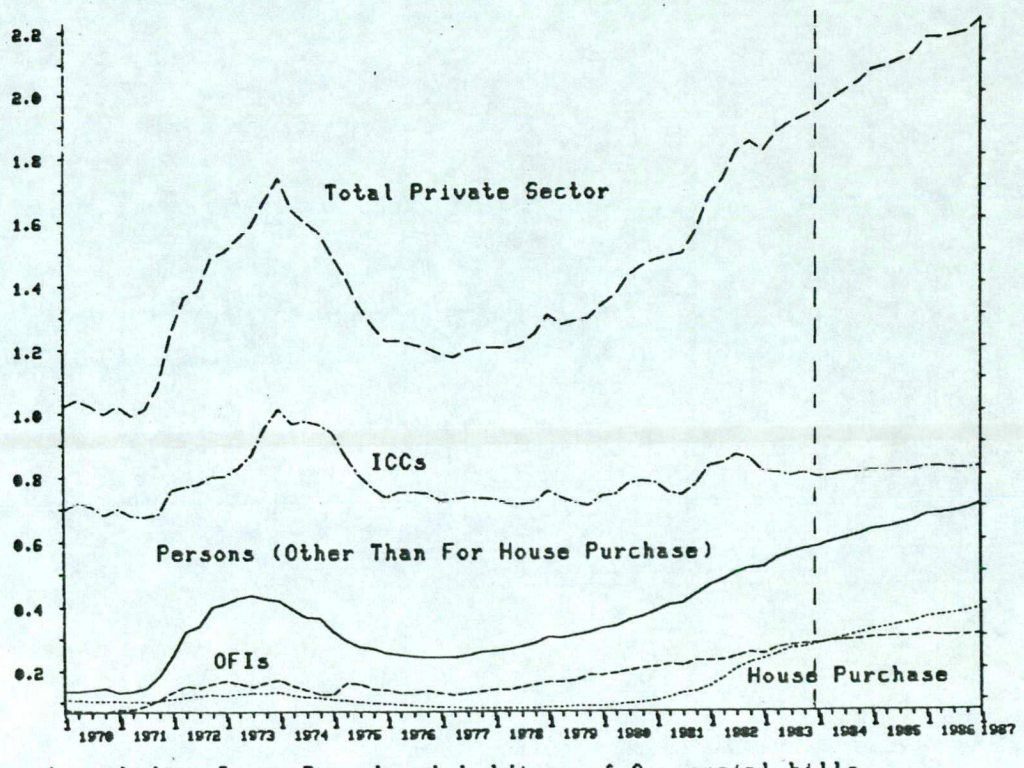
16. With inflows into life insurance and pension funds expected to be flat, the scenario should enable persons to take up £3 billion of national savings and still have room to spare for a recovery in the build up of their bank deposits. The latter have been very depressed in recent quarters, reflecting the abnormal interest rate differential between bank and building society deposits. Since this will have been reflected in an equally exceptional build up of building society bank deposits, we expect this position to reverse itself when building societies lend out this money in 1984/85.

17. The forecast for bank lending in sterling to the private sector is shown below:

Sterling bank lending, £billion (% change on year earlier in brackets)

	Persons		ICCs	OFIs	Total Private Sector
	Consumption + Unincorporated Business	House Purchase			
1982/83	4.7(22.3)	4.8(70.9)	2.5(6.6)	2.2(20.9)	14.2(18.6)
1983/84	5.4(20.9)	3.5(29.9)	2.3(5.8)	2.7(21.3)	13.9(15.3)
1984/85	5.2(16.6)	3.6(23.6)	4.0(9.4)	2.1(13.6)	14.9(14.2)
1985/86	5.2(14.2)	3.6(19.4)	4.0(8.5)	1.6(9.4)	14.4(12.1)

CHART 1 Bank Lending In Sterling To The Private Sector Relative To Private Sector GDP - By sector



* Including Issue Department holdings of Commercial bills

The Building Societies

18. Building Society inflows have continued to proceed at record levels. We expect them to remain aggressive competitors in the market for retail money and they should benefit from the composite rate ruling which should help divert additional money from the banks. Building society liabilities form a large proportion of M2 and PSL2. The share of their liabilities which qualify, however, tends to vary depending on which maturity deposit is being most aggressively marketed. We have assumed that 60% of inflows qualify for M2 and 80% qualify for PSL2.

	Recommended Interest Rates		Net Receipts	Advances	
	Net Share	Mortgage	£ billion	Gross £ billion	Net
1983/84	7.0	11.0	12.4	19.7	11.3
1984/85	6.4	10.6	11.0	21.8	12.2
1985/86	5.6	9.7	11.5	23.0	12.2

19. The forecast assumes that the mortgage rate is reduced by ½%* on 1st April, ¼% less than previously assumed because of the narrowing of the societies' margins as a result of the changed tax treatment of their profit on gilts. We have also allowed for a larger cut in their interest rates in general in 1985/86 due to the introduction of the composite rate on the banks.

Banks' balance sheets and market assistance

20. Although the introduction of the composite rate is expected to put pressure on the banks' ability to attract retail deposits, we expect the net effect to be mainly on relative interest rates between banks and building societies rather than on the net flow of bank deposits. As before, therefore, the bank will probably be able to finance the bulk of their lending to the private sector, boosted by the budget measures, from their deposit inflows and the continued run down of local authority debt. There will, however, at the short term interest rates assumed, be the need for assistance in both 1984/85 and 1985/86.

*The societies have just announced (12 noon 16.3.84) that the cut will be 1% not ½%. The assumption about margins proved correct however. This larger cut effectively brings forward the further ½% cut we assumed would occur in the New Year. Inflows and therefore PSL2 and M2 growth projected for 1984/85 may thus turn out to be (slight) overestimates.

Banks' portfolio shares (%) (excl. discount houses)

	Liabilities				Assets					
	Deposits	Net f.c. Position	Non Deposit Liabilities	Total	Reserves etc	Public Sector Debt	Private Sector Advances	Miscellaneous	Total	Issue Dept. Bills
1983/4	89.3	-4.0	14.7	100	6.4	12.6	85.2	-4.2	100	6.5
1984/5	88.7	-3.4	14.7	100	5.7	10.0	88.0	-3.7	100	6.3
1985/6	88.3	-3.0	14.7	100	5.3	8.6	89.5	-3.4	100	6.5

PANEL B

Changes £ billion, Banks (excl. discount houses)

	Liabilities				Assets					
	Deposits	Net f.c. Position	Non Deposit Liabilities	Total	Reserves etc	Public Sector Debt	Private Sector Advances	Miscellaneous	Total	Issue Dept. Bills
1983/4	11.0	-0.4	3.2	13.8	-1.9	- 0.6	17.0	-0.7	13.8	2.3
1984/5	13.1	0.3	2.4	15.8	-0.1	- 1.8	17.7	0	15.8	0.8
1985/6	13.3	0.1	2.2	15.6	0.2	- 0.8	16.2	0	15.6	1.4

PANEL C

Money Market Influences £ billion

	Notes and Coin	National Savings	CTDs	Gilts	Minus CGBR	Reserves Change	Money Market Influences	Over Funding
1983/84	0.8	3.1	-0.4	12.1	-13.3	0.2	2.6	1.7
1984/85	0.8	3.0	0.2	8.0	-11.1	0	1.0	1.2
1985/86	0.8	3.0	0.2	7.1	- 9.9	0	1.3	1.1

£M3 and the counterparts

£billion	1983-84	1984-85	1985-86
PSBR	9.9	7.2*	7.0*
Net sales of public sector debt to non bank private sector			
(a) Gilts	10.0	6.2	5.5
(b) National Savings	3.1	3.0	3.0
(c) Other	- 1.6	- 0.8	- 0.4
Changes in £ bank lending to the private sector	13.9	14.9	14.4
Net external adjustments	0.3	- 1.7	- 1.8
Increase (-) in net non-deposit liabilities	4.0	2.4	2.2
Change in £M3	8.5	9.6	9.3
(a) financial year (%)	9	9*	8*
(b) target period (%)	10	9*	8*

* New definition of the PSBR and £M3

Debt Sales

21. As in the January forecast we are projecting gilt sales to the non bank private sector to be £6 billion in 1984/85, a long way below the 1983/84 level of £10 billion. As argued above, this seems a reasonable projection, notwithstanding the public sector asset sales, especially in a climate where long term interest rates are expected to decline. Sales to other sectors are set to decline in roughly equal proportions except for overseas who are expected to continue buying in some strength.

Gilt Sales by Sector

	Persons	ICCs	OFIs*	Banks etc	Overseas	Total
1983/84	2.2	0.4	7.4	1.0	1.1	12.1
1984/85	1.4	0.3	4.6	0.6	1.1	8.0
1985/86	1.1	0.1	4.3	0.6	1.0	7.1

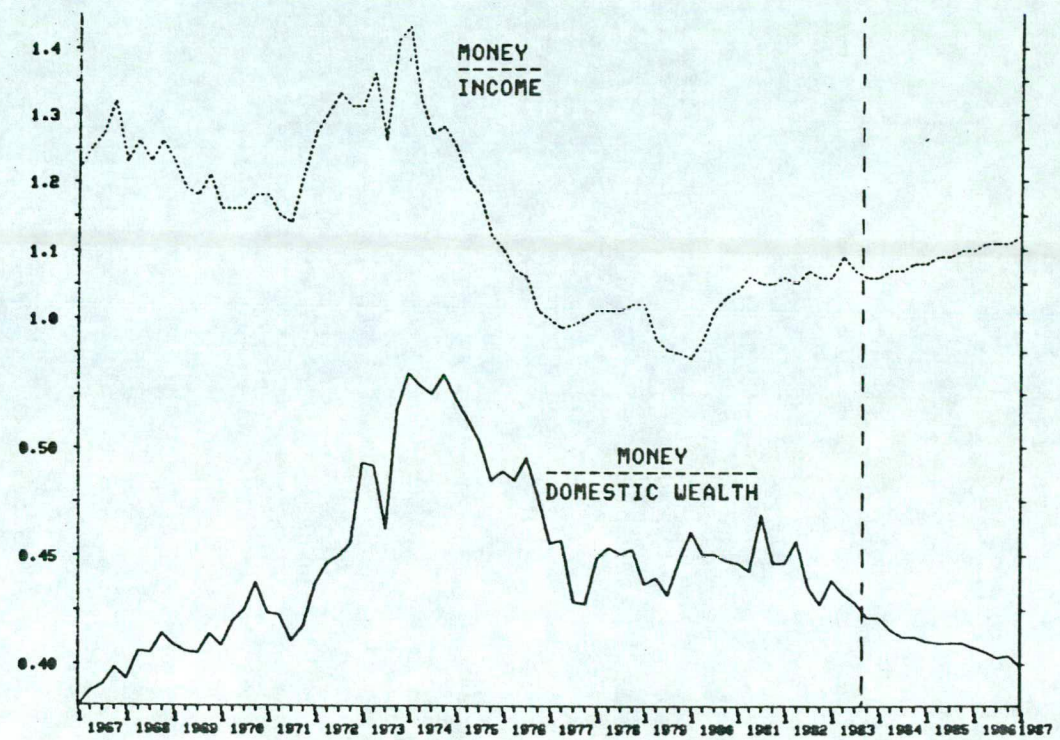
* including building societies

22. The National savings target of £3 billion in 1984/85 is broadly compatible with a normal build up of person bank deposits. CTDs, having been run off in 1983/84, are expected to resume a more usual path over the forecast period. Finally, local authorities and public corporations are shown as continuing to repay market debt, both to non banks and banks.

Monetary Aggregates

23. £M3, which threatened to outstrip the target range during the first half of the financial year, now looks likely to fall comfortably within the range this year, reflecting the reassertion of control of the PSBR (mainly the July measures) and exceptionally buoyant gilt sales. We expect this deceleration in £M3 growth to continue to keep £M3 within the range in 1984/85 and beyond. PSL2 growth, by contrast, which is still being swollen by high building society inflows, is more or less certain to exceed the range recommended for £M3 this year and may well do so in later years too. This represents an upward revision to the forecast made in January, mainly reflecting the budget measures. Nonetheless, overall the picture remains one of acceleration in the wide monetary aggregates, in line with the slow down in the growth of the private sector's total financial wealth.

CHART 2 STERLING M3 IN RELATION TO INCOME & WEALTH



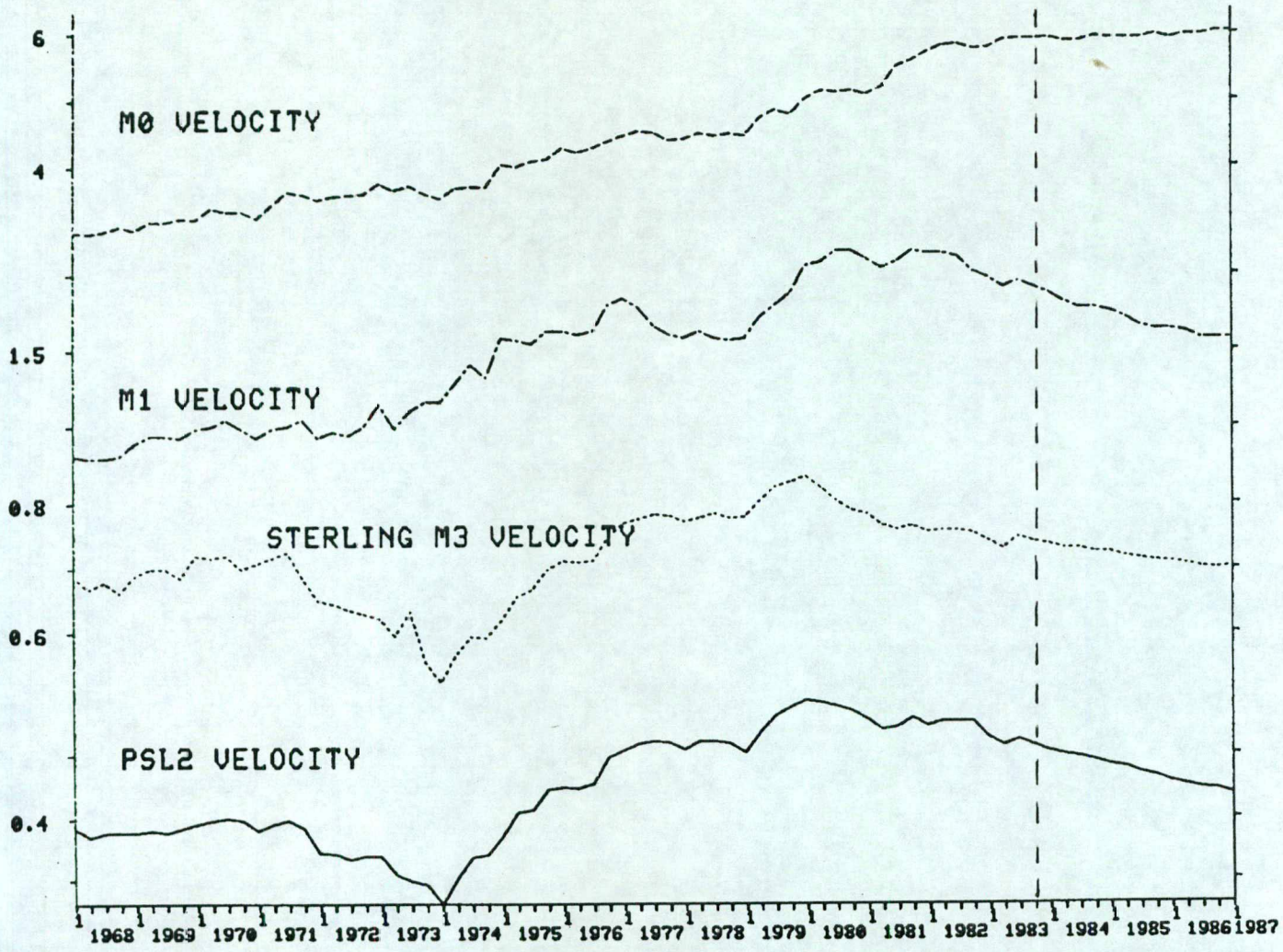
24. As for the narrow aggregates, M0 is forecast to continue its relatively slow growth. As assumed before the increasing use of cash saving technology like credit cards etc is expected to offset the expansionary effect of falling interest rates and keep M0 growth within its recommended range throughout the forecast period. The growth of M1, in contrast, is likely to be fairly rapid, being the most interest sensitive of all the aggregates, and may not fall below 10% until 1986/87 or later. The projection for M2 depends critically upon one's assumption about qualifying inflows into building societies and thereby about the societies' policy on relative interest rates on 7 day as opposed to 3 month accounts. Our forecast is therefore highly uncertain, but it seems probable that M2 growth will, in relation to the last two years, be comparatively fast. In particular, the close association M2 has born with M0 in the past is not likely to continue.

Monetary Aggregates Growth Rates (target period at annual rate)

	M0	M1	M2	£M3	PSL2
1983/84	6	11¾	10	10	12½
1984/85	6	11	10	9	10½
1985/86	5½	10	10	8	9½

25. Gross financial wealth is expected to continue to increase more rapidly than nominal GDP, partly as a result of the faster accumulation of financial assets and partly due to revaluations to existing assets (gilts). Reflecting this the velocities of the wide monetary aggregates are shown as maintaining their decline over the forecast period. The velocity of M1 should also decline, in response to the lower level of nominal interest rates. M0 velocity, which has trended upward over the past, should flatten out, also in response to lower interest rates. The velocity of the main aggregates is shown below.

CHART 3 MONETARY AGGREGRATE VELOCITIES



ANNEX A

TRACK RECORD OF FINANCIAL FORECASTING

The table below shows how successive forecasts of some of the principal financial variables over the last financial year have fared in comparison with our best estimates of their outturn in 1983/84. The table shows forecasts for growth rates of MO, M1, £M3, PSL2 and £ bank lending, and also forecasts of short and long term interest rates. Apart from PSL2, forecasts for all these variables made at the time of the budget last year look like turning out to be remarkably accurate. After the budget, however, forecasts for both £M3 and M1 strayed upwards. The PSL2 forecast, on the other hand, was brought smartly back on track. The £M3 divergence was mainly a reflection of the PSBR forecast, and, as the PSBR was brought under control so was the £M3 projection revised back down. The M1 divergence owed more to a tendency for the equation to overpredict during this period. The initial under estimate of PSL2 was due to building society inflows being rather higher than we expected at budget time. The forecast for inflows was revised up significantly in June.

	1982/83 Outturn	1983/84 FSBR	June	Sept	AS	Jan	Outturn**
MO*	4.0	6.4	5.7	5.5	6.7	6.5	6.0
M1*	12.3	11.9	13.9	13.5	13.5	12.9	11.8
£M3*	11.2	9.0	12.6	12.0	11.2	11.0	10.0
PSL2*	11.5	8.8	13.3	13.5	12.8	13.0	13.5
Bank £ Lending	18.6	14.2	13.2	14.4	13.4	16.7	15.3
3 month interbank	11.5	9.6	9.8	9.5	9.7	9.7	9.7
20 year gilt rate	12.1	10.6	10.7	10.4	10.5	10.5	10.5

* Target period

** As judged by latest monthly money supply forecast

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FROM: HUW EVANS
12 December 1984

A.53

MR RILEY

cc Sir T Burns
Mr Odling-Smee
Mr S Davies
Mr Grice
Mr Spencer
Mrs Campbell

MACROECONOMIC PAPER FOR CHEVENING

The section on successive versions of the MTFS needs some care. Perhaps the text should recognize that the 1980 MTFS never mentioned money GDP at all. More importantly the comparison on page 4 needs to take account of the different price basis: the shift from 1975 to 1980 price.

	Percentage changes				
	1979-80	1980-81	1981-82	1982-83	1983-84
Output					
1980 MTFS		-2.2	-0.2	1.4	2.8
Latest estimate					
- at 1975 prices	2.2	-3.5	-1.1	1.6	[3]*
- at 1980 prices	2.6	-4.0	-0.2	2.6	3.4

					Total
difference between 1980 MTFS					
and '75 priced outturn	-1.3	-0.9	+0.2	[0.2]	-1.8
and '80 priced outturn	-1.8	0	+1.2	[0.6]	0

*my guess

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2. The comparison in your table, between a '75 price projection and a 1980 price outturn, shows a cumulative difference of nil, over the four financial years. But it seems to me clear that the comparison should be made on the same price basis, ie 1975 price, and on that basis output growth was a little lower; and the split of nominal income growth between output and prices was close to expectations (taking the '75 price figures literally, the split was slightly worse than expected).

3. There are a number of problems with all this:

(i) The output figures are sensitive to the precise period chosen (financial years v calendar years).

(ii) Part, but not all, of the upward revision between the last published 75-based and latest 80-based figures represents upward revision to date, rather than a pure price difference.

(iii) Of the overall increase in nominal GDP between 1979-80 and 1983-84, some [60] per cent, almost all was price, and only 0-2 per cent was volume. Whether the split was more or less favourable than expected therefore turns on very small differences indeed in output. It would be safest to say that:

(a) nominal GDP was close to (a bit below) what had been assumed;

(b) virtually all of this - perhaps not quite - represented prices not volumes;

(c) this split was more favourable than most outsiders then expected, and more favourable than expected by some internal assessments. The overall projection of nominal GDP, and its split, were both remarkably accurate.

4. Your immediate reaction was that the 80-based figures were the best measure of output. I agree; but they should be compared with a projection on the same basis; and it is easier to do that at 1975 prices.

5. I have not attempted to go into the oil/non-oil output comparison: to the extent that the rise in UK oil output exceeded expectations over this period, then it can be argued that it made the achievement of a given rise in total output that much easier. Equally, there are other factors, such as world output, that also need to be taken into account.

6. I would not myself put as much emphasis as you do on the mix of fiscal and monetary policies being very different from what was expected: I suspect we can attribute higher than expected real interest rates mainly to world real interest rates, and to a less than full understanding a few years ago of what kept real interest rates so low (negative) in the 70s.

VH

pp. H P EVANS