PREM 19/714

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Part 18

Confidential Filing

Economic Strategy

Pay & Prices Monthly Economic Report

The Economic Project

Treasury Weekly Brief

ECONOMIC POLICY

Part 1: May 1979

Part 18: July 1982

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
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PART 18 ends:-

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PART 19 begins:-

Treasury Brief : 1-11-82

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
MISC 14 (82) 7	22.7.82
CC (82) 40th Conclusions, Minutes 6 & 7	29.7.82
E(82) 60	2.8.82
E(82) 61	27.8.82
E(82) 65	1.10.82
E(82) 74	29.10.82

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed OMWayland Date 16 August 2012

PREM Records Team

PERSONAL AND CONFIDENTIAL

(2)

Econ. Pol

Prime Minister

HOUSE OF COMMONS
LONDON SWIA OAA

27 October 1982

Rt Hon Cecil Parkinson MP
Conservative & Unionist Central Office
32 Smith Square
London S W 1

Dear Cecil

POLICY WORK

You may find it helpful to see the attached letter. This both sets out where we've got to with the exercise, describes the arrangements we hope to create for Parliamentary liaison, and suggests how we should handle the delicate issue of publicity. Now that the Groups are about to begin their work I have suggested to each Chairman that he or she should get in touch with the Ministers in charge of the Departments whose responsibilities concern him to arrange for early input to each group of advice, ideas and any background information which may be relevant to the group's work.

I am copying this letter to the PM, Chief Whip and other Cabinet colleagues.

Yours

Geoffrey

GEOFFREY HOWE

PERSONAL AND CONFIDENTIAL

27 October 1982

As you probably already know, the Prime Minister has decided to set up a small number of Policy Groups and has asked Cecil Parkinson and me to co-ordinate them. I am therefore writing to you to tell you what is intended and to ensure that the policy groups, our Backbench Committees and the Party's groups on the Select Committees are all "on net".

The need at this time is not, as you will understand, for the kind of comprehensive (and sometimes leisurely) review which we customarily undertake in Opposition, but rather for a selective and fairly swift examination of key areas of policy, which complements the work already in hand in Departments. I attach for your information a list of the nine groups which are being created (there may be one or two more) and their chairmen. As always their membership (which has to be reasonably small and workmanlike) will reflect the interests of Conservative members of both Houses, the European Parliament and of the Party at large, as well as drawing on some outside expertise. (You may like to know, by the way, that Lord Beloff is Vice Chairman and Lord Thomas a member of the Advisory Board of the Research Department, appointed by the Prime Minister).

I am asking all Policy Group Chairmen to get in touch as soon as is practicable with the Chairmen of Backbench Committees and the Chairmen or Conservative leaders of Select Committees which deal with matters relevant to their policy groups. The main purpose of these consultations will naturally be to ensure that the agenda of each group is established in the full knowledge of the views of Select or Backbench Committees, and that arrangements are made for Policy Groups to consider any suggestions the Committees may want to make. Backbench Committees (and their officers) of course remain free, as ever, to bring forward their own ideas through the customary channels.

This activity may, of course, be the object of some curiosity and publicity. It is clear that the line we all take should be the same as it has been with such work in the past. The Press have been informed already in general terms of the decision to set up the policy groups, by means of the attached Central Office Release of September 27. It would not be appropriate to go further and make generally available details of the subjects for study or the names of Chairmen and members. The business of the policy groups themselves must, of course, be confidential and I have no doubt that you and other Parliamentary colleagues will wish to exercise appropriate discretion over this.

The arrangements I am proposing will, I hope, make for good liaison and thus contribute importantly to the value of this initiative. Please do not hesitate to get in touch with me if you have any queries about what is proposed.

Copies of this letter are going to Backbench Committee Chairmen and Chairmen or Conservative leaders of Select Committees.

GEOFFREY HOWE

POLICY GROUPS AND CHAIRMEN

UNEMPLOYMENT	Tim Renton
ENTERPRISE	Keith Wickenden
FAMILY & WOMEN	Lady Young
EDUCATION	Lord Beloff
INNER CITIES	Tim Sainsbury
POVERTY TRAP, WHY WORK ETC.	Terence Higgins
EUROPE	Lord Thomas
NATIONALISED INDUSTRIES	Tim Eggar
URBAN TRANSPORT	John Lee

Conservative Central Office

NEWS SERVICE

Release time: Immediate/MONDAY, 27th September 1982 611/82

POLICY GROUPS

The Conservative Party is setting up a series of Policy Groups which will review selected areas of policy and identify programmes and measures for the second term of office of the present administration.

The Groups will in the main be chaired by back bench members of the two Houses of Parliament. Membership of the Groups will be drawn from all sections of the Party and will include academics and technical experts.

The subjects to be covered include employment, the promotion of enterprise and new business, inner cities, the interplay of tax and social security, the quality of education and problems of urban transport.

Coordination of the work of the Groups is being undertaken by the Chancellor of the Exchequer, the Rt. Hon. Sir Geoffrey Howe QC MP and the Party Chairman, the Rt. Hon. Cecil Parkinson MP. Secretarial back-up to the groups will be provided by the Conservative Research Department.

END

PPS/CHANCELLOR

file no TEB/CA/01

copied to:

Mr Salveson (for transmission to No.10)
PS/CST
PS/FST
PS/EST
PS/MST(C)
PS/MST(R)
PS/Home Secretary
PS/Lord Chancellor
PS/Foreign Secretary
PS/Secretary of State for Education and Science
PS/Lord President of the Council
PS/Secretary of State for Northern Ireland
PS/Secretary of State for Defence
PS/Minister of Agriculture, Fisheries and Food
PS/Secretary of State for Environment
PS/Secretary of State for Scotland
PS/Secretary of State for Wales
PS/Lord Privy Seal
PS/Secretary of State for Industry
PS/Secretary of State for Social Services
PS/Secretary of State for Trade
PS/Secretary of State for Energy
PS/Secretary of State for Transport
PS/Chancellor of the Duchy of Lancaster
PS/Secretary of State for Employment
PS/Paymaster General
and officials in HMT, Revenue Departments and other Departments in Whitehall

TREASURY BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 15 October, are sidelined.

M M Deyes

M M DEYES

RGA

R I G ALLEN

25 October 1982

EB Division
H M Treasury
01-233-5503

1/1

ECONOMIC BRIEF: CONTENTS

A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

Main objectives are to achieve, over a period, a sustained improvement in the economy through reduction of inflation and promotion of enterprise and initiative. Reduction of inflation requires maintaining steady but not excessive downward pressure on monetary variables, and complementary fiscal policies. Improvement of supply side depends on restoration of flexible and competitive market economy and better incentives.

2. Fiscal boost desirable?

If there were some quick and easy solutions we would have adopted them. What is needed now is to sustain steady economic policies designed to reduce interest rates and inflation, and to create climate in which industry can invest and sell its products. That does not mean, of course, that possible fiscal measures cannot be debated on their merits. But it does mean keeping in mind also their total effect on borrowing and interest rates, and on the economy generally.

3. Recovery over?

Delayed but not over. Activity still 1 per cent above trough in Spring 1981. Pause this year largely reflects external developments. Expected recovery in world trade and output expected at Budget time has not materialised.

4. Recovery next year?

Prospect remains for resumed modest recovery next year - supported by upturn in cyclical indicators and by most outside forecasts. [NB. Next Industry Act forecast will be published in November.]

5. Where will growth come from?

Sources of growth are expected to be:

- some modest recovery in world activity;
- improved confidence as inflation comes down, encouraging more investment and risk-taking;
- lower interest rates improving companies' financial position and encouraging more fixed investment and stockbuilding;
- increased consumers' expenditure, partly reflecting lower inflation.

6. Government policies have caused recession by deflating demand?

No. Output had fallen more strongly than demand during the current recession; and in year to 1982 Q2 real demand rose by 3 per cent, real output by only 1 per cent. Import penetration rose 10 per cent between two halves of last year. Essential problems of economy lie on 'supply side' -lack of competitiveness etc. Government policies aimed at helping industry to redress these problems by : deregulating, restoring incentives and implementing a financial strategy under which inflation and interest rates can fall over the medium term.

7. What factors have caused flattening out in recovery this year?

Number of factors - last summer/autumn's temporary rise in interest rates and pause in progress on reducing inflation; slower, and later than expected, world recovery - all probably weakened confidence and activity. These factors now working the other way - inflation and interest rates coming down fast - and will contribute to future recovery.

8. PSBR undershooting/fiscal policy too tight?

As Chancellor said in Mansion House Speech (21 October), this year's PSBR may be running somewhat below the estimate at time of Budget. We are assessing the information and looking at the likely trends in revenue and expenditure for the rest of the year. Latest estimate will be published as part of the autumn Industry Act forecast. Await Autumn Statement (see A4 above).

9. Room for tax cuts?

See D3

10. Business confidence collapsed?

Recognise that business confidence is weak, reflecting depressed trading conditions at home and worldwide. But great majority of businessmen support Government's basic economic strategy and are optimistic about prospects for company growth/profits over next two years. [NB Next CBI Survey due to be published on 28 October].

11. Chancellor's Mansion House Speech points to abandonment of monetary targets?

No. Chancellor specifically said that 'we need to maintain a prudent monetary strategy' and that we cannot ease up on inflation: '5 per cent is still too high'. Of course, as Government has recognised for a long time, 'flexibility has to be achieved without a drift into laxity'. [For further material on monetary developments, see Section J].

12. Public spending cuts? Think tank report?

See E4

13. Unemployment trend worsening?

[NB: October unemployment figures to be published 26 October: See Section C.]

14. Poor prospects for world economic recovery?

See T1.

15. Is there an impending world financial crisis?

See T4.

16. Autumn Statement?

[Government's reply to report on Budgetary reform from TCSC published 5 August. Will involve some changes in Budgetary procedure. But these will not go all the way towards implementing Committee's recommendations.]

Government intend to take full account of TCSC's proposals in continuing to build on significant progress already made towards greater integration of economic decision-making (eg MTFS) and involvement in it of Parliament and public. In particular, Government will advance these developments by publishing around late November/early December an Autumn Statement which will allow fuller and better-informed discussion of monetary and fiscal prospects than in past. Structure and contents of Autumn Statement will build on what is already published and can be expected to evolve over time. This year's autumn statement probably in November.

17. What will it contain?

As stated in reply to TCSC, Autumn Statement will contain Industry Act forecast, commentary on economic developments and prospects, information about public expenditure decisions for the year ahead, and tax ready reckoners.

BULL POINTS As at 25.10.82

(i) Activity. Underlying level of output broadly flat since last Autumn but industrial and manufacturing output above levels spring 1981. Most recent major independent forecasts see prospect of modest recovery later this year and next.

(ii) Interest rates. Bank base rates have fallen 6½ points since last autumn (now 9½ per cent). Lowest level for almost four years. Recent falls reflect several factors:- single figure inflation, M1, £M3 and PSL2 developing favourably in relation to 8-12 per cent target, Government borrowing under control, exchange rate firm.

(iii) Inflation. The increase in the RPI over the 12 Months to September was 7.3 per cent. This is the lowest since September 1972 and close to a quarter of the peak level of 26.9 per cent in August 1975. The September level of prices is no higher than June and actually below the August level - the first fall since August 1970. Forecast of annual rate RPI inflation 6½ per cent by end of 1982 and prospect of 5 per cent by Spring of 1983. Manufacturers' output prices up 7½ per cent in year to September.

(v) Costs.

- Increase in average earnings halved in 1980-81 pay round. Public sector pay in line. Further moderation in average level of settlements in 1981-82 round. CBI pay databank for manufacturing settlements suggests average now around 7 per cent compared with 9 per cent in 1980-81 round.
- Manufacturers' unit wage and salary costs up only 5½ per cent up in year to July, below average of major competitors.
- Manufacturers' input prices up just 3¼ per cent in year to September.
- CBI August survey shows lowest degree of unit cost pressures for 15 years.

(v) Manufacturing productivity. Output per head has risen about 12 per cent since end 1980. Output per head and output per hour now about 6 and 9 per cent higher than previous peak in 1H 1979.

(vi) Competitiveness. Cost competitiveness improved by 10-15 per cent during 1981 reflecting pay moderation, higher productivity and exchange rate fall, but remains $^1/_3$ worse than in 1975.

(vii) Profits: Industrial and commercial companies' gross trading profits (net of stock appreciation, excluding North Sea) risen 16 per cent in 1H 1982 compared with 1H 1981. Recovery in profits from very low base: pre-tax real rate of return of ICC's (excluding North Sea) only 3 per cent in 1981.

(viii) Housing starts (total) - up over a quarter in first eight months of 1982 compared with same period 1981.

(ix) Exports (non oil, excluding erratics) only 1 per cent lower in 12 months to August 1982 than in 1980, despite earlier substantial loss of competitiveness.

(x) Special employment measures. Total provision for special employment schemes planned to reach £1½ billion in 1982-83. Further measures announced end-July - new community work programme (started October), job splitting subsidy schemes (from January 1983).

(xi) Overseas investment in UK: US direct investment in Britain amounted to stock of over $14 billion in 1980. Nearly 60 per cent of all US outward non-oil direct investment now takes place in EC - over half of that in UK. Half of all Japanese investment in the EC also comes to Britain. Investment intentions survey of 231 German owned companies in the UK shows great majority intend to expand here in the near future.

(xii) Overseas debt repayments. Official external debt reduced from over $22 billion in May 1979 to around $12½ billion at end-September 1982.

Economic Briefing Division, HM Treasury, 01-233 5514/5503

B ECONOMIC ACTIVITY AND PROSPECTS

1. Recent output figures

[Latest GDP figures (all three measures) suggest any growth in economic activity in H1 1982 over H2 1981 was slight, but output about 1 per cent higher than in Q2 1981. Industrial production in three months to July unchanged compared with previous three months once adjustments made for holidays in May and June. Underlying level of industrial output 1½ per cent above 1981 Q2 trough - largely attributable to North Sea oil. Trend in manufacturing activity at best flat and may be deteriorating.]

Prospects for recovery this year undoubtedly receded since Budget partly because world recovery has not materialised. But rapid progress on inflation and interest rates, and productivity is higher. Beginnings of recovery in industrial competitiveness must not be undetermined. Industry's contribution to sustaining recovery is decisive; must be ready to meet (modest) recovery in world activity expected next year (see T1).

2. Other evidence of improvement in economy?

See Bull Points (following Section A).

3. Latest CBI assessments?

[CBI Monthly Trends Enquiry shows little overall change in total order books since November, but a deterioration of export order books since March of this year. Net balance of firms expecting to increase output in next four months has fallen (to minus 7) and net balance of firms reporting excess stocks unchanged. Also further decline in net balance of firms expecting to increase prices in next four months. Latest forecast suggests only marginal rises in GDP (output) in Q3 and Q4 leaving GDP on 1982 ½ per cent up on 1981].

CBI September Monthly Trends Enquiry and latest forecast further confirmation of flattening out in activity since last autumn. Government always maintained recovery would initially be slow and patchy. It will continue to be so particularly given more depressed world outlook. As with most outside forecasters the CBI expect gradual recovery over next 18 months and future financial developments to be favourable.
[NB Next CBI trends survey to be published 28 October].

4. New orders figures depressing?

[New construction orders in August fell by 22 per cent from around £450 million to £350 million (at 1975 prices) compared previous month. In three months to August, orders fell 6 per cent compared previous three. Volume of new orders in engineering industries fell 9 per cent in three months to July compared previous three.]

Figures manifest depressed economic activity which itself partly reflects flatness in world trade.

5. Fall in investment and reduction in stocks?

[Capital expenditure by the manufacturing, distributive and service industries in Q2 1982 4 per cent lower than level in previous quarter. Investment in manufacturing in H1 1982 was 3 per cent lower than in Q4 1981. Stocks fell by £30 million ('75 prices) in Q2; but in the first half of 1982 stocks increased by £100 million compared with destocking of £520 million in second half of 1981.]

Figures another manifestation of hesitation in economic activity. Despite this, some categories of investment, notably plant and machinery, have held up quite well. [IF PRESSED: latest DOI investment intentions survey shows slight fall in manufacturing investment between 1981 and 1982; Q2 figure not inconsistent with this.]

6. Stock levels a threat to recovery?

Falling interest rates (nominal rates lowest for four years) have eased cash pressures and should assist recovery in stock cycle.

7. Competitiveness not improved this year?

Competitiveness improved 10-15 per cent during 1981 [but remains one third worse than in 1975]. Further improvements, which are essential to regain markets and create new ones, depend above all on substantially lower wage settlements in this pay round than in the last one.

8. Productivity growth falling off?

No; productivity growth in manufacturing at 4½ per cent over last year is well above the UK historical average.

9. CSO's index of leading cyclical indicators?

Longer leading index rose again in September reflecting further falls in interest rates and an increase in share prices. Shorter leading index also rose in July and August. These changes encouraging through precise implications for future movements in economic activity will not become clear until some more later data are available.

10. FSBR forecast now looks too optimistic?

[Several independent forecasts have revised down their forecasts of growth in 1982 marginally (from around 1½ per cent to about ½-1 per cent), largely reflecting the recent disappointing levels of world trade. Despite this most groups have not altered their assessment of the strength of the recovery in 1983, and most are more optimistic about financial developments, inflation and interest rates.]

Output growth for 1982 is likely to be less than expected at Budget time, partly in face of less buoyant world activity, but we are doing much better than expected on inflation and interest rates. Clearly there are uncertainties, not least the international environment - though some indications that worst of recession is over in US (see T7). At present there is no reason to doubt that gradual recovery will resume in 1983. Certainly the majority of outside forecasters do not doubt it.

10. Latest Industry Act forecast

Next publication of Treasury forecasts in November.

11. Outside forecasts

[GDP profile in recent major assessments:

Per cent change

	NIESR	LBS	St James	Phillips & Drew	Simon & Coates	CBI	OECD	FSBR
	(May)	(June)	(Aug)	(Oct)	(Oct)	(Aug)	(July)	(March)
1982 on 1981	+1	+1	+1¼	+¾	+½	+½	+1¼	+1½
1983 on 1982	+1	+3	+2½	+2	+2½	+1½	+1¾	+2

Nearly all see prospect of continued recovery and lower inflation.

C LABOUR MARKET

[NB October unemployment and vacancies figures being published Tuesday on 26 October.]

1. Government concerned over unemployment?

Of course Government is concerned, and so is pursuing balanced fiscal and monetary policies to curb inflation, and creating conditions for enterprise - the only measures that will ensure sustainable increase in employment. Nevertheless Government has substantially increased spending on schemes to alleviate impact on especially vulnerable groups - e.g. plan to spend £1½ billion in cash in 1982-83 (40 per cent more than in 1981-82) on special employment and training measures (including new Youth Training Scheme costing £1 billion a year from 1982-83); the new community programme which is designed to provide up to 130,000 places for the long term unemployed; and the new Job Splitting Subsidy which will be open on 1 January next year to encourage the extension of part time work and provide additional opportunities for productive jobs for unemployed people.

2. Cost of unemployment? Effect on PSBR/

There can be no single estimate of 'the cost of unemployment'. Only costs that can be at all readily identified are additional expenditure on unemployment benefit, supplementary benefit, rent and rate rebates and administration. (Even these dependent on characteristics of those becoming unemployed - family status, resources etc). These could average £1800 in 1982-83 for each additional registered unemployed person. (NB This cannot be multiplied out by the total number unemployed.)

[IF PRESSED: Estimates of effect of othe influences on PSBR directly or indirectly associated with unemployment vary widely depending on large number of highly debatable assumptions. And a major change in the level of unemployment would have impact on other economic indicators effective in the calculation of PSBR.]

3. Recent unemployment figures and other labour market indicators?

[Underlying trend in unemployment is deteriorating; but no sharp rise in 'headline total' expected till January. Recent unemployment/vacancy figures shown below:

	1980 Q4	1981 Q1	Q2	Q3	Q4	1982 Q1	Q2	Q3	Sept
Total unemployment	2.16	2.46	2.59	2.93	2.96	3.04	3.01	3.28	3.34 (14.0% rate)
UK adult sa total (millions)	2.02	2.28	2.48	2.64	2.75	2.82	2.88	2.98	3.04 (12.7% rate)
increase in period (000's)	+105	+77	+62	+51	+33*	+21*	+30*	+42*	+49*
Vacancies (000's)	99	98	89	96	104	112	107	111.0	107.0

*After allowing for over 60's transferring to supplementary benefit.

Other labour market indicators (e.g overtime, short-time) roughly flat for last 6 months.]

Figures are tragic but problems took a long time to build up will also take a long time to check or reverse. Recent figures reflect levelling out in activity since last autumn.

4. Unemployment in UK higher than in other countries?

[On standardised definitions in Q2 1982 UK unemployment was 12.7 per cent compared with 8.1 per cent OECD rate; little over doubling for UK compared with OECD rise of over one half since 1979.]

Unemployment now rising very fast in many industrialised countries - much faster in some e.g. Netherlands, Belgium and Canada.

5. UK's true unemployment figures really much higher?

[Sunday Times 19 September suggested 700,000 'hidden' jobless.]

No one seeks to deny there are unregistered unemployed but reliable estimates of their numbers are difficult to obtain. Available estimates vary quite widely. Figures of registered unemployed are based on accurate counts, have been accepted by successive administrations and provide reasonable estimates of trend.

6. Unemployment expected to continue rising rapidly?

Unemployment forecasts uncertain; independent forecasters encompass differing views for 1983 - several projecting stabilisation, some [a slight] decline. Though there has been a worsening in the underlying trend in unemployment since June this year, rise for year as a whole has only been some 40 per cent of rate over same period last year. Employment situation should benefit from some further recovery in activity.

7. Fiddling the statistics?

[Rayner cost-saving exercise means that from November onwards method of measuring unemployed will change. November count will be some 100,000 lower than on traditional measure. Even further reduced in summer when school leavers register.]

No question of a fiddle. Detailed and considered study revealed substantial savings on collecting statistics for registered non-claimants. D.Employment will be providing estimates of effect on past statistics, and will provide similar information for up to a year from the change.

8. What is Government's own forecast of unemployment?

Government does not publish such a forecast. Nor did its predecessors. Unemployment depends on many factors: labour supply changes, growth in output and real earnings - all difficult to predict

IF PRESSED: in early 1980 no major outside forecasters accurately foretold fall in manufacturing output nor dramatic labour 'shake-out' of 1980-early 1981.

9. Employment continuing to fall?

[Total employment declined 2.2 million (9½ per cent) between mid 1979 and Q2 1982.]

First indications are that total employment (seasonally adjusted) fell by more than 150,000 in Q2, substantially more than the 91,000 fell in Q1. Best help for permanent jobs is sustainable recovery.

10. Recent productivity gains inimical to higher employment/lower unemployment?

[Output per head in manufacturing up 12 per cent since end-1980.]

This may be true in the short run. But in the longer term, as experience in UK and many other countries clearly demonstrates, higher productivity essential for growth and employment opportunities.

D TAXATION

1. Burden of taxation

[Total taxation (including NIC) as proportion of GDP was 34½ per cent in 1978-79 and is forecast to be 39¾ per cent in 1982-83. Corresponding figures excluding NIC are 28½ per cent and 33 per cent].

Burden has inevitably risen because of upward pressures on public expenditure caused by the recession. Increases in taxation are better - and more honest - means of financing this than borrowing, because of adverse effects borrowing has on interest rates and inflation.

2. British tax burden high by international standards?

Not so. Accurate comparisons difficult, but UK burden about average for OECD countries [1981 data from Lloyds Bank Economic Bulletin, October 1982]. Similarly, UK taxes on household income and employees' social security contributions about average for EC countries and lower than Japan and USA [1980 provisional OECD data].

3. Prospects for cuts in taxation in 1983 Budget?

[Reference Chancellor's speech to Conservative Party Conference 6 October and Weekend World interview 10 October].

Cannot, of course, comment now. Progress on inflation and interest rates must be maintained. Remain committed to tax reductions, but these will be made only when they can be afforded.

4. Future of married man's personal allowance?

[Labour party commitment to phase out in favour of increased child benefit etc; reported SDP proposals to abolish as part of new tax-credit scheme to assist lower paid.]

Government launched debate with December 1980 Green Paper on Taxation of Husband and Wife. Very wide range of views received, which government is considering. Abolition of married man's allowance advocated in some quarters would affect many millions of taxpayers and by itself leave a basic rate taxpayer £5 a week worse off. Costs to the losers of large scale schemes to redistribute income cannot be ignored.

5. Why should private schools enjoy tax reliefs?

Fully in favour of private schools. Tax relief per pupil minor by comparison with cost of state education. [IF PRESSED: tax reliefs difficult to cost but probably worth up to £40 million a year plus around £100 million for exempting fees from VAT.]

6. Previous reductions in personal taxation favour the rich?

1979 Budget cut absurdly high top rates of income tax to European levels, as part of package which also involved substantial increase in thresholds. Such action was essential to restore incentives. No 'pot of gold' in higher rate tax; restoration of 83 per cent top rate would finance a cut of under ¼p in the basic rate.

7. Burden of taxation risen most for the poor?

Proportion of income paid in income tax and NICs has fallen in 1982-83 for lowest paid taxpayers. Low paid with children are also entitled to benefits such as FIS.

8. Poverty and unemployment traps

Government equally concerned about poverty and unemployment traps, in context of incentives as a whole. They will remain a key factor in considerations of future tax policy. Traps are essentially caused by measures to relieve poverty and unemployment. Substantive action to alleviate them through the tax system would be extremely costly. Long-term solution must be an increase in wages as a result of a sustained improvement in economic performance. (See G6 for comment on SDP proposals.)

9. Further reduction in NIS?

This year's reduction will benefit private sector by £640 million in 1982-83. In addition, employers have been shielded from increases in NIC rates over last two years. Cannot comment on possibilty of further reductions, which would be expensive.

10. Further action to encourage wider share ownership?

Already seen encouraging growth of employee share-ownership, as result of liberalisation and extension of arrangements to promote profit sharing and share option schemes in 1980 and subsequent Finance Acts. Total of almost 500 profit-sharing and share option schemes now approved by Inland Revenue. Compares with less than 30 in May 1979.

E PUBLIC EXPENDITURE AND FINANCE

[Public Expenditure White Paper (Cmnd 8494) published 9 March. Gives planning totals of £115.2 billion in 1982-83, £121.1 in 1983-84 and £128.4 in 1984-85. About £5 billion higher than last White Paper in 1982-83 and £7 billion in 1983-84. Net effect of changes announced in Budget is to reduce totals to £114.9 billion, £120.4 billion and £127.6 billion].

1. Public expenditure too high?

Spending in 1982-83 planned to be about £5 billion (4½ per cent) lower than intended by last Government even if higher than planned when this Government first took office. Decisions to increase spending represent flexible but prudent response to changed circumstances e.g additional spending to help young unemployed. Drive to improve management in public sector and reduce administration expenses continues.

2. Ratio of public spending to GDP is getting back to peak levels of mid 1970's?

Ratios in 1980-81 (43 per cent) and 1981-82 (44½ per cent forecast) remain below level of 1974-75 and 1975-76 (46 per cent in both years). Rise in ratio in 1981-82 mainly reflects higher expenditure on social security at a time when real GDP falling. Ratio expected to fall in next few years: assumptions in MTFS would mean figures of 44½ per cent in 1982-83, 42½ per cent in 1983-84 and 41 per cent in 1984-85. Reflects assumed GDP growth and curbing of public expenditure.

3. Higher figures quoted in Weekend World programme 10 October?

[Ratio of public expenditure planned for 1982-83 to GDP in that year given in Weekend World programme was 46.8 per cent. Apparently derived (incorrectly) by someone at ITV taking from the FSBR the wrong numerator for the ratio. They took it from Table 8. The correct figures were given in the FSBR at para 2.21, and a reconciliation set out in Table 6.]

Figure of 46.8 per cent shown on Weekend World for 1982-83 based by them on incorrect calculation. The estimated ratio of public expenditure to GDP in 1982-83 is 44.5 per cent - which compares with 46 per cent in 1975-76 before Mr Healey went to the IMF. As Chancellor said, the intention is to reduce the ratio of public spending to GDP and it could be down to 41 per cent in 1984-85

4. Longer-term outlook for public expenditure?

[Economist 18-24 September reported that radical CPRS proposals to cut public spending in the longer term were tabled but not discussed at Cabinet 9 September.]

There is a problem in that public expenditure has an inherent tendency to creep ever upward - though this Government has been more successful than most in putting the brakes on, Government is looking seriously at various options. No necessarily questions of 'decimating' services; rather of finding best ways of financing better quality with wider choice. No specific decisions have been taken as a result.

5. Increase spending in recession?

No good trying to spend way out of recession. Any benefits would be short-term. If increased spending not financed responsibly, would soon lead to more inflation. If financed prudently, would lead to higher interest rates and/or higher taxes. We are responding, within limits of prudence, to needs of current circumstances.

6. Spending Ministers seeking extra public expenditure in 1983-84?/Treasury once again seeking cuts in public expenditure?

Bids for additional expenditure put forward in usual way as part of annual public expenditure survey. Ministers collectively will have to decide which are to be allowed and, depending on size of any increase, to what extent the increase should be met by savings elsewhere.

7. Not enough 'productive' public investment/needs being jeopardised?

Government not cutting 'productive' investment. Partly question of definition - within figures for capital expenditure totals, council house sales count as a negative item and defence procurement counts as current expenditure. Also, since mid-1970's some needs ~~have declined~~; future standards and public amenities will not be jeopardised.

8. More capital projects in public sector to help private industry?

Government prepared to give priority to worthwhile capital projects within overall totals. But no question of artificial and inflationary stimulus to demand. New projects must be considered on merits. Nationalised industries investment in 1982-83 planned to be about quarter higher than previous year's outturn. Real answer: to provide private sector with prospect of higher rates of return on investment by continuing policies to lower interest rates and increase incentives.

9. Cash planning means concentration on first year, not enough on services in later years?

Government recognise case for medium-term planning. But planning must be related to availability of finance as well as prospective real resources. Cannot accept unconditional commitment to forward plans for services. Volume plans formerly had to be cut when conflicted with financial constraints - e.g after IMF intervention in 1976.

10. End-year flexibility?

Possibility of end year flexibility is being looked at again. There could be some managerial advantages in such a scheme. But we also have to consider question of cost.

11. Why so much underspending on Central Government voted cash limits 1981-82?

[Provisional outturn figures published 29 July].

Though rather more in 1981-82 than in each of previous three years, this is natural consequence of treating them as limits and not as targets. Extent of underspending on individual limits varies and is governed by range of factors - which can differ markedly from one cash limit to another. In general, moderation in rate of inflation, which departmental managers may not have fully anticipated, made it easier to remain within cash limits.

12. Why so much underspending by local authorities on capital expenditure?

Number of reasons including lower tender prices working through. But overwhelming reason was success in selling council houses and unused land.

13. Cut public sector pay bill/administrative costs of central government?

Only one third of current expenditure is on wages and salaries and much of that is for nurses, teachers, members of armed forces, police and so on. Provision for public service pay increases 1982-83 limited to 4 per cent. Administrative costs are not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain drive for more efficient management throughout public sector.

14. What allowance will Government make for pay increase in public services next year?

Government attaches great importance to realistic wage settlements next year, in both public and private sectors. Provision for public service pay will be made from within cash plans.

15. 3½ per cent pay assumption for 1983-84?

[Announced from Treasury 10 October.]

Assumption is not a 'norm'. Nor is it a decision on the offer to be made in any particular case. Each will be considered on its merits. It concerns the provision in public expenditure plans for next year for those groups for which Government is directly responsible, other than NHS. It does not directly cover local authorities, or nationalised industries, which are not within Government's direct control. But they will be controlled by the rate support grant and the external financing limits.

16. Will Government's operation of cash limits for civil service [and NHS] pay change as result of Megaw Inquiry Report?

Government is committed to policy of using cash limits to control public expenditure. We will consider and discuss the implications of Megaw report (see F4) in due course.

LOCAL GOVERNMENT

17. Local authority capital underspending and measures to prevent recurrence in 1983-84

[Speculation in Press reports 21 October.]

Following underspend of more than £¾ billion in 1981-82, local authorities seem set to underspend their capital cash limits for 1982-83 by at least £1 billion - possibly up to £1½ billion (GB figures). Some steps are in hand to reduce the underspend: Prime Minister is writing to local authority associations, and extra allocations - particularly for improvement grants - will be given to authorities who can use them. Environment Secretary has also announced steps to reduce the risk of a further underspend in 1983-84.

BACKGROUND - CAN BE DRAWN UPON: Steps taken by Environment Secretary reported in Press in rather confused way. Local authorities are given individual spending allocations which have legal force, but which can be supplemented with capital receipts from sale of assets. Authorities seem prepared to spend up to allocations, but not to use receipts. Their cash limits and public expenditure totals are net of these receipts; receipts are very high because of success in selling council houses and unused land; hence the underspending. Environment Secretary has announced he will in 1983-84 extend to other services present arrangements for housing allocations - where half of forecast level of receipts is built into initial allocations. In aggregate, authorities can therefore commit in advance half of additional expenditure justified by receipts; can then individually only use half of receipts to supplement allocation. Reduces individual authorities' ability to save receipts towards future projects, and perceived by them as loss of freedom, although it should mean higher allocations and therefore higher spending.

18. Current overspending in 1982-83

Local authorities planning to spend some £1½ billion above Government's plans in 1982-83. In response, Secretaries of State have announced intentions to penalise over-spending by reducing the amount of grant to be distributed to them. (For details, refer to statements in Parliament 27/28 July by Secretaries of State.)

19. Local government finance 1983-84?

Because local authorities are spending so much this year, Government recognise they will spend more in 1983-84. So current expenditure provisions have been increased to ensure that they remain realistic. (For details refer to statements by Secretaries of State in Parliament 27/28 July). Figures announced are subject to consultation with local authorities, but Government is determined that they should be held to levels consistent with objectives for public expenditure and macro-economy.

20. Rate increases in 1983-84?

Spending in line with Government plans would imply only very modest increases overall, and in some areas no need for any increase at all. Of course, in areas where rating authorities overspend, ratepayers will bear a greater burden.

21. Government's plans imply enormous job losses?

Not necessarily. Government's plans for local authority expenditure are realistic and achievable. Local authorities could do a lot to help themselves by moderating pay and improving efficiency.

22. Proposals for direct control of local government spending?

Local authority overspending shows that the traditional consensus with central government is breaking down. We cannot afford to let damaging levels of expenditure continue unchecked. Local authorities' own responsible behaviour may force us to consider more direct action.

23. Green Paper on Domestic Rating System: Government response?

Government is considering carefully all representations received. We wish to produce proposals for a scheme that will remedy shortcomings of present system while commanding wide support.

FALKLANDS EXPENDITURE

24. Latest information on Falklands defence costs? Treasury 'lost battle' with MOD?

No difference between Treasury and Ministry of Defence about financing of Falklands costs. Latest estimates of these will be dealt with by PM on Tuesday 26 October [in reply to Mr Dalyell MP].

25. What will be costs of repairing damage and reconstructing the Islands' economy?

Too soon to say what these costs will be. Work has begun on restoration of essential services and on implementing Civil Commissioner's recommendations for priority action (accommodation, inter-Islands air service, education). Up to £10 million is being made available. Not yet clear whether these costs will require additions to existing FCO and ODA funds and how far additional sums will be needed.

26. Cost of paying compensation for war damage?

Too soon to say what total will be. Claims are being processed, and further claims may be received. About £1 million has so far been paid out, but this is no guide to what the final total might be. Not yet clear whether the compensation scheme will require an addition to existing FCO programme.

27. Cost of proposals in Lord Shackleton's report?

[Published 13 September. Some very large possible spending figures being bandied about by media]

Report will need careful study, both in UK and the Falklands, before decisions on all these proposals are reached. In advance of decisions not possible to say what cost might be.

[BACKGROUND WHICH CAN BE DRAWN UPON: Estimates of cost given in the Report are £31-36 million for new development aid; £40 million for offshore fishing; up to £12 million for additional housing/infrastructure. Total estimate of £83-89 million (at 1982 prices) excludes aid for rehabilitation and compensation for war damage already being made available.]

F CIVIL SERVICE STAFFING AND PAY

1. Civil service too big/does too much/is over staffed?

Since Government came to office, Civil Service has been reduced by 10 per cent to 659,300. Results from reduction in functions, privatisation and improvements in efficiency. On course to achieve aim of having Civil Service of 630,000 by April 1984. This is 102,000 fewer staff in post than in April 1979, and will mean smallest Civil Service since end of Second World war.

2. Civil service efficiency?

[Government reply to TCSC was published 28 September entitled 'Efficiency and Effectiveness in the Civil Service Government Observations on TCSC Report Cmnd 8616].

Measures to increase efficiency in civil service set out in Government's recent White Paper welcoming Report from TSCS, and accepting (totally or with reservations) no less than 20 of the Committee's 26 recommendations. White Paper gives details of new financial management initiative, and responds to Committee recommendations on management information systems, training in management and financial management, and the filling of senior posts.

3. ~~Civil~~ service pay in 1983?

Unions have asked Government, in light of 3½ per cent planning assumption announced 1 October (see E 15), whether Government intend to have genuine negotiations, and whether arbitration will be available. They believe arbitration should be unconditionally binding ie not subject to Parliamentary over-ride.

4. Megaw Report

[MST speech Harrogate 21 October].

Report of Megaw Inquiry into arrangements for deciding civil service pay in future (Cmnd 8590) contained number of important recommendations which are now being considered. Government pleased with widespread support that has emerged for the general approaches which the Inquiry endorsed. Preliminary 'ground-clearing' discussions with unions have commenced. Not likely new system can be agreed in time for 1983 pay.

4. Scott Report/Public sector pensions?

See K 18.

G SOCIAL SECURITY

1. Restore abatement of Unemployment Benefit?

[Uprating in November 1980 was abated by 5 per cent; this foreshadowed in Budget Speech announcing plans to bring UB into tax.]

Our position on this has been made clear. We reviewed the possibility of restoring the abatement when the benefit was brought into tax in July, but concluded that we could not afford to do so. The matter is being kept under review, and I have nothing more to add.

2. But abatement was a proxy for tax?

Always made clear when decision to abate was announced that it was not solely a proxy for tax but also part of a public expenditure savings package, and a measure likely to improve work incentives.

3. Cost of restoration substantially less than tax revenue?

[Cost of restoration £20 million first year, £60 million full year. Revenue from taxation now estimated at £650 million.]

Wrong in principle to hypothecate money from taxing benefits. But if MPs want to make such a comparison I would draw attention to cost of restoring shortfall in November 1981 uprating - £525 million in full year - this and other increases in social security expenditure more than accounts for the additional revenue.

4. Abatement hits at poorest section of the community?

Only one quarter of the unemployed are solely dependent on UB and hence affected by the abatement. All those affected will have been unemployed for no more than a year and are primarily single people or childless married couples.

5. Increase in National Insurance contributions?

We are currently in the early stages of the annual review of national insurance contributions conducted by the Government Actuary. It is too early to say what that review will produce.

6. SDP plan for unified benefit to abolish 'poverty trap'?

Cannot comment on details when have only seen advance Press reports. But on basis of those, SDP scheme would redistribute income to poor at expense of the average working man and his family, and even then unlikely to achieve abolition of poverty trap at the quoted cost of £4 billion - we reckon for example some £10 billion would be minimum needed to provide comprehensive solution along tax credit lines.

7. Burden of State pension scheme too high?

[Government Actuary's Department Quinquennial Review of National Insurance Fund, published Wednesday 21 July, analysed possible future (up to forty years) cost of contributory benefits and levels of contributions needed to pay for them. Most important factor is increasing expenditure on earnings-related pension. Conclusions depend on assumptions about growth in earnings, prices, unemployment etc over period, but on certain assumptions contributions could change from present relationship to earnings - 16.5 per cent combined employees' and employers' contributions - to 15.4 per cent by 1985-86, but rise to 16.7 per cent by year 2005-6 and 21.9 per cent by 2025-6.]

Government Actuary's conclusions not firm predictions but illustrations of possible future burden on certain assumptions. We shall be considering report carefully before reaching any conclusion. In meantime DHSS are consulting widely with interested organisations and would welcome comments by end of this year.

8. Death grant - increase to realistic level?

[Consultative document about death grant published 3 March, deadline for comments 30 July.]

Social Services Secretary grateful for comments received on consultative document on death grant published in spring and is considering them carefully. As document made clear, aim is to redistribute in more sensible fashion resources now devoted to death grant - cannot afford to add to those resources.

9. Uprating benefits - will Government claw back any overshoot?

[Most benefits will be uprated by 11 per cent on 23 November. 9 per cent of this is to compensate for price increases over previous year].

Inflation is falling faster than was forecast at Budget time and we expect the outcome to be lower than the 9 per cent forecast. We shall not know the extent for a couple of months yet. This November's uprating will of course go ahead as planned. The 1983 uprating will be decided nearer the time. It will depend on the forecast movement in prices which will be made at Budget time, and whether the Government decides to take account of any overshoot this year. No decision has yet been taken.

H FISCAL POLICY AND THE PSBR

1. Progress on fiscal policy?

[Aim is to achieve reduction in PSBR as percentage of GDP over run of years, so as to achieve lower inflation and interest rates.]

Have made progress; Government has succeeded in reducing PSBR as percentage of GDP, and further reduction is projected. Inflation has fallen fast and is expected to fall further (see K2-3). Long term interest rates now lower than at any time in last 9 years. Benefits seen in recovery of debenture market. [IF PRESSED: Government would like to see rates lower still, so long as further reductions not likely to endanger progress or inflation.]

2. How does UK fiscal stance compare with other countries?

[IMF Annual Report noted that among major industrial countries by far the largest 'restrictive shift' over past two years, equivalent to more than 3½ per cent, was that of UK.]

Many countries reducing borrowing; UK budget deficit now well below average of OECD countries. France demonstrates problems with reflation option and US experience shows that fiscal and monetary policy must be broadly consistent.

3. 1981-82 undershoot shows fiscal policy too tight?

[PSBR for last year turned out £1.8 billion lower than estimate of £10.6 billion given in 1982-83 FSBR.]

Last year's undershoot probably does mean fiscal policy somewhat tighter than planned, but must examine strategy as a whole. Firm control of Government borrowing one factor responsible for fall in short term interest rates (6½ percentage points down since last autumn). Recovery of corporate bond market shows how lower PSBR creates room for investment.

4. Why treat PSBR as crucial statistic when prone to very substantial forecasting error?

[Margins of error are wide: plus or minus £4 billion.]

Although forecasting PSBR is hazardous, this in no way diminishes importance of achieving better balance between Government spending and income. Recognised by all Governments, whatever the difficulties of forecasting.

5. 1982-83 PSBR heading for undershoot?

[1982-83 FSBR forecast £9.5 billion. PSBR April-September £4.5 billion (£3.0 billion seasonally adjusted).]

Now looks as though PSBR in 1982-83 could be lower than the 1982 Budget forecast. Next indication of likely PSBR outturn will be given at time of Industry Act forecast (to be published, probably, next month).

6. PSBR in 1982-83 likely to be about £6 billion?

[Seasonally adjusted, PSBR April-September £3.0 billion. Commentators may multiply this by two to get £6 billion as PSBR figure for year as whole.]

No; wrong to multiply seasonally adjusted half-yearly outturn by two as there are many erratic and irregular influences in the underlying data which seasonal adjustment does not pick up.

[IF PRESSED: what factors will increase PSBR in rest of year?

Public corporations expected to borrow more in second half of year than their £0.4 billion to end-September; there are a number of outstanding public sector pay awards which have not been implemented (eg nurses); National Insurance up-rating of 11 per cent, higher than present rate of inflation, will affect second half of year.]

7. Unadjusted PSBR misleading guide to fiscal action?

~~Cyclically-adjusted~~ PSBR may have some merit as indicator but poor guide to fiscal policy. It is actual Government expenditure and revenue that have to be financed and influence interest rates and aggregate demand.

8. Inflation-adjusted or 'real' PSBR in surplus - isn't fiscal policy too tight?

['Real' PSBR subtracts from actual PSBR erosion by inflation of real value of Government debt. Calculations by Bank of England and others produce a surplus 'real' PSBR in most years since the 60's].

Policy of this Government is to fight inflation, not to accommodate it. If 'inflation-adjusted PSBR' is in surplus, this calls for cut in inflation, not expansion of actual PSBR.

J MONETARY AND FINANCIAL POLICY

1. Monetary growth in 1982-83 on target

[The target aggregates M1, £M3 and PSL2 grew by 1.2, 1.1 and 0.9 per cent respectively in banking September. These changes bring rates of growth in the 1982-83 target period to 9½, 11½ and 8½ per cent per annum respectively, compared with target range of 8-12 per cent (all figures seasonally adjusted).]

Rates of growth of all three target aggregates are within Government's target range. £M3 is towards top of range. But looking also at behaviour of exchange rate and progress in reducing inflation, overall picture is of sound domestic monetary conditions.

2. Prospects for further reductions in interest rates?

[Last reduction in bank base rates made on 13 October to 9½ per cent. Have come down by three points since early July. Long term interest rates also reduced significantly - by one point in October alone.]

Substantial interest rate reductions this year reflect sound monetary conditions, and good inflation prospects. Impulse also from US developments. Government would like to see rates lower still, so long as further reductions do not seem likely to endanger progress on inflation.

3. Effect of US interest rates on ours?

[US rates fell substantially during July/August, and again in October.]

The falls in US rates were helpful and facilitated reductions in our own. But of course US rates are not sole determinant of UK's, and this spring progress was made in reducing ours at a time when US rates were rising. UK rates are determined in the light of domestic monetary conditions generally, including the behaviour of the exchange rate.

4. Monetary conditions too tight - stifling recovery?

No. Behaviour of exchange rate and money supply suggest financial conditions moderately restrictive, as intended. Interest rates reductions have cut companies' costs and should promote climate for investment.

5. Bank lending growing too fast?

[Lower growth rate in May/June not maintained. Increased by £1.3 billion in banking August and £2 billion in September (seasonally adjusted).]

Reasons for growth of bank lending to companies not entirely clear. Companies may be trying to build up gross liquidity levels which fell back in spring. Strong growth in personal lending is partly result of structural changes, such as move by banks into home loans market, replacing lending by building societies; ending of HP controls in July does not appear to have had a large effect. To the extent that increases in bank lending are additional, ie not just in substitution for lending by eg building societies, do represent potential cause for concern, as add to monetary growth. To be taken into account in interest rate policy.

6. Prospects for reactivation of corporate bond market?

[Tax treatment of 'zero coupon' and 'deep discount' stocks and removal of embargo on company issues of this type of stock announced 25 June. BOC announced issue of £100 million conventional bond 10 September, followed by other companies.]

Zeros broaden options available to companies, though not expected to transform captial market. Best hopes for resurgence of market provided by lower interest rates and inflation, for which we are on course.

7. Why has Bank of England been providing such large-scale money market assistance?

The rapid growth of bank lending has caused problems for conduct of monetary policy. By selling long-term Government debt on a larger scale outside the banking system, it has been possible to contain the rapid growth in money which could otherwise have taken place. This in turn has created shortages of liquidity in money markets. If Bank had not intervened, short-term interest rates would have been forced up to unnecessarily high levels. Measures announced in June [ie variable rate loans facility made available to local authorities etc from National Loans Fund/Public Works Loans Board; companies allowed to issue 'zero coupon' and 'deep discount' stocks] should reduce rate of growth of bank lending-by encouraging LAs etc to borrow from the NLF instead of from banks and by broadening options available to companies issuing their own debt-and so reduce levels of assistance required.

K PRICES AND EARNINGS

PRICES

1. September RPI

[Year on year increase in RPI 7.3 per cent in September, compared with 8.0 per cent in August].

Annual rate of inflation fell sharply in September to 7.3 per cent, its lowest level for 10 years (compared 7.0 per cent in September 1972). The price level in September was no higher than in June and actually slightly (0.1 per cent) lower than in August - the first time the index has fallen for 12 years (since August 1970).

2. How low inflation by end 1982?

[Budget time forecast Q4 1981 to Q4 1982 9 per cent and Q2 1982 to Q2 1983 7½ per cent.]

We expect inflation could be as low as 6½ per cent by end 1982.

3. Further falls likely in 1983?

We expect inflation to be down to 5 per cent next spring.

4. Inflation turning up again next autumn?

Cannot predict precise course of inflation but Government policies will be designed to secure yet further reductions.

5. Inflation lower than under previous Government?

[Average year-on-year rate of inflation between February 1974 and May 1979 was 15.4 per cent; average level of inflation since May 1979 has been 12.8 per cent.]

Year-on-year rate of inflation was 10.3 per cent and rising when previous Government left office in May 1979. Now (September 1982) 7.3 per cent and falling. We will be first Government for quarter of a century to achieve a lower average rate of inflation during its term of office than the previous Administration.

6. Inflation still not as low as competitors?

[August figures: UK inflation 8.0 per cent compared with 5.7 per cent in US, 5.1 per cent in West Germany, and 3.1 per cent in Japan.]

UK inflation now lower than Western European (OECD Europe) average, and well below many countries - such as France and Italy. Still some way to go to match US, West Germany and Japan, but good progress being made in right direction.

7. Long term inflation objective?

Recent developments encouraging. But inflation rate still higher than some competitors e.g Germany. Must not let up. Have always made it clear that price stability not unattainable.

8. TPI now shows pay increases need to be ½ per cent higher than RPI to maintain living standards?

[Increase in TPI over 12 months to September 7.9 per cent, compared with RPI increase of 7.3 per cent].

The gap between the RPI and the TPI (now 0.6 percentage points) widened in July when benefits paid to the unemployed became taxable. Pay increases go to people in work, who will not pay any more tax as result of the change - except for the minority who have a spell of unemployment during the year.

9. Nationalised industry prices

[Increase over 12 months to September 13.7 per cent, compared RPI increase of 7.3 per cent].

Increases regrettable, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so. But sustained improvement only possible if industries succeed in holding down current costs, particularly pay. (See also Section R).

PAY

10. Average earnings index

[Year on year growth 9.8 per cent in August compared with 10.9 per cent in July, but August index artificially low because of large amount of civil service back pay paid in August 1981. Underlying increase about 9 per cent in both July and August.]

Encouraging that underlying rate of growth continues to fall. Further moderation in settlements can only be helpful in maintaining jobs and getting inflation down.

11. A 3½ per cent pay policy?

The 3½ per cent pay assumption [announced 1 October for calculating the pay element in cash expenditure plans for 1983-84] does not represent a 'norm', still less an 'incomes policy'. Nor is it a decision on the offer to be made in any individual case. Settlements higher or lower than the assumption are not ruled out. Each case will be considered on merits.

12. What pay settlements does Government now want?

Low enough to be consistent with improved job prospects in the industry concerned. The lower the better. Certainly lower than in the past year.

13. What has been average over past year/pay round?

[CBI Databank suggests 7 per cent average for manufacturing in last (1981-82) pay round. Top management earnings in year to March 1982 reported to have increased by average 11 per cent; examples of current pay for chairman range downwards from £477,000 p.a FT 25 October].

Average has been in single figures, and moving downwards, in each of past two years. We need a substantial further reduction, with really low settlements, and thus a better outlook for jobs, in the year ahead.

14. Government exhortations on pay imply aiming to cut living standards?

[Real earnings show little variation over past two years; August 1982 broadly similar to August 1981 and about 1 per cent higher than August 1980.]

Lower pay settlements have not in fact cut real earnings in either of the past two years; prices have also come down. This fact casts doubt on the wilder claims about the effect of pay moderation on living standards.

15. Incomes Policy

Proposals for incomes policies, including recent refinements, do not avoid many of the familiar problems of norms, administrative costs, and interference with market forces. Experience gives no encouragement to the idea that incomes policy can be made to work on a permanent basis. They always succumb to the distortions they create.

16 Current position on NHS dispute

Government has twice increased money available, to final offers ranging from 6 to 7½ per cent. Now offered two-year pay settlement. Unions have refused to move from original claim of 12 per cent. Unlike Royal College of Nurses and other professional bodies, unions have refused even to discuss latest proposals.

17. A miners' strike?

Confident that good sense will prevail.

18. Index-linked pensions and Scott report?

Question debated in House of Commons 22 October, when Government announced they favoured Megaw Committee suggestion that civil service pension scheme be made contributory. Reduction in inflation has greatly eased disparity between private and public sector pensions; Government's main aim at present is to ensure appropriate contributions are paid for index-linked benefits.

L BALANCE OF PAYMENTS

[NB Trade figures for September to be published Tuesday 26 October.]

1. Trade figures and current account

[August trade figures show trade account in broad balance though non-oil trade has shown increasing deficit; projected invisibles surplus of £260 million a month in Q2. Cumulative current account surplus of £2.1 billion in eight months to August.]

Signs are that the current account continues in substantial surplus, albeit reduced from last year's levels.

2. Export trends

Exports during 1982 have been very erratic. The underlying trend seems to be holding up better than expected given the poor level of world trade.

3. Import trends

Manufactured imports increased in August but were still below their high May levels. The underlying level of manufacturing imports has probably not altered since end-81 when manufacturing activity levelled off.

4. New import controls on way?

[Press speculation over weekend 23-24 October].

Wish make clear, as Chancellor said last Friday [Caterham 22 October] that 'we will be continuing to defend the open trading system'.

5. Figures for 1981

Only the 1981 August export figures now remain to be published. These should become available shortly.

6. Overseas investment takes jobs away from UK?

30 per cent of UK exports are bought by overseas firms connected with UK companies. By increasing links between UK and overseas companies, overseas investment helps UK exports and production, so producing more jobs. If UK does not take profitable opportunities to invest overseas, others will.

P INDUSTRY

1. Prospects for industry-recovery?

See A3-5 and Section B.

2. Companies' financial position?

[

	1979	1980	1981 Year	H1	H2	£bn 1982 H1
Net borrowing requirement (+)/repayments (-)	+6.3	+6.5	+5.1	-1.5	+6.6	+5.6
Financial surplus (+)/deficit (-)	-2.9	-1.4	+1.8	+1.0	+0.8	-1.3]

Financial position of industrial and commercial companies (excluding North Sea) improved last year, relative to 1979 and 1980. Improvement in part reflected companies' efforts to cut costs, for example by de-stocking. Some apparent deterioration in second half 1981 financial position due to slowdown in de-stocking and unwinding of delays in tax payments because of the civil service dispute. Figures for H1 1982 suggest reduction in companies' borrowing requirements relative to H2 1981; but borrowing needs still high.

3. How many new firms starting up?

[Correspondence in progress between Treasury and D Industry about value of giving 'net' figures of 'birth' of minus 'deaths' of companies based on VAT registrations.]

On a very rough average some 10,000 new companies come into being every month.

4. Profits rate of return still too low?

[Gross trading profits of industrial and commercial companies (ICCs) (net of stock appreciation) rose 40 per cent to Q1 1982. But increase was from very low base: ICC's real pre-tax rate of return just 2½ per cent in 1981 - half the previous lowest figure in 1975.]

Government can help best by getting inflation down and setting sound basis for sustained recovery. Fundamental improvement in ICC's rates of return depend on better performance by companies. Some encouragement from recent productivity gains and trend towards moderate pay settlements.

5. High interest rates damaging for industry and investment?

Banks' base rates have fallen 6½ percentage points since last October, and 3 points over last three months. Outside analysis suggests that a 1 per cent reduction in interest rates improves the net financial position of the company sector by about £250 million over a full year. Lower interest rates reflect Government's firm fiscal and monetary stance and will help industry and investment.

6. Lower rates for industry?

De-rating one of a number of possible ways of assisting industry and business, but in last Budget preference given to other forms of relief, notably reductions in NIS. De-rating would be expensive, though less so if applied to industry alone - even so, 10 per cent de-rating would cost about £140 million per annum. Legislation would be required.

7. Government help for small firms

Budget provided further help for small businesses, increasing the number of measures taken so far to over ninety. Enterprise package included further reduction in weight of corporation tax; further increases in VAT registration limits; increase in global amount available for loans under Loan Guarantee Scheme (see below); and doubling of investment limit under Business Start-Up Scheme to £20,000 a year. New measures will encourage start-ups and existing firms.

8. Response to Loan Guarantee Scheme?

[Over 6,400 guarantees already issued - about half to new businesses. Total lending under scheme around £215 million. Budget provided for lending ceiling in first year (to May 1982) to be raised from £100 million to £150 million and for further £150 million to be available in second year (to May 1983). Thirty financial institutions now participating.]

Scheme operating successfully. Too early to assess overall cost . After first year, out of over 6000 guarantees issued, only 150 have so far been 'called'. Cost has been covered by the premium income received over the period. Scheme is kept under continuous review.

9. Enterprise zones

Chancellor announced Tuesday 27 July eleven new Enterprise Zones to be created: 7 in England; two in Scotland; one each in Wales and Northern Ireland. All first eleven zones now in operation. Response has been very encouraging. Many new firms are setting up in the zones, existing firms are expanding their activities and vacant land has been brought into use. Too early to assess success of zones.

10. <u>Is is true that a committee has been set up to consider changing basis of regional assistance</u>?

[Report in <u>FT</u> 25 October.]

Regional policy is, like other Government policies, continually open to scrutiny in case improvements can be made. [IF PRESSED: But cannot comment on precise details of official committees.]

R NATIONALISED INDUSTRIES

NATIONALISED INDUSTRY PAY AND PRICES

1. Nationalised industries' prices

[Having risen approximately in line with retail prices for several months, the latest figures show bigger 12 months increase in nationalised industry prices, water charges and London Transport fares than all items RPI (13.7 per cent in August compared 7.3 per cent). This differential reflects March increase in LT fares. Removal of these temporary distortions confirms that nationalised industry prices are still increasing somewhat faster than RPI, largely because of increases in energy sector.]

Gap between nationalised industry price increases and RPI has been due in large measure to cumulative effect of years of artifical price restraint. World oil price rises of 1979 and 1980 have also played an important part. We greatly regret the need for these increases, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so. The differential between RPI (all items) and NI prices (including water charges and London Transport fares) is now 6 per cent compared with 14 per cent in January 1982. But sustained improvement will only be possible if the industries succeed in holding down their current costs, particularly pay.

2. Increase in gas prices?

[Domestic gas prices increased on 1 October. Some Press speculation that industry will have to pay 1p per therm more each quarter as contracts come up for renewal next year]

Large increase in domestic prices over last three years needed to remedy under-pricing by previous Government. There will be no more massive increases in gas prices. Industrial gas users have benefited from two years of virtual freeze on renewal prices for contract gas. BCG not yet decided on pricing strategy following lifting of the freeze at end of this year.

3. What is Government doing to improve nationalised industries' efficiency?

We continue to press for greater efficiency within NIs. We are setting realistic financial targets and performance aims. A rolling programme of Monopolies and Mergers Commission investigations has been set up. The introduction of market forces provides greatest incentive to efficiency.

INVESTMENT

4. Nationalised industries' investment should be stepped up to/improve infrastructure/provide orders to private sector/as boost to economy

Government has not prevented the industries from carrying forward a large number of profitable investment programmes. It would be wasteful to provide funds for public sector projects with lower returns than those in the private sector. Unfortunately, the pre-tax rate of return on nationalised industries' capital (including subsidies) in 1980 (latest available figures) was minus one per cent, compared with 3 per cent for industrial and commercial companies.

5. Finance more nationalised industry investment by cutting current spending?

As in private sector, moderate pay settlements and control of other costs are essential. Ability to finance new investment in nationalised industries bound to diminish if excessive pay settlements agreed. Each 1 per cent off wages saves about £140 million this year; and each 1 per cent off total costs saves £330 million this year.

6. Take nationalised industry investment out of PSBR?

Real problem of pressure on resources cannot be solved by changing statistical definitions. Since nationalised industries are part of public sector, their borrowing - for whatever purpose - must by definition form part of public sector borrowing requirement.

7. Private finance for NI investment?

In discussions in NEDC and elsewhere, we have indicated our willingness to consider new financing proposals, provided they can be structured so as to induce improvements in efficiency at least sufficient to offset the extra cost, and provided the finance is raised in fair competition with the private sector.

8. Investment plans unlikely to be attained?

No Government can unconditionally guarantee a level of investment by the nationalised industries. Approved levels set out in last White Paper (Cmnd 8494) are consistent with the industries' agreed external financing requirements, on the basis of their internal resource forecasts. But perfectly possible that plans might need to be revised, for example if the industries fail to restrain their current costs, including pay.

EXTERNAL FINANCING LIMITS

9. EFLs for 1982-83 and future years?

Nationalised industries' total external finance increased by £1.3 billion in 1982-83 (£1.2 billion after allowing for NIS cut and other changes). Increase in 1982-83 was roughly half what the industries bid for. Government has given full recognition to problems faced by the industries in a period of recession. EFL's for 1983-84 will be announced later this year, as usual.

PRIVATISATION

10. Special asset sales in 1981-82

Gross sales in 1981-82 totalled £481 million, so target published in 1981 Public Expenditure White Paper of £500 million nearly met. Pleasing result - included two large sales - Cable and Wireless (£182 million) and Amersham International (£64 million). True that delivery of BNOC oil in 1981-82 paid for in 1980-81 and taken into account in special disposals figure for that year reduced 1981-82 receipts by £573 million to total of -£92 million. But it is gross figure which is true measure of success of Government's privatisation programme. As Chancellor said in Cambridge 3 July, 'Public utilities and the so-called "natural monopolies" cannot be allowed permanently and without challenge to remain within State ownership'.

11. What further sales expected?

Special sales of assets in 1982-83 forecast at around £600 million and expected to increase in subsequent years. This year's and next year's involve primarily very large sales of energy assets - Britoil and the British Gas Corporation's major offshore oil assets - made possible by Oil and Gas (Enterprise) Act (which received Royal Assent in June). Industry Secretary announced 19 July plans to sell 51 per cent of British Telecom - but not before next Election.

12. Will Government postpone Britoil sale in view of the weak oil market?

Government intends to sell majority of Britoil shares by end of 1982, if market conditions permit. Will take decision on whether to go ahead when the time comes. To that end the Energy Secretary has laid an Order which will transfer the 100 per cent shareholding in Britoil to his ownership on 1 November.

13. Contribution to giving people satisfaction of property ownership?

Exercise of returning enterprises from State ownership to ownership by the public has included measures to promote employee share ownership in the enterprise they work for; for example free offers of shares (British Aerospace, Cable and Wireless, Amersham); preference in allocation of shares (B Ae, C & W, Amersham, BP); provision for matching shares - one for each share subscribed for - (B Ae, Amersham, BP). Most radical initiative taken by consortium of managers and employees who bought National Freight Company.

14. Government has sold assets too cheap?

[Heavy oversubscription for British Aerospace, Cable and Wireless, Amersham International, followed by large increases in prices when shares first traded.]

Not in Government's interest to see shares underpriced, given the loss to the PSBR, but also risks in pitching price too high. Getting balance right not easy - especially when company's shares have not previously been traded. Government will continue to consider alternative forms of sale eg tender, but critics should note that sale by tender could make it harder for small investor to buy shares.

S NORTH SEA AND UK ECONOMY

1. Is Government underestimating North Sea revenues?

[FSBR projections (in money of the day) of Government revenues from North Sea: £6.4 billion in 1981-82, £6.2 billion in 1982-83, £6.1 billion in 1983-84, and £8.0 billion in 1984-84. Lower than last year's projections, principally because of downward revision to oil price expectations].

Projections of oil revenues and crucially dependent on inherently uncertain cost, price and production assumptions. Prospects for North Sea revenues have improved since FSBR published because of higher than assumed oil prices. Higher recent estimates of Scott, Goff and Hancock and the Midland Bank Review are based on higher expected future production and lower expected future capital expenditure.

2. Onerous tax system damaging future field developments?

[Shell/ESSO have shelved plans for Tern partly because of tax system; Phillips postponing T-block complex and BP their Andrew field; BP statement issued with their interim results criticised fiscal regime.].

Other adverse factors - falling oil prices earlier this year; high development costs - much more important. Detailed study has shown that under new tax structure, levels of profitability should still be sufficient to make exploration and development attractive. Hope that present structure will provide more secure and stable tax regime.

3. Talks with companies on North Sea fiscal regime 'bogged down'?

[FT article 21 October reported that discussions had run into difficulties.]

Dialogue with UKOOA continues. Discussions also taking place with individual companies. Government wishes to give oil companies every opportunity to present their evidence about profitability of investment in North Sea.

4. Taxation of petrochemical feedstocks

[Government has announced that new rules on valuation of ethane for petrochemical use in interaffiliate transfers (Finance Act Section 134) should be extended to mixed streams of gas with a large ethane component. ICI complain that the extension and the rules themselves give unfair advantage to their integrated oil company competitors and have taken out writ against the Government.]

Government convinced that new formula will give fair valuation. New valuation will not have effect of providing subsidy to ICI's competitors. Have done best to reassure ICI. Will resist ICI's legal action.

5. Government should do more to promote UK Continental Shelf oil production in 1990's?

[Select Committee on Energy's Report on Depletion Policy published 18 May: emphasised development of fields entering production in 1990s by increasing pace of licensing rounds and overhauling fiscal regime. Recommended reserve powers to impose production cuts. Energy Secretary and Chancellor replied in joint memorandum on 29 July].

HMG agrees with general conclusions encouraging North Sea exploration and development, thereby maximising economic oil production over time; eg decision recently announced not to impose production cuts before 1985. Agree uncertainties in oil markets too great to justify deferring new field developments in foreseeable future. Cannot accept Committee's criticism of North Sea fiscal regime - opposed to another fundamental review; industry does not want a structural upheaval.

6. Benefits of North Sea should be used to strengthen economy?

[Contribution of North Sea to GNP estimated at 4 per cent of GNP in 1981. Not projected to rise before 1985.]

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve lower level of interest rates to benefit of industry and economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Less than 6 per cent of total General Government receipts in 1981-82.

7. North Sea revenues should be channelled into special fund?

North Sea revenues are already committed. Setting up special Fund would make no difference. More money would not magically become available.

8. Future North Sea oil prices?

A matter for commercial negotiation between oil companies and BNOC.

9. Are we really any better off for our North Sea oil?

We are better off with oil - at current oil prices - than we would have been without it. We have been spared fall in real national income that other industrial countries have suffered following oil price rises. But North Sea oil costly to produce, so we are not necessarily any better off than we would have been had oil prices not risen. No need therefore for possession of oil to require a contraction in our industrial base.

T WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Prospects for world recovery?

[IMF, London Business School and Bank of England Quarterly Bulletin all gloomy about immediate prospects. No overall growth seen in major countries in 1982, and only weak recovery next year. Press reports suggest OECD will also revise its previous forecasts this autumn.]

Output in the major economies appears to have recovered slightly in the spring after the downturn last winter. US economy grew slightly in both Q1 and Q3. The major European economies, however, remain depressed, and it is too early to say that a broad upturn has started. Lower inflation and interest rates however offer prospects for better growth next year.

2. Why don't major industrial countries together expand demand?

Leaders of the major countries agreed at the OECD, Summit and IMF meetings on the need to continue the fight against inflation. As the OECD's Economic Outlook explains, Governments are convinced 'a significant part of any stimulus to demand would increase public sector deficits, and dissipate itself rather quickly as an increase in inflation'.

3. Anti-inflation policies are working

[Consumer price inflation down from a year ago in all 7 major economies on latest available figures: US (from 10.7 to 5.9 per cent), UK (11.6 to 7.3 per cent), Japan (3.8 to 3.1 per cent), Italy (18.3 to 17.2 per cent), Canada (12.7 to 10.5 per cent) France (13.8 to 10.2 per cent), Germany (6.5 to 4.9 per cent).]

Inflation has fallen in all major countries in the past year. Firm fiscal and monetary responses to 1979-80 oil price rise vindicated. UK close behind US and Germany in bringing down inflation, and ahead of some other European countries. Realism in wage settlements is growing; US, Germany and Japan all have wage settlements in single figures.

4. International financial collapse?

Concern about effects of over-borrowing noted at Toronto IMF meeting. But should not exaggerate alarm. Important of course to sustain system's stability. Lower interest rates should help, as should IMF programmes to restore countries' credit-worthiness. Further progress needed on banking supervision including risk assessment and prudential standards; also watertight allocation of supervisory responsibilities.

5. What about US ideas for emergency IMF assistance to countries heavily indebted to the international banking system?

The IMF must certainly be endowed with the resources it needs to carry out its present role. There is widespread agreement that a substantial increase in its quotas is necessary. Its resources may need o be supplemented even further. The US ideas are only one of a number which need to be studied carefully.

6. Another oil energy crisis looming?

[Latest World Energy Outlook from International Energy Agency raises possibility that tight oil market could reappear in late 1980's].

Always difficult to foresee future oil prices. But they are weak at present and likely to remain so in near future. In longer term, energy conservation should permanently reduce countries' dependence on oil.

7. US economy?

[US GNP rose only very slightly in Q3 after 1 per cent rise in Q2. Unemployment has risen above 10 per cent. Consumer price inflation has fallen to 5.9 per cent. Tax cuts effective July were expected to boost consumer demand but retail sales and industrial production remain flat. Interest rates, however, have fallen 4½ per cent since July].

US output rose slightly in Q3 after small rise in Q2. Still too early to say that a strong recovery is under way, but falls in interest rates and inflation hold out better prospects for growth over the next year.

8. US Budget?

[Despite package of tax increases totalling $98.3 over next three years, passed in August, US budget deficit for 1982 expected to be about $109 billion; deficit for 1983 forecast to be ~~even larger~~].

Welcome Congress approval of tax package. US has won a battle but long campaign lies ahead to put deficits on convincing declining path in medium term.

9. US monetary policy

[US interest rates have fallen and Federal Reserve has reduced its discount rate from 9½ to 9 per cent. Chairman Volcker has said US authorities will be attaching much less than usual weight to M1 over period ahead].

Accept that monetary indicators in US must be interpreted flexibly in light of financial innovations. Federal Reserve Chairman, Mr Volcker has made clear that reduction of inflation remains a priority and that monetary targets have not been abandoned.

10. Gloomy prospects for Europe?

[EC Commission Annual Report published last week predicted only 1.2 per cent growth in Europe next year and 10.3 per cent unemployment.]

True that prospects for recovery in Europe weaker than in US or Japan. But budget deficits higher and inflation rapid in many European countries. Note that EC Commission draws attention to need to curb budget deficits and reduce labour costs. This the way to improve Europe's competitiveness and prospects.

11. French franc/balance of payments?

[French trade deficit soared to F Fr 12.2 billion (£1 billion) in September. M. Joubert admits that deficit for 1982 will reach FFr 100 billion. Despite raising $4 billion standby credit on international capital markets in September, franc remains weak. French Government recently announced package of measures aimed at improving balance of payments by encouraging exports and requiring all goods to bear label showing country of origin.]

Strength of world economy depends on ensuring stability of major currencies. Glad to see French Government has acted to curb budget deficits. Suitable monetary and fiscal policies essential if balance of payments to be improved and franc strengthened. Important that -understandable- measures to promote domestic trade performance should not encourage protectionism.

12. French government's monetary and fiscal policies?

[After prices and incomes freeze announced in June and F.Fr 10 billion economies in social security spending announced July, budget for 1983 was announced 1 September. Borrowing ceiling set at 3 per cent of GDP. Government has also announced increases in duties on tobacco and alcohol, and delays in planned increases in some social payments, including pensions].

Strength and stability of world economy will benefit if all countries can control inflation. So we welcome French government's commitment to reduce inflation and to rein in Government borrowing.

13. Competitive devaluations

[Recent devaluation of Swedish krona by 16 per cent widely criticised by other Governments. Finnish marka subsequently devalued by 6 per cent. Independent 'wise men's' report on Danish economy suggests withdrawing from EMS temporarily in order to allow 20 per cent devaluation].

IMF rules forbid countries to manipulate exchange rates to gain unfair competitive advantage. Authorities in Sweden will have noted strong objections from her major trading partners. Prosperity of world economy depends on maintaining open and fair trading system. Large devaluations may hinder this, and risk encouraging competitive devaluations by others. [IF PRESSED: IMF is examining Swedish action.]

14. Japanese reflation?

[Japanese Government have introduced reflationary package of £4½ billion (Y 2020 trillion) or just under 1 per cent of GDP. Mainly consists of increased expenditure upon public work in current fiscal year.]

Different conditions from UK. Inflation in Japan only 3.1 per cent; unemployment 2.3 per cent; savings high.

COMMENTARY ON RECENT ECONOMIC DEVELOPMENTS AND STATISTICS 25 OCTOBER 1982

Summary comment

Recent financial developments favourable - inflation and interest rates falling - but activity remains flat.

World Economy: expectations held by most forecasters for an upturn in activity of 1 per cent this year unfulfilled. Outside forecasters expect only a weak recovery next year.

. world commodity prices are at their lowest level in real terms for thirty years;

. oil prices are weak and likely to remain so for the near future;

. consumer price inflation (OECD major 7) around 7 per cent in August (12 per cent in August 1981): ranging from 17 per cent in Italy to 3 per cent in Japan;

. average world 3-month interest rates 10.3 per cent at 11th October a fall of 7 points on the 1981 Q3 average; US 3 month rate stood at 9 per cent on 22 October; real interest rates remain clearly positive;

. world trade volume has been more or less flat since the middle of last year;

. total industrial production for the OECD Major 7 fell 6 per cent in the twelve months to July; in the US it fell by 9½ per cent in the 12 months to September;

. unemployment (major 7) now 8½ per cent, compared with 6½ per cent in mid-1981.

UK Balance of Payments: non-oil trade balance has deteriorated quite sharply but current account remains in balance. Both the loss of competitiveness during 1979 and 1980 and a smaller world market are affecting our trade at home and abroad.

. OPEC and Third World countries are cutting back on imports because of low commodity prices, high interest rates and debt problems in some countries. UK exports are substantially down in the three months to August.

. import volume rose sharply as activity recovered last year and import penetration rose too; imports broadly flat this year.

. the effective exchange rate has been broadly stable since summer 1981; currently 92.8.

Financial Developments

.M1, £M3, PSL2 within target range for 1982-83;

.short term interest rates down 6½ points since last October;

.real interest rates have fallen but remain clearly positive (higher real rates are being experienced in the US and Japan);

.PSBR £3 billion in first two quarters of financial year, remains within the FSBR forecast of £9½ billion for 1982-83.

Inflation

.retail price inflation, 7.3 per cent in year to September. Forecast 6½ per cent before Xmas, with prospect of 5 per cent by spring 1983;

.TPI increase in 12 months to September was 7.9 per cent;

.Wholesale price inflation also moderating; input prices up 3¼ per cent in year to September; output prices 7½ per cent;

GDP and industrial production

.GDP has been broadly flat since 1981 Q4, as has the underlying level of industrial production; but latter 1½ per cent above spring 1981 trough;

.within industrial production total, increased North Sea oil and gas production has offset a 1 per cent reduction in manufacturing output since 1981 Q4.

Demand Components

.consumer spending has remained broadly unchanged since 1979, over period when other components of final demand fell some 4-5 per cent. Some fall in RPDI (see below) offset by lower savings ratio. Retail sales in July -September 2 per cent higher than in spring, partly reflecting abolition of HP controls.

.gross fixed investment fell back by 4 per cent in 1982 Q2 - from a strong first quarter - to a level similar to that in 1981 H1 and 10 per cent below the level in 1979. Manufacturing investment has been weak. Plant and machinery investment, however, has held up.

.the massive destocking of 1980 H2 and 1981 is over but the 1982 Q2 figures show no return to positive stockbuilding. September CBI survey suggests some further scope for destocking in manufacturing;

.government consumption in 1982 H1 was 2 per cent above its level in the same period last year. 1982 Q2 data suggests that the upward trend in volume may be flattening out.

.there has been some fall in the volume of exports in recent months reflecting both loss of competitiveness and the flatness in world trade;

.imports rose very sharply between the two halves of 1981, reflecting both the increase in activity and increased import penetration, before stabilising.

Productivity and Competitiveness

.manufacturing productivity continues to rise strongly - at 6½ per cent annual rate so far this year, following 8-10 per cent last year;

.unit wage/salary costs up only 6 per cent on 3 months to Aug in same period 1981;

.during 1981 external price and cost competitiveness improved at least 10 per cent but little or no further improvement this year.

Company Sector

.ICCs pre-tax real rates of return on capital in 1981 were very low; only 2 per cent in the manufacturing sector. Some slight improvement likely this year.

.after falling in first quarter of 1982 gross trading profits (net of stock appreciation) of ICCs rose in the second quarter by 5 per cent; this follows the strong recovery in 1981;

.non-North Sea profits in 1982 H1 were 22 per cent above their level in 1981 H1;

.gross profits of North Sea oil companies rose 10 per cent over the same period;

.ICCs financial deficit was £1.3 billion in 1982 H1, following £0.8 billion surplus in 1981 H2, partly reflecting less destocking. Over same period net borrowing requirement fell from £6½ billion to £5½ billion.

Personal Sector

.wage settlements in 1981-82 were on average around 7 per cent, 2 per cent lower than in the previous round;

.underlying rate of increase in average earnings in year to July 1982 was about 9-9½ per cent;

.real earnings broadly flat in last 12 months but RPDI is about 1½ per cent lower than the average for 1981.

Labour Market

.UK employment fell 2.2 million (10 per cent) between 1979 Q2 and 1982 Q1 (two-thirds concentrated in manufacturing); between 1981 Q1 and 1982 Q1 employment fell by 800,000;

.first indications are that total employment fell more in the second quarter of 1982 than in the previous quarter;

.total registered unemployment rose by 50,000 to 3.3 million (14 per cent) in September;

.UK adult unemployment rose by 49,000 to 3 million (12.7 per cent) in September; trend since June has accelerated;

.vacancies have not altered much in recent months;

.other labour market indicators - short time, overtime working, etc - continue to suggest some flattening out following last year's improvements.

Forward Indicators.

.car production (seasonally adjusted) fell from 77,000 August to 69,000 in September;

.steel production (seasonally adjusted) fell from 229 m tons in August to 224 m tons in September;

.the volume of new construction orders, which remained broadly flat since the first half of 1981, fell 6 per cent in the 3 months to August. Within the total, orders for new housing, particularly in the private sector, remain slightly below their level last spring. Engineering orders also disappointing with a 9 per cent fall in the lastest 3 months.

.total manufacturing order books, as monitored in the CBI's monthly industrial trends enquiry, after strengthening last year, have shown no further improvement; and export order books have tended to weaken.

.total housing starts, having increased from an average 40,000 a quarter in 1980 to 53,000 in 1982 Q1, fell back in the spring, though there is some sign that the trend is levelling out at a rate well up on last year. Total completion continues to drift slowly downwards.

.seasonal falls in school leavers registrations occur after October but a sharp seasonal rise in unemployment occurs in January;

.CSO's index of longer leading indicators rose in August and September reflecting lower interest rates and higher share prices, following a fall from April to July.

Business Sentiment

.Business confidence remains depressed though most industrialists are optimistic about prospects for company sector growth/profits over the next two or three years.

Outside forecasts

.Outside forecasting groups are now less optimistic about recovery in 1982, suggesting that growth this year will be less than the 1-1½ per cent expected at Budget time; for 1983 most still expect growth in the 2-2½ per cent range, assuming some recovery in world economy, with inflation/interest rates continuing to fall at least for some time into next year.

.New Treasury forecast will be published later in the autumn.

Key Statistics Week-Ending Friday 29 October

Tues 26: Unemployment and Vacancies (October).
Tues 26: Balance of Payments (September trade figures).
Thurs 28: CBI Trends Survey (October).
Thurs 28: D. Em. Gazette: Employment (August); overtime and short-time (August).

Econ Pol

PPS/CHANCELLOR

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Mr Salveson (for transmission to No.10)
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PS/Chancellor of the Duchy of Lancaster
PS/Secretary of State for Employment
PS/Paymaster General
and officials in HMT, Revenue Departments and other Departments in Whitehall

TREASURY BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 21 September, are sidelined.

M M Deyes

M M DEYES

RIA

R I G ALLEN

15 October 1982

EB Division
H M Treasury
01-233-5503

ECONOMIC BRIEF: CONTENTS

A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

Main objectives are to achieve, over a period, a sustained improvement in the economy through reduction of inflation and promotion of enterprise and initiative. Reduction of inflation requires maintaining steady but not excessive downward pressure on monetary variables, and complementary fiscal policies. Improvement of supply side depends on restoration of flexible and competitive market economy and better incentives.

2. Fiscal boost desirable?

If there were some quick and easy solutions we would have adopted them. What is needed now is to sustain steady economic policies designed to reduce interest rates and inflation, and to create climate in which industry can invest and sell its products. That does not mean, of course, that possible fiscal measures cannot be debated on their merits. But it does mean keeping in mind also their total effect on borrowing and interest rates, and on the economy generally.

3. Recovery Over?

Delayed but not over. Activity still 1 per cent above trough in Spring 1981. Pause this year largely reflects external developments. Expected recovery in world trade and growth expected at Budget time has not materialised.

4. Recovery next year?

Prospect remains for resumed modest recovery next year - supported by most outside forecasters. [NB. Next Industry Act forecast will be published later in Autumn.]

5. Where will growth come from?

Sources of growth are expected to be :

- some modest recovery in world activity;
- a recovery in confidence as inflation prospect improves;
- fall in interest rates improves companies' financial position and encourages a revival of fixed investment and stockbuilding;
- increased consumers' expenditure as the result of lower inflation.

6. <u>Government policies have caused recession by deflating demand</u>?

No. Output had fallen more strongly than demand during the current recession; and in year to 1982 Q2 real demand rose by 3 per cent, real output by only 1 per cent. Import penetration rose 10 per cent last year. Essential problems of economy lie on 'supply side' - lack of competitiveness etc. Government policies aimed at helping industry to redress these problems by : deregulating, restoring incentives and implementing a financial strategy under which inflation and interest rates can fall over the medium term.

7. <u>What factors have caused flattening out in recovery this year</u>?

Number of factors - last summer/autumn's temporary rise in interest rates and pause in progress on reducing inflation; slower, and later than expected, world recovery - all probably weakened confidence and activity. These factors now working the other way - inflation and interest rates coming down fast - and will contribute to future recovery.

8. <u>Tighter than expected fiscal policy to blame</u>?

Fiscal policy stance 1982-83, so far as can be judged at this stage, consistent with Budget judgement. Monetary aggregates also on target. Undershoot on PSBR <u>last</u> year contributed to strong fall in interest rates - down 6½ percentage points since last autumn. (See also Section H).

9. <u>Business confidence collapsed</u>?

Business sentiment at present difficult to assess. Certainly cannot discount recent gloomy reports from West Midlands and Association of British Chambers of Commerce. But different surveys cover different samples and ask different questions. CBI asks its members about changes in optimism compared with four months previously. <u>The Times</u> Business Forum, covering most major companies as financial institutions recently posed a question about the <u>level</u> of optimism and it showed a remarkably high level of optimism on prospects for company growth/profits over next two years. [NB Next CBI Survey due to be published on 26 October].

10. <u>Recent interest rate/monetary developments</u>?

Steady reduction in UK rates made possible by satisfactory developments in main monetary aggregates, exchange rate, strength of and progress on inflation. (For further material on monetary developments, including bank lending, see section J.)

11. Who benefits from lower interest rates?

[Personal sector as a whole is a net asset holder and will lose; so will any companies which are similarly placed].

Home-buyers and the company sector will benefit from lower interest rates. Each 1 per cent reduction in interest rates eases companies financial position by £250-300 million over a full year.

[IF PRESSED: not all personal sector gains but first time house-buyers whose financial position is often difficult will benefit substantially].

12. Public spending cuts? Think tank report?

See E3

13. Unemployment trend worsening?

See C3.

14. Poor prospects for world economic recovery?

See T1 .

15. Is there an impending world financial crisis?

See T4.

16. Autumn Statement?

[Government's reply to Report on Budgetary reform from TCSC published 5 August. Will involve some changes in Budgetary procedure in current year. But these will not go all the way towards implementing Committee's recommendations.]

Government intend to take full account of TCSC's proposals in continuing to build on significant progress already made towards greater integration of economic decision-making (eg MTFS) and involvement in it of Parliament and public. In particular, Government will advance these developments by publishing around late November/early December an Autumn Statement which will allow fuller and better-informed discussion of monetary and fiscal prospects than in past. Structure and contents of Autumn Statement will build on what is already published and can be expected to evolve over time.

BULL POINTS As at 15.10.82

(i) Activity. Underlying level of output broadly flat since last Autumn but industrial and manufacturing output above levels spring 1981. Most recent major independent forecasts see prospect of modest recovery later this year and next.

(ii) Interest rates. Bank base rates have fallen 6½ points since last autumn (now 9½ per cent). Lowest level for almost four years. Recent falls reflect several factors:- single figure inflation, M1, £M3 and PSL2 developing favourably in relation to 8-12 per cent target, Government borrowing under control, exchange rate firm.

(iii) Inflation. The increase in the RPI over the 12 Months to September was 7.3 per cent. This is the lowest since September 1972 and close to a quarter of the peak level of 26.9 per cent in August 1975. The September level of prices is no higher than June and actually below the August level - the first fall since August 1970. Prospect of annual rate RPI inflation ~~6½~~ per cent by end of 1982. Manufacturers' output prices up 7½ per cent in year to September.

(v) ~~Costs.~~

- Increase in average earnings halved in 1980-81 pay round. Public sector pay in line. Further moderation in average level of settlements in 1981-82 round. CBI pay databank for manufacturing settlements suggests average now around 7 per cent compared with 9 per cent in 1980-81 round.
- Manufacturers' unit wage and salary costs up only 5½ per cent up in year to July, below average of major competitors.
- Manufacturers' input prices up just 3¾ per cent in year to September.
- CBI August survey shows lowest degree of unit cost pressures for 15 years.

(v) Manufacturing productivity. Output per head has risen about 12 per cent since end 1980. Output per head and output per hour now about 6 and 9 per cent higher than previous peak in 1H 1979.

(vi) Competitiveness. Cost competitiveness improved by 10-15 per cent during 1981 reflecting pay moderation, higher productivity and exchange rate fall, but remains $^{1}/_{3}$ worse than in 1975.

(vii) Profits: Industrial and commercial companies' gross trading profits (net of stock appreciation, excluding North Sea) risen 16 per cent in 1H 1982 compared with 1H 1981. Recovery in profits from very low base: pre-tax real rate of return of ICC's (excluding North Sea) only 3 per cent in 1981.

(viii) Housing starts (total) - up over a quarter in first eight months of 1982 compared with same period 1981.

(ix) Exports (non oil, excluding erratics) only 1 per cent lower in 12 months to August 1982 than in 1980, despite earlier substantial loss of competitiveness.

(x) Special employment measures. Total provision for special employment schemes planned to reach £1½ billion in 1982-83. Further measures announced end-July - new community work programme (started October), job splitting subsidy schemes (from January 1983).

(xi) Overseas investment in UK: US direct investment in Britain amounted to stock of over $14 billion in 1980. Nearly 60 per cent of all US outward non-oil direct investment now takes place in EC - over half of that in UK. Half of all Japanese investment in the EC also comes to Britain. Investment intentions survey of 231 German owned companies in the UK shows great majority intend to expand here in the near future.

(xii) Overseas debt repayments. Official external debt reduced from over $22 billion in May 1979 to around $12½ billion at end-September 1982.

Economic Briefing Division, HM Treasury, 01-233 5514/5503

B ECONOMIC ACTIVITY AND PROSPECTS

1. Recent output figures

[Latest GDP figures (all three measures) suggest any growth in economic activity in H1 1982 over H2 1981 was slight, but output about 1 per cent higher than in Q2 1981. Industrial production in three months to July unchanged compared with previous three months once adjustments made for holidays in May and June. Underlying level of industrial output 1½ per cent above 1981 Q2 trough - largely attributable to North Sea oil. Trend in manufacturing activity at best flat and may be deteriorating.]

Prospects for recovery this year undoubtedly receded since Budget, particularly since world recovery has not materialised. But rapid progress on inflation and interest rates, and productivity is higher. Beginnings of recovery in industrial competitiveness must not be undermined. Industry's contribution to sustaining recovery is decisive; must be ready to meet (modest) recovery in world activity expected next year (see T1).

2. Other evidence of improvement in economy?

See Bull Points (following Section A).

3. Latest CBI assessments?

[CBI Monthly Trends Enquiry shows little overall change in total order books since November, but a deterioration of export order books since March of this year. Net balance of firms expecting to increase output in next four months has fallen (to minus 7) and net balance of firms reporting excess stocks unchanged. Also further decline in net balance of firms expecting to increase prices in next four months. Latest forecast suggests only marginal rises in GDP (output) in Q3 and Q4 leaving GDP on 1982 ½ per cent up on 1981].

CBI September Monthly Trends Enquiry and latest forecast further confirmation of flattening out in activity since last autumn. Government always maintained recovery would initially be slow and patchy. It will continue to be so particularly given more depressed world outlook. As with most outside forecasters the CBI expect gradual recovery over next 18 months and future financial developments to be favourable.

[NB Next CBI trends survey to be published 26 October].

4. Fall in investment and reduction in stocks?

[Capital expenditure by the manufacturing, distributive and service industries in Q2 1982 4 per cent lower than level in previous quarter. Investment in manufacturing in H1 1982 was 3 per cent lower than in Q4 1981. Stocks fell by £30 million ('75 prices) in Q2; but in the first half of 1982 stocks increased by £100 million compared with destocking of £520 million in second half of 1981.]

Figures another manifestation of hesitation in economic activity. Despite this, investment in private sector, especially in plant and machinery, has held up quite well relative to output over last two years. [IF PRESSED: latest DOI investment intentions survey shows slight fall in manufacturing investment between 1981 and 1982; Q2 figure not inconsistent with this.]

5. Stock levels a threat to recovery?

Falling interest rates (nominal rates lowest for four years) have eased cash pressures and should assist recovery in stock cycle.

6. Competitiveness not improved this year?

Competitiveness improved 10-15 per cent during 1981 [but remains one third worse than in 1975]. Further improvements, which are essential to regain markets and create new ones, depend above all on substantially lower wage settlements in this pay round than in the last one.

7. Productivity growth falling off?

No; productivity growth in manufacturing at 6 per cent over last year is well above the UK historical average.

8. CSO's index of leading cyclical indicators?

Longer ~~leading index~~ rose in August reflecting further falls in interest rates and an increase in share prices. Shorter leading index, also fell between April and July. Implications of recent values of these leading indices for future movements in economic activity will not become clear until some more later data are available. The co-incident index has continued to increase from its low point in April 1981, with upward effects from most components.

9. FSBR forecast now looks too optimistic?

[Several independent forecasts have revised down their forecasts of growth in 1982 marginally (from around 1½ per cent to about ½-1 per cent), largely reflecting the recent disappointing levels of world trade. Despite this most groups have not altered their assessment of the strength of the recovery in 1983, and most are more optimistic about financial developments, inflation and interest rates.]

Output growth for 1982 is likely to be less than expected at Budget time, in face of less buoyant world activity, but we are doing much better than expected on inflation and interest rates. Clearly there are uncertainties, not least the international environment - though some indications that worst of recession is over in US (see T19). At present there is no reason to doubt that gradual recovery will resume in 1983. Certainly the majority of outside forecasters do not doubt it.

10. Latest Industry Act forecast

Next publication of Treasury forecasts will be in autumn.

11. Outside forecasts

[GDP profile in recent major assessments:

Per cent change

	NIESR	LBS	St James	Phillips & Drew	Simon & Coates	CBI	OECD	FSBR
	(May)	(June)	(Aug)	(Oct)	(Oct)	(Aug)	(July)	(March)
1982 on 1981	+1	+1	+1¼	+¾	+½	+½	+1¼	+1½
1983 on 1982	+1	+3	+2½	+2	+2½	+1½	+1¾	+2

Nearly all see prospect of continued recovery and lower inflation.

C LABOUR MARKET

1. Government concerned over unemployment?

Of course Government is concerned, and so is pursuing balanced fiscal and monetary policies to curb inflation, and creating conditions for enterprise - the only measures that will ensure sustainable increase in employment. Nevertheless Government has substantially increased spending on schemes to alleviate impact on especially vulnerable groups - e.g. plan to spend £1½ billion in cash on 1982-83 (40 per cent more than in 1981-82) on special employment and training measures; new Youth Training Scheme costing £1 billion a year from 1982-83; the new community programme which is designed to provide up to 130,000 places for the long term unemployed; and the new Job Splitting Subsidy which will be open on 1 January next year to encourage the extension of part time work and provide additional opportunities for productive jobs for unemployed people.

2. Cost of unemployment? Effect on PSBR

There can be no single estimate of 'the cost of unemployment'. Only costs that can be at all readily identified are additional expenditure on unemployment benefit, supplementary benefit, rent and rate rebates and administration. (Even these dependent on characteristics of those becoming unemployed - family status, resources etc). These could average £1800 in 1982-83 for each additional registered unemployed person. (NB This cannot be multiplied out by the total number unemployed.)

[IF PRESSED: Estimates of effect of other influences on PSBR directly or indirectly associated with unemployment vary widely depending on large number of highly debatable assumptions. And a major change in the level of unemployment would have impact on other economic indicators effective in the calculation of PSBR.]

3. Recent unemployment figures and other labour market indicators?

[UK seasonally adjusted unemployment excluding school leavers was 3,087,000 (12.7 per cent) in September. Total UK registered unemployed rose by 59,000 to 3,343,000 (14.0 per cent). Underlying increase in Q3 was 42,000 per month compared with 30,000 a month in Q2. Trend is deteriorating but no sharp rises now likely until January. UK seasonally adjusted vacancies decreased by 7,000 to 107,000 in September. Number unemployed for over 1 year was 1.071 million in July. Recent unemployment/vacancy figures shown below:

	1980 Q4	1981 Q1	Q2	Q3	Q4	1982 Q1	Q2	Q3
Unemployment (UK adult sa) increase	+105	+77	+62	+51	+33*	+21*	+30*	+42*
Vacancies level	99	98	89	96	104	112	107	110.9

*After allowing for over 60's transferring to supplementary benefit.

Other labour market indicators (overtime, short-time, roughly flat for last 6 months.

Figures are tragic but problems took a long time to build up; will also take a long time to check or reverse. Recent figures reflect levelling out in activity since last autumn.

4. Unemployment in UK higher than in other countries?

[On standardised definitions in Q1 1982 UK unemployment was 12.7 per cent compared with 8.0 per cent OECD rate; little over doubling for UK compared with OECD rise of over one half since 1979.]

Unemployment now rising very fast in many industrialised countries - much faster in some e.g. Netherlands, Belgium and Canada.

5. UK's true unemployment figures really much higher?

[Sunday Times 19 September suggested 700,000 'hidden' jobless.]

No one seeks to deny there are unregistered unemployed but reliable estimates of their numbers are difficult to obtain. Available estimates vary quite widely. Figures of registered unemployed are based on accurate counts, have been accepted by successive administrations and provide reasonable estimates of trend.

6. Unemployment expected to continue rising rapidly?

Unemployment forecasts uncertain; independent forecasters encompass differing views for 1983 - several projecting stabilisation, some [a slight] decline. Though there has been a worsening in the underlying trend in unemployment since June this year, rise for year as a whole has only been some 40 per cent of rate over same period last year. Employment situation should benefit from some further recovery in activity.

7. Fiddling the statistics?

[Rayner cost-saving exercise means that from November onwards method of measuring unemployed will change. November count will be some 100,000 lower than on traditional measure. Even further reduced in summer when school leavers register.]

No question of a fiddle. Detailed and considered study revealed substantial savings on collecting statistics for registered non-claimants. D.Employment will be providing estimates of effect on past statistics, and will provide similar information for up to a year from the change.

8. What is Government's own forecast of unemployment?

Government does not publish such a forecast. Nor did its predecessors. Unemployment depends on many factors: labour supply changes, growth in output and real earnings - all difficult to predict

IF PRESSED: in early 1980 no major outside forecasters accurately foretold fall in manufacturing output nor dramatic labour 'shake-out' of 1980-early 1981.

9. Employment continuing to fall?

[Total employment declined 2.2 million (9½ per cent) between mid 1979 and Q1 1982.]

Decline in Q1 1982 about one-third that in H1 1981. Best help for permanent jobs is sustainable recovery.

10. Recent productivity gains inimical to higher employment/lower unemployment?

[Output per head in manufacturing up 12 per cent since end-1980.]

This may be true in the short run. But in the longer term, as experience in UK and many other countries clearly demonstrates, higher productivity essential for growth and employment opportunities.

D TAXATION

1. Burden of taxation

[Total taxation (including NIC) as proportion of GDP was 34½ per cent in 1978-79 and is forecast to be 39¾ per cent in 1982-83. Corresponding figures excluding NIC are 28½ per cent and 33 per cent].

Burden has inevitably risen because of upward pressures on public expenditure caused by the recession. Increases in taxation are better - and more honest - means of financing this than borrowing, because of adverse effects borrowing has on interest rates and inflation.

2. British tax burden high by international standards?

Not so. Accurate comparisons difficult, but UK burden about average for OECD countries [1981 data from Lloyds Bank Economic Bulletin, October 1982]. Similarly, UK taxes on household income and employees' social security contributions about average for EC countries and lower than Japan and USA [1980 provisional OECD data].

3. Prospects for cuts in taxation in 1983 Budget?

[Reference Chancellor's speech to Conservative Party Conference 6 October and Weekend World interview 10 October].

Cannot, of course, comment now. Progress on inflation and interest rates must be maintained. Remain committed to tax reductions, but these will be made only when they can be afforded.

4. Previous reductions in personal taxation favour the rich?

1979 Budget cut absurdly high top rates of income tax to European levels, as part of package which also involved substantial increase in thresholds. Such action was essential to restore incentives. No 'pot of gold' in higher rate tax; restoration of 83 per cent top rate would finance a cut of under ¼p in the basic rate.

5. Burden of taxation risen most for the poor?

Proportion of income paid in income tax and NICs has fallen in 1982-83 for lowest paid taxpayers. Low paid with children are also entitled to benefits such as FIS.

6. Poverty and unemployment traps

Government equally concerned about poverty and unemployment traps, in context of incentives as a whole. They will remain a key factor in considerations of future tax policy. Traps are essentially caused by measures to relieve poverty and unemployment. Substantive action to alleviate them through the tax system would be extremely costly. Long-term solution must be an increase in wages as a result of a sustained improvement in economic performance.

7. Further reduction in NIS?

This year's reduction will benefit private sector by £640 million in 1982-83. In addition, employers have been shielded from increases in NIC rates over last two years. Cannot comment on possibility of further reductions, which would be expensive.

8. Further action to encourage wider share ownership?

Already seen encouraging growth of employee share-ownership, as result of liberalisation and extension of arrangements to promote profit sharing and share option schemes in 1980 and subsequent Finance Acts. Total of almost 500 profit-sharing and share option schemes now approved by Inland Revenue. Compares with less than 30 in May 1979.

E PUBLIC EXPENDITURE AND FINANCE

[Public Expenditure White Paper (Cmnd 8494) published 9 March. Gives planning totals of £115.2 billion in 1982-83, £121.1 in 1983-84 and £128.4 in 1984-85. About £5 billion higher than last White Paper in 1982-83 and £7 billion in 1983-84. Net effect of changes announced in Budget is to reduce totals to £114.9 billion, £120.4 billion and £127.6 billion].

1. Public expenditure too high?

Spending in 1982-83 planned to be about £5 billion (4½ per cent) lower than intended by last Government even if higher than planned when this Government first took office. Decisions to increase spending represent flexible but prudent response to changed circumstances e.g additional spending to help young unemployed. Drive to improve management in public sector and reduce administration expenses continues.

2. Ratio of public spending to GDP is getting back to peak levels of mid 1970's?

Ratios in 1980-81 (43 per cent) and 1981-82 (44½ per cent forecast) remain below level of 1974-75 and 1975-76 (46 per cent in both years). Rise in ratio in 1981-82 mainly reflects higher expenditure on social security at a time when real GDP falling. Ratio expected to fall in next few years: assumptions in MTFS would mean figures of 44½ per cent in 1982-83, 42½ per cent in 1983-84 and 41 per cent in 1984-85. Reflects assumed GDP growth and curbing of public expenditure.

3. Higher figures quoted in Weekend World programme 10 October?

[Ratio of public expenditure planned for 1982-83 to GDP in that year given in Weekend World programme was 46.8 per cent. Apparently derived (incorrectly) by someone at ITV taking from the FSBR the wrong numerator for the ratio. They took it from Table 8. The correct figures were given in the FSBR at para 2.21, and a reconciliation set out in Table 6.]

Figure of 46.8 per cent shown on Weekend World for 1982-83 based by them on incorrect calculation. The estimated ratio of public expenditure to GDP in 1982-83 is 44.5 per cent - which compares with 46 per cent in 1975-76 before Mr Healey went to the IMF. As Chancellor said, the intention is to reduce the ratio of public spending to GDP and it could be down to 41 per cent in 1984-85

4. Longer-term outlook for public expenditure?

[Economist 18-24 September reported that radical CPRS proposals to cut public spending in the longer term were tabled but not discussed at Cabinet 9 September.]

There is a problem in that public expenditure has an inherent tendency to creep ever upward - though this Government has been more successful than most in putting the brakes on, Government is looking seriously at various options. No necessarily questions of 'decimating' services; rather of finding best ways of financing better quality with wider choice. No specific decisions have been taken as a result.

5. Increase spending in recession?

No good trying to spend way out of recession. Any benefits would be short-term. If increased spending not financed responsibly, would soon lead to more inflation. If financed prudently, would lead to higher interest rates and/or higher taxes. We are responding, within limits of prudence, to needs of current circumstances.

6. Spending Ministers seeking extra public expenditure in 1983-84?/Treasury once again seeking cuts in public expenditure?

Bids for additional expenditure put forward in usual way as part of annual public expenditure survey. Ministers collectively will have to decide which are to be allowed and, depending on size of any increase, to what extent the increase should be met by savings elsewhere.

7. Not enough 'productive' public investment/needs being jeopardised?

Government not cutting 'productive' investment. Partly question of definition - within figures for capital expenditure totals, council house sales count as a negative item and defence procurement counts as current expenditure. Moreover nationalised industries financing an increasing proportion of investment out of own resources. Also, since mid-1970's some needs have declined; future standards and public amenities will not be jeopardised.

8. More capital projects in public sector to help private industry?

Government prepared to give priority to worthwhile capital projects within overall totals. But no question of artificial and inflationary stimulus to demand. New projects must be considered on merits. Nationalised industries investment in 1982-83 planned to be about quarter higher than previous year. Real answer: to provide private sector with prospect of higher rates of return on investment by continuing policies to lower interest rates and increase incentives.

9. Cash planning means concentration on first year, not enough on services in later years?

Government recognise case for medium-term planning. But planning must be related to availability of finance as well as prospective real resources. Cannot accept unconditional commitment to forward plans for services. Volume plans formerly had to be cut when conflicted with financial constraints - e.g after IMF intervention in 1976.

10. End-year flexibility?

Possibility of end year flexibility is being looked at again. There could be some managerial advantages in such a scheme. But we also have to consider question of cost.

11. Why so much underspending on Central Government voted cash limits 1981-82?

[Provisional outturn figures published 29 July].

Though rather more in 1981-82 than in each of previous three years, this is natural consequence of treating them as limits and not as targets. Extent of underspending on individual limits varies and is governed by range of factors - which can differ markedly from one cash limit to another. In general, moderation in rate of inflation, which departmental managers may not have fully anticipated, made it easier to remain within cash limits.

12. Why so much underspending by local authorities on capital expenditure?

Number of reasons including lower tender prices working through. But overwhelming reason was success in selling council houses and unused land.

13. Cut public sector pay bill/administrative costs of central government?

Only one third of current expenditure is on wages and salaries and much of that is for nurses, teachers, members of armed forces, police and so on. Provision for public service pay increases 1982-83 limited to 4 per cent. Administrative costs are not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain drive for more efficient management throughout public sector.

14. What allowance will Government make for pay increase in public services next year?

Government attaches great importance to realistic wage settlements next year, in both public and private sectors. Provision for public service pay will be made from within cash plans.

15. 3½ per cent pay assumption for 1983-84?

[Announced from Treasury 10 October.]

Assumption is not a 'norm'. Nor is it a decision on the offer to be made in any particular case. Each will be considered on its merits. It concerns the provision in public expenditure plans for next year for those groups for which Government is directly responsible, other than NHS. It does not directly cover local authorities, or nationalised industries, which are not within Government's direct control. But they will be controlled by the rate support grant and the external financing limits.

16. Will Government's operation of cash limits for civil service [and NHS] pay change as result of Megaw Inquiry Report?

Government is committed to policy of using cash limits to control public expenditure. We will consider and discuss the implications of Megaw report (see F4) in due course.

LOCAL GOVERNMENT

17. Overspending in 1982-83

Local authorities planning to spend some £1½ billion above Government's plans in 1982-83. In response, Secretaries of State have announced intentions to penalise over-spending by reducing the amount of grant to be distributed to them. (For details, refer to statements in Parliament 27/28 July by Secretaries of State.)

18. Local government finance 1983-84?

Because local authorities are spending so much this year, Government recognise they will spend more in 1983-84. So current expenditure provisions have been increased to ensure that they remain realistic. (For details refer to statements by Secretaries of State in Parliament 27/28 July). Figures announced are subject to consultation with local authorities, but Government is determined that they should be held to levels consistent with objectives for public expenditure and macro-economy.

19. Rate increases in 1983-84?

Spending in line with Government plans would imply only very modest increases overall, and in some areas no need for any increase at all. Of course, in areas where rating authorities overspend, ratepayers will bear a greater burden.

20. Government's plans imply enormous job losses?

Not necessarily. Government's plans for local authority expenditure are realistic and achievable. Local authorities could do a lot to help themselves by moderating pay and improving efficiency.

21. Proposals for direct control of local government spending?

Local authority overspending shows that the traditional consensus with central government is breaking down. We cannot afford to let damaging levels of expenditure continue unchecked. Local authorities' own irresponsible behaviour may force us to consider more direct action.

22. Green Paper on Domestic Rating System: Government response?

Government is considering carefully all representations received. We wish to produce proposals for a scheme that will remedy shortcomings of present system while commanding wide support.

FALKLANDS EXPENDITURE

23. Falklands defence costs?

Preliminary assessment of broad order of defence costs (excluding garrison costs) is about £570 million in 1982-83, and £200 million in each of the following two years. Non-defence costs (compensation, rehabilitation) are expected to be minor in comparison. Totals should represent only a very small proportion of total public expenditure.

24. What will be costs of repairing damage and reconstructing the Islands' economy?

Too soon to say what these costs will be. Work has begun on restoration of essential services and on implementing Civil Commissioner's recommendations for priority action (accommodation, inter-Islands air service, education). Up to £10 million is being made available. Not yet clear whether these costs will require additions to existing FCO and ODA funds and how far additional sums will be needed.

25. Cost of paying compensation for war damage?

Too soon to say what total will be. Claims are being processed, and further claims may be received. About £1 million has so far been paid out, but this is no guide to what the final total might be. Not yet clear whether the compensation scheme will require an addition to existing FCO programme.

26. How will the various costs be met?

Intention is to try to absorb 1982-83 extra costs within the Contingency Reserve. How future years' expenditure is to be funded will depend on decisions in this year's Public Expenditure Survey. Extra costs to defence budget (costs of the operation eg fuel ship chartering, and equipment replacement) will be met out of monies additional to the 3 per cent annual rate of real growth already reflected in sums currently provided for defence. Decisions have yet to be taken on other programmes. In any case, the costs will be met in a way consistent with the Government's economic strategy.

27. Cost of proposals in Lord Shackleton's report?

[Published 13 September. Some very large possible spending figures being bandied about by media]

Report will need careful study, both in UK and the Falklands, before decisions on all these proposals are reached. In advance of decisions not possible to say what cost might be.

[BACKGROUND WHICH CAN BE DRAWN UPON: Estimates of cost given in the Report are £31-36 million for new development aid; £40 million for offshore fishing; up to £12 million for additional housing/infrastructure. Total estimate of £83-89 million (at 1982 prices) excludes aid for rehabilitation and compensation for war damage already being made available.]

F CIVIL SERVICE STAFFING AND PAY

1. Civil service too big/does too much/is over staffed?

Since Government came to office, Civil Service has been reduced by 10 per cent to 659,300. Results from reduction in functions, privatisation and improvements in efficiency. On course to achieve aim of having Civil Service of 630,000 by April 1984. This is 102,000 fewer staff in post than in April 1979, and will mean smallest Civil Service since end of Second World war.

2. Civil service efficiency?

[Government reply to TCSC was published 28 September entitled 'Efficiency and Effectiveness in the Civil Service: Government Observations on TCSC Report Cmnd 8616].

Measures to increase efficiency in civil service set out in Government's recent White Paper welcoming Report from TSCS, and accepting (totally or with reservations) no less than 20 of the Committee's 26 recommendations. White Paper gives details of new financial management initiative, and responds to Committee recommendations on management information systems, training in management and financial management, and the filling of senior posts.

3. Civil service pay in 1983?

Unions have asked Government, in light of 3½ per cent planning assumption announced 1 October (see E 15), whether Government intend to have genuine negotiations, and whether arbitration will be available. They believe arbitration should be unconditionally binding ie not subject to Parliamentary over-ride.

4. Megaw Report

Report of Megaw Inquiry into arrangements for deciding civil service pay in future (Cmnd 8590) contained number of important recommendations which are now being considered. Preliminary 'ground-clearing' discussions with unions have commenced. (See also E16.)

4. Scott Report/Public sector pensions?

See K 17.

G SOCIAL SECURITY

1. Restore abatement of Unemployment Benefit?

[Uprating in November 1980 was abated by 5 per cent; this foreshadowed in Budget Speech announcing plans to bring UB into tax.]

Our position on this has been made clear. We reviewed the possibility of restoring the abatement when the benefit was brought into tax in July, but concluded that we could not afford to do so. The matter is being kept under review, and I have nothing more to add.

2. But abatement was a proxy for tax?

Always made clear when decision to abate was announced that it was not solely a proxy for tax but also part of a public expenditure savings package, and a measure likely to improve work incentives.

3. Cost of restoration substantially less than tax revenue?

[Cost of restoration £20 million first year, £60 million full year. Revenue from taxation now estimated at £650 million.]

Wrong in principle to hypothecate money from taxing benefits. But if MPs want to make such a comparison I would draw attention to cost of restoring shortfall in November 1981 uprating - £525 million in full year - this and other increases in social security expenditure more than accounts for the additional revenue.

4. Abatement hits at poorest section of the community?

Only one quarter of the unemployed are solely dependent on UB and hence affected by the abatement. All those affected will have been unemployed for no more than a year and are primarily single people or childless married couples.

5. Increase in National Insurance contributions?

We are currently in the early stages of the annual review of national insurance contributions conducted by the Government Actuary. It is too early to say what that review will produce.

6. Burden of State pension scheme too high?

[Government Actuary's Department Quinquennial Review of National Insurance Fund, published Wednesday 21 July, analysed possible future (up to forty years) cost of contributory benefits and levels of contributions needed to pay for them. Most important factor is increasing expenditure on earnings-related pension. Conclusions depend on assumptions about growth in earnings, prices, unemployment etc over period, but on certain assumptions contributions could change from present relationship to earnings - 16.5 per cent combined employees' and employers' contributions - to 15.4 per cent by 1985-86, but rise to 16.7 per cent by year 2005-6 and 21.9 per cent by 2025-6.]

Government Actuary's conclusions not firm predictions but illustrations of possible future burden on certain assumptions. We shall be considering report carefully before reaching any conclusion. In meantime DHSS are consulting widely with interested organisations and would welcome comments by end of this year.

7. Death grant - increase to realistic level?

[Consultative document about death grant published 3 March, deadline for comments 30 July.]

Social Services Secretary grateful for comments received on consultative document on death grant published in spring and is considering them carefully. As document made clear, aim is to redistribute in more sensible fashion resources now devoted to death grant - cannot afford to add to those resources.

8. Uprating benefits - will Government claw back any overshoot?

[Most benefits will be uprated by 11 per cent on 23 November. 9 per cent of this is to compensate for price increases over previous year].

Inflation is falling faster than was forecast at Budget time and we expect the outcome to be lower than the 9 per cent forecast. We shall not know the extent for a couple of months yet. This November's uprating will of course go ahead as planned. The 1983 uprating will be decided nearer the time. It will depend on the forecast movement in prices which will be made at Budget time, and whether the Government decides to take account of any overshoot this year. No decision has yet been taken.

H FISCAL POLICY AND THE PSBR

1. Progress on Fiscal Policy?

[Aim is to achieve reduction in PSBR as percentage of GDP over run of years, so as to achieve lower inflation and interest rates.]

Have made progress; Government has succeeded in reducing PSBR as percentage of GDP, and further reduction is projected. Inflation has fallen fast and is expected to fall further (see K2-3). Long term interest rates now lower than at any time in last 9 years. Benefits seen in recovery of debenture market. [IF PRESSED: Government would like to see rates lower still, so long as further reductions not likely to endanger progress or inflation.]

2. How does UK fiscal stance compare with other countries?

[IMF Annual Report noted that among major industrial countries by far the largest 'restrictive shift' over past two years, equivalent to more than 3½ per cent, was that of UK.]

Many countries reducing borrowing; UK budget deficit now well below average of OECD countries. France demonstrates problems with reflation option and US experience shows that fiscal and monetary policy must be broadly consistent.

3. 1981-82 undershoot shows fiscal policy too tight?

[PSBR for last year turned out £1.8 billion lower than estimate of £10.6 billion given in 1982-83 FSBR.]

Last year's undershoot probably does mean fiscal policy somewhat tighter than planned, but must examine strategy as a whole. Firm control of Government borrowing one factor responsible for fall in short term interest rates (6½ percentage points down since last autumn). Recovery of corporate bond market shows how lower PSBR creates room for investment.

4. Why treat PSBR as crucial statistic when prone to very substantial forecasting error?

[Margins of error are wide: plus or minus £4 billion.]

Although forecasting PSBR is hazardous, this in no way diminishes importance of achieving better balance between Government spending and income. Recognised by all Governments, whatever the difficulties of forecasting.

5. Isn't 1982-83 PSBR likely to undershoot too?

[Budget forecast for 1982-83 was £9.5 billion. PSBR for June quarter £2.8 billion (£1.6 billion seasonally adjusted) - broadly consistent with forecast for 1982-83 as a whole.]

Too early to say. Some of factors responsible for undershoot last year may indicate lower PSBR this year (eg higher income tax receipts). But other factors could go other way -

pressure on Contingency Reserve from Falklands spending, changes in estimated NI contributions, lower prices reducing VAT. [NB. PSBR for September quarter to be published 21 October. NOT FOR USE. Likely to indicate cumulative PSBR April-September of about £4.6 billion].

6. Implications of CGBR outturn in August for PSBR in 1982-83?

[CGBR September £0.3 billion; April-September inclusive £5.6 billion,compared £9.7 billion for same period last year].

CGBR figures so far not in consistent with £9.5 billion PSBR forecast. Comparisons with last year (distorted heavily by civil service industrial action) can be very misleading. (Also change in rules for local authority borrowing cause switch from Local Authority Borrowing Requirement to Central Government Borrowing Requirement with no effect on PSBR).

7. If PSBR higher in 1982-83 than in 1981-82 won't interest rates have to rise?

Link between PSBR and interest rates not a mechanical one. Moreover, as percentage of GDP, outturn for 1981-82 is more or less equal to the forecast for 1982-83 i.e around 3½ per cent. The 1982-83 forecast is still a low figure both by comparison with deficits abroad and in relation to size of deficits over past decade.

8. Unadjusted PSBR misleading guide to fiscal action?

Cyclically-adjusted PSBR may have some merit as indicator but poor guide to fiscal policy. It is actual Government expenditure and revenue that have to be financed and influence interest rates and aggregate demand.

9. Inflation-adjusted or 'real' PSBR in surplus - isn't fiscal policy too tight?

['Real' PSBR subtracts from actual PSBR erosion by inflation of real value of Government debt. Calculations by Bank of England and others produce a surplus 'real' PSBR in most years since the 60's].

Policy of this Government is to fight inflation, not to accommodate it. If 'inflation-adjusted PSBR' is in surplus, this calls for cut in inflation, not expansion of actual PSBR.

J MONETARY AND FINANCIAL POLICY

1. Monetary growth in 1982-83 on target

[The target aggregates M1, £M3 and PSL2 grew by 1.2, 1.1 and 0.9 per cent respectively in banking September. These changes bring rates of growth in the 1982-83 target period to 9½, 11½ and 8½ per cent per annum respectively, compared with target range of 8-12 per cent (all figures seasonally adjusted).]

Rates of growth of all three target aggregates are within Government's target range. £M3 is towards top of range. But looking also at behaviour of exchange rate and progress in reducing inflation, overall picture is of sound domestic monetary conditions.

2. Prospects for further reductions in interest rates?

[Last reduction in bank base rates made on 13 October to 9½ per cent. Have come down by three points since early July.]

Substantial interest rate reductions this year reflect sound monetary conditions, and good inflation prospects. Impulse also from US developments. Government would like to see rates lower still, so long as further reductions do not seem likely to endanger progress on inflation.

3. Effect of US interest rates on ours?

[US rates fell substantially during July/August, and again this month.]

The falls in US rates were helpful and facilitated reductions in our own. But of course US rates are not sole determinant of UK's, and this spring progress was made in reducing ours at a time when US rates were rising. UK rates are determined in the light of domestic monetary conditions generally, including the behaviour of the exchange rate.

4. Monetary conditions too tight - stifling recovery?

No. Behaviour of exchange rate and money supply suggest financial conditions moderately restrictive, as intended. Interest rates reductions have cut companies' cost and should promote climate for investment.

5. Bank lending growing too fast?

[Lower growth rate in May/June not maintained. Increased by £1.3 billion in banking August and £2 billion in September (seasonally adjusted).]

Reasons for growth of bank lending to companies not entirely clear. Companies may be trying to build up gross liquidity levels which fell back in spring. Personal lending also quite strong. Growth partly the result of structural changes, such as move by banks into home loans market, replacing lending by building societies. Ending of HP controls in July does not appear to have had a large effect.

6. <u>Prospects for reactivation of corporate bond market</u>?

[Tax treatment of 'zero coupon' and 'deep discount' stocks and removal of embargo on company issues of this type of stock announced 25 June. BOC announced issue of £100 million conventional bond 10 September.]

Zeros broaden options available to companies, though not expected to transform captial market. Best hopes for resurgence of market provided by lower interest rates and inflation, for which we are on course.

7. <u>Why has Bank of England been providing such large-scale money market assistance</u>?

The rapid growth of bank lending has caused problems for conduct of monetary policy. By selling long-term Government debt on a larger scale outside the banking system it has been possible to contain the rapid growth in money which could otherwise have taken place. This in turn has created shortages of liquidity in the money markets. If the Bank had not intervened to relieve these, short-term interest rates would have been forced up to unnecessarily high levels. The measures announced in June [ie variable rate loans facility made available to local authorities etc from the National Loans Fund/Public Works Loans Board; companies allowed to issue zero coupon and deep discount stocks] should reduce rate of growth of bank lending, by encouraging LAs etc to borrow from the NLF instead of from banks and by broadening options available to companies issuing their own debt, and so reduce levels of assistance required.

K PRICES AND EARNINGS

PRICES

1. September RPI

[Year on year increase in RPI 7.3 per cent in September, compared with 8.0 per cent in August].

Annual rate of inflation fell sharply in September to 7.3 per cent, its lowest level for 10 years (compared 7.0 per cent in September 1972). The price level in September was no higher than in June and actually slightly (0.1 per cent) lower than in August - the first time the index has fallen for 12 years (since August 1970).

2. How low inflation by end 1982?

[Budget time forecast Q4 1981 to Q4 1982 9 per cent and Q2 1982 to Q2 1983 7½ per cent.]

Chancellor has recently predicted [in Washington 20 September] that inflation could be as low as 6½ per cent by end 1982.

3. Further falls likely in 1983?

We expect continued progress in reducing the rate of inflation in the new year.

4. Inflation lower than under previous Government?

[Average year-on-year rate of inflation between February 1974 and May 1979 was 15.4 per cent; average level of inflation since May 1979 has been 12.8 per cent.]

Year-on-year rate of inflation was 10.3 per cent and rising when previous Government left office in May 1979. Now (September 1982) 7.3 per cent and falling. We will be first Government for quarter of a century to achieve a lower average rate of inflation during its term of office than the previous Administration.

5. Inflation still not as low as competitors?

[August figures: UK inflation 8.0 per cent compared with 5.7 per cent in US, 5.1 per cent in West Germany, and 3.1 per cent in Japan.]

UK inflation now lower than Western European (OECD Europe) average, and well below many countries - such as France and Italy. Still some way to go to match US, West Germany and Japan, but good progress being made in right direction.

6. Long term inflation objective?

Recent developments encouraging. But inflation rate still higher than some competitors e.g Germany. Must not let up. Have always made it clear that price stability not unattainable.

7. TPI now shows pay increases need to be ½ per cent higher than RPI to maintain living standards?

[Increase in TPI over 12 months to September 7.9 per cent, compared with RPI increase of 7.3 per cent].

The gap between the RPI and the TPI (now 0.6 percentage points) widened in July when benefits paid to the unemployed became taxable. Pay increases go to people in work, who will not pay any more tax as result of the change - except for the minority who have a spell of unemployment during the year.

8. Nationalised industry prices

[Increase over 12 months to September 13.7 per cent, compared with RPI increase of 7.3 per cent].

Gap between nationalised industry price increases and RPI due in large measure to cumulative effect of years of artificial price restraint. World oil price rises of 1979 and 1980 have also played important part. Increases regrettable, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so. The differential between RPI and NI prices (including water charges and London Transport fares) is now 6 per cent compared with 14 per cent in January 1982. But sustained improvement only possible if industries succeed in holding down current costs, particularly pay. (See also R1; for gas price rise in October see R2).

PAY

9. A 3½ per cent pay policy?

The 3½ per cent pay assumption [announced 1 October for calculating the pay element in cash expenditure plans for 1983-84] does not represent a 'norm', still less an 'incomes policy'. Nor is it a decision on the offer to be made in any individual case. Settlements higher or lower than the assumption are not ruled out. Each case will be considered on merits.

10. What pay settlements does Government now want?

Low enough to be consistent with improved job prospects in the industry concerned. The lower the better. Certainly lower than in the past year.

11. What has been average over past year/pay round?

[CBI Databank suggests 7 per cent average for manufacturing in last (1981-82) pay round].

Average has been in single figures, and moving downwards, in each of past two years. We need a substantial further reduction, with really low settlements, and thus a better outlook for jobs, in the year ahead.

12. Government exhortations on pay imply aiming to cut living standards?

[Real earnings show some improvement over past two years; in July 1982 2 per cent higher than July 1981 and 3 per cent higher than July 1980.]

Lower pay settlements have not in fact cut real earnings in either of the past two years; prices have also come down. This fact casts doubt on the wilder claims about the effect of pay moderation on living standards.

13. Incomes Policy

Proposals for incomes policies, including recent refinements, do not avoid many of the familiar problems of norms, administrative costs, and interference with market forces. Experience gives no encouragement to the idea that incomes policy can be made to work on a permanent basis. They always succumb to the distortions they create.

14 NHS pay

Discussions are still continuing with Royal College of Nurses and other professional bodies on proposals for two year settlement. Disappointing that TUC unions unwilling to participate in these talks.

15. Top Salaries Review Board increases too large?

[Government announced on 12 May increases of 14.3 per cent for senior civil servants and senior members of the Armed Forces, and 18.6 per cent for the judiciary.]

Government believes these increases are fully justified. Essential to ensure adequate supply of candidates of sufficient calibre for the Bench, and to provide adequate career structure and differentials in higher levels of Civil Service and Armed Forces. TSRB are only group whose present salaries are below those recommended for April 1980.

16. Average earnings index

[Year on year growth 10.9 per cent in July compared with 9.8 per cent in June. However, underlying (unpublished) increase slightly lower than in June at around 9¼ per cent.]

Encouraging that underlying rate of growth continues to fall. July index inflated because of back pay and delayed settlements paid in July 1981 (eg civil servants). Further moderation in settlements can only be helpful in maintaining jobs and getting inflation down.

17. Index-linked pensions and Scott report?

The Government is considering whole question in light of Scott Report. Our aim is to ensure that public servants' pensions are fair to taxpayers, as well as to current employees and pensioners and their dependants.

L BALANCE OF PAYMENTS

1. Trade figures and current account

[August trade figures show trade account in broad balance though non-oil trade has shown increasing deficit; projected invisibles surplus of £260 million a month in Q2. Cumulative current account surplus of £2.1 billion in eight months to August.]

Signs are that the current account continues in substantial surplus, albeit reduced from last year's levels.

2. Export trends

Exports during 1982 have been very erratic. The underlying trend seems to be holding up better than expected given the poor level of world trade.

3. Import trends

Manufactured imports increased in August but were still below their high May levels. The underlying level of manufacturing imports has probably not altered since end-81 when manufacturing activity levelled off.

4. Figures for 1981

Only the 1981 August export figures now remain to be published. These should become available shortly.

5. Overseas investment takes jobs away from UK?

30 per cent of UK exports are bought by overseas firms connected with UK companies. By increasing links between UK and overseas companies, overseas investment helps UK exports and production, so producing more jobs. If UK does not take profitable opportunities to invest overseas, others will.

M EXCHANGE RATE AND THE RESERVES

1. Policy towards the exchange rate

[The average £ effective rate in Q3 1982 was nearly 10 per cent lower than in Q1 1981. In last few months £ has remained broadly stable. Rates at noon on 153 October were $1.7030, DM 4.2955 and an effective of 92.78. Previous lows were $1.6821 on 5 October, DM 4.098 on 21 May. Highs were $1.97 on 30 November 1981, DM 4.407 on 9 February. Reserves at end September stood at $18.3 billion, compared with $18.1 billion at end August.]

Government has no target for exchange rate. The exchange rate is only one of the factors taken into account in interpreting domestic monetary conditions and taking decisions on policy. Sterling's effective exchange rate has continued to show the broadly stable pattern of recent months. This stability reflects the continuing international confidence in this Government's economic policies.

2. Bank of England intervening to support the rate?

Policy is unchanged. Bank do intervene to smooth excessive fluctuations and preserve orderly markets particularly when conditions unsettled. But, as Chancellor has already stated, we have no target - undisclosed, secret or otherwise - for the exchange rate. Most recent reserves figures confirm that policy is unchanged.

3. Concerted intervention to reduce value of dollar?

All experience in recent years that exchange rates for major currencies cannot be manipulated by intervention alone. Intervention can help to steady markets, but not counter major exchange rate trends. That takes changes in real policies, affecting interest rates, monetary conditions and fiscal policies. Lower US inflation is in everyone's interest: matter for real concern is US fiscal/interest rate mix, a problem all countries are familiar with.

4. Improve UK competitiveness by devaluing exchange rate?

Experience shows that exchange rate cannot be manipulated by Government against underlying market trends. Any attempt to lower it by intervention or by relaxing monetary control leads to higher inflation. For example the effective exchange rate depreciated by over a quarter between 1972 and 1976 without leading to any improvement in UK competitiveness.

5. Debt repayments

We have made excellent progress with our plans to reduce the burden of external debt substantially during this Parliament. We aimed to reduce official external debt to $14 billion by end of 1981. This has been more than achieved - external debt is now around $13 billion, compared with over $22 billion when the Government took office.

N EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. UK budget settlement

Foreign Ministers agreed on 25 May to a settlement for the UK budget contribution for 1982. The settlement provides for a basic refund of £490 million ecus in respect of 1982, with provision for changes to this figure if our unadjusted net contribution varies from the Commission estimate of £880 million. It was also agreed that the problem for the longer term would be settled by the end of November.

2. Implementation of budget settlement

Details still under discussion in Brussels. The 25 May agreement envisaged partial rebates to Germany, Italy, Greece and Ireland for their share in financing UK refunds, making France bear a larger burden - but France will remain a substantial net recipient from the budget.

3. UK objectives for longer-term negotiations?

Government has made it clear that, in spite of our relative economic position, UK is prepared to remain a net contributor - but only on a very modest scale.

4. Will Government withhold contributions?

We hope very much that the issue of our Budget contributions can be satisfactorily settled without the need for recourse to such a step.

5. Commission's ideas for changes to 'own resources' system

Understand that Commission are considering measures to diversify Community's revenue sources. If they put forward proposals we will consider them. Our opposition to any increase in the 1 per cent VAT ceiling is well known.

6. Policy for CAP reform

Key measures are price restraint, curbs on surplus production and strict control of the growth of guarantee expenditure.

7. Costs of CAP to UK consumers

The Minister of Agriculture has dealt with a number of questions on this. Costs to consumers of the CAP as such depend on nature of alternative support system that is envisaged. Arrangements leading to a reduction in the cost of food to the consumer could well involve increased costs to taxpayers.

EUROPEAN MONETARY SYSTEM

8. What is the current attitude of the UK Government?

We fully support the EMS, and acknowledge the contribution which it has made to stability in the exchange markets. However, we do not yet feel able to join the exchange rate mechanism. We must wait until conditions are right for the system and for ourselves.

9. Join the EMS for exchange rate stability?

There is no reason to suppose that by the simple act of joining the EMS exchange rate mechanism we would guarantee exchange rate stability. This has not been the experience of the current participants. Genuine stability requires a return to low inflation rates throughout the Community.

P INDUSTRY

1. Prospects for industry-recovery?

See A 3-5 and Section B.

2. Companies' financial position?

[£bn

	1979	1980	1981 Year	H1	H2	1982 Q1
Net borrowing requirement (+)/repayments (-)	+6.1	+5.7	+4.4	-1.2	+5.6	+3.5
Financial surplus (+)/deficit (-)	-2.7	- 1½	+1.2	+1.5	-0.3	-0.5]

Financial position of industrial and commercial companies (excluding North Sea) improved last year, relative to 1979 and 1980. Improvement in part reflected companies' efforts to cut costs, for example by de-stocking. Some apparent deterioration in second half 1981 financial position due to slowdown in de-stocking and unwinding of delays in tax payments because of the civil service dispute. Figures for H1 1982 suggest reduction in companies' borrowing requirements relative to H2 1981; but borrowing needs still high.

3. Profits rate of return still too low?

[Gross trading profits of industrial and commercial companies (ICCs) (net of stock appreciation) rose 40 per cent to Q1 1982. But increase was from very low base: ICC's real pre-tax rate of return just 2½ per cent in 1981 - half the previous lowest figure in 1975.]

Government can help best by getting inflation down and setting sound basis for sustained recovery. Fundamental improvement in ICC's rates of return depend on better performance by companies. Some encouragement from recent productivity gains and trend towards moderate pay settlements.

4. High interest rates damaging for industry and investment?

Banks' base rates have fallen 6½ percentage points since last October, and 3 points over last three months. Outside analysis suggests that a 1 per cent reduction in interest rates improves the net financial position of the company sector by about £250 million over a full year. Lower interest rates reflect Government's firm fiscal and monetary stance and will help industry and investment.

5. Lower rates for industry?

De-rating one of a number of possible ways of assisting industry and business, but in last Budget preference given to other forms of relief, notably reductions in NIS. De-rating would be expensive, though less so if applied to industry alone - even so, 10 per cent de-rating would cost about £140 million per annum. Legislation would be required.

6. Government help for small firms

Budget provided further help for small businesses, increasing the number of measures taken so far to over ninety. Enterprise package included further reduction in weight of corporation tax; further increases in VAT registration limits; increase in global amount available for loans under Loan Guarantee Scheme (see below); and doubling of investment limit under Business Start-Up Scheme to £20,000 a year. New measures will encourage start-ups and existing firms.

7. Response to Loan Guarantee Scheme?

[Over 6,400 guarantees already issued - about half to new businesses. Total lending under scheme around £215 million. Budget provided for lending ceiling in first year (to May 1982) to be raised from £100 million to £150 million and for further £150 million to be available in second year (to May 1983). Thirty financial institutions now participating. (Report on sample survey of borrowers placed in Library of House by Parliamentary Under Secretary of State for Industry (Mr MacGregor) on 12 July).]

Scheme operating successfully. Too early to assess overall cost . After first year, out of over 6000 guarantees issued, only 150 have so far been 'called'. Cost has been covered by the premium income received over the period. Scheme is kept under continuous review.

8. Enterprise zones

Chancellor announced Tuesday 27 July eleven new Enterprise Zones to be created: 7 in England; two in Scotland; one each in Wales and Northern Ireland. All first eleven zones now in operation. Response has been very encouraging. Many new firms are setting up in the zones, existing firms are expanding their activities and vacant land has been brought into use. Too early to assess success of zones.

R NATIONALISED INDUSTRIES

NATIONALISED INDUSTRY PAY AND PRICES

1. Nationalised industries' prices

[Having risen approximately in line with retail prices for several months, the latest figures show bigger 12 months increase in nationalised industry prices, water charges and London Transport fares than all items RPI (13.7 per cent in August compared 7.3 per cent). This differential reflects March increase in LT fares. Removal of these temporary distortions confirms that nationalised industry prices are still increasing somewhat faster than RPI, largely because of increases in energy sector.]

Gap between nationalised industry price increases and RPI has been due in large measure to cumulative effect of years of artifical price restraint. World oil price rises of 1979 and 1980 have also played an important part. We greatly regret the need for these increases, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so. The differential between RPI (all items) and NI prices (including water charges and London Transport fares) is now [6] per cent compared with 14 per cent in January 1982. But sustained improvement will only be possible if the industries succeed in holding down their current costs, particularly pay.

2. Increase in gas prices?

[Domestic gas prices increased on 1 October. Some Press speculation that industry will have to pay 1p per therm more each quarter as contracts come up for renewal next year]

Large increase in domestic prices over last three years needed to remedy under-pricing by previous Government. There will be no more massive increases in gas prices. Industrial gas users have benefited from two years of virtual freeze on renewal prices for contract gas. BCG not yet decided on pricing strategy following lifting of the freeze at end of this year.

3. What is Government doing to improve Nationalised industries' efficiency?

We continue to press for greater efficiency within NIs. We are setting realistic financial targets and performance aims. A rolling programme of Monopolies and Mergers Commission investigations has been set up. The introduction of market forces provides greatest incentive to efficiency.

INVESTMENT

4. Nationalised industries' investment should be stepped up to/improve infrastructure/provide orders to private sector/as boost to economy

Government has not prevented the industries from carrying forward a large number of profitable investment programmes. It would be wasteful to provide funds for public sector projects with lower returns than those in the private sector. Unfortunately, the pre-tax rate of return on nationalised industries' capital (including subsidies) in 1980 (latest available figures) was minus one per cent, compared with 3 per cent for industrial and commercial companies.

5. Finance more nationalised industry investment by cutting current spending?

As in private sector, moderate pay settlements and control of other costs are essential. Ability to finance new investment in nationalised industries bound to diminish if excessive pay settlements agreed. Each 1 per cent off wages saves about £140 million this year; and each 1 per cent off total costs saves £330 million this year.

6. Take nationalised industry investment out of PSBR?

Real problem of pressure on resources cannot be solved by changing statistical definitions. Since nationalised industries are part of public sector, their borrowing - for whatever purpose - must by definition form part of public sector borrowing requirement.

7. Private finance for NI investment?

In discussions in NEDC and elsewhere, we have indicated our willingness to consider new financing proposals, provided they can be structured so as to induce improvements in efficiency at least sufficient to offset the extra cost, and provided the finance is raised in fair competition with the private sector.

8. Investment plans unlikely to be attained?

No Government can unconditionally guarantee a level of investment by the nationalised industries. Approved levels set out in last White Paper (Cmnd 8494) are consistent with the industries' agreed external financing requirements, on the basis of their internal resource forecasts. But perfectly possible that plans might need to be revised, for example if the industries fail to restrain their current costs, including pay.

EXTERNAL FINANCING LIMITS

9. EFLs for 1982-83 and future years?

Nationalised industries' total external finance increased by £1.3 billion in 1982-83 (£1.2 billion after allowing for NIS cut and other changes). Increase in 1982-83 was roughly half what the industries bid for. Government has given full recognition to problems faced by the industries in a period of recession. EFL's for 1983-84 will be announced later this year, as usual.

PRIVATISATION

10. Special asset sales in 1981-82

Gross sales in 1981-82 totalled £481 million, so target published in 1981 Public Expenditure White Paper of £500 million nearly met. Pleasing result - included two large sales - Cable and Wireless (£182 million) and Amersham International (£64 million). True that delivery of BNOC oil in 1981-82 paid for in 1980-81 and taken into account in special disposals figure for that year reduced 1981-82 receipts by £573 million to total of -£92 million. But it is gross figure which is true measure of success of Government's privatisation programme. As Chancellor said in Cambridge 3 July, 'Public utilities and the so-called "natural monopolies" cannot be allowed permanently and without challenge to remain within State ownership'.

11. What further sales expected?

Special sales of assets in 1982-83 forecast at around £600 million and expected to increase in subsequent years. This year's and next year's involve primarily very large sales of energy assets - Britoil and the British Gas Corporation's major offshore oil assets - made possible by Oil and Gas (Enterprise) Act (which received Royal Assent in June). Industry Secretary announced 19 July plans to sell 51 per cent of British Telecom - but not before next Election.

12. Will Government postpone Britoil sale in view of the weak oil market?

Government intends to sell majority of Britoil shares by end of 1982, if market conditions permit. Will take decision on whether to go ahead when the time comes. To that end the Energy Secretary has laid an Order which will transfer the 100 per cent shareholding in Britoil to his ownership on 1 November.

13. Contribution to giving people satisfaction of property ownership?

Exercise of returning enterprises from State ownership to ownership by the public has included measures to promote employee share ownership in the enterprise they work for; for example free offers of shares (British Aerospace, Cable and Wireless, Amersham);

preference in allocation of shares (B Ae, C & W, Amersham, BP); provision for matching shares - one for each share subscribed for - (B Ae, Amersham, BP). Most radical initiative taken by consortium of managers and employees who bought National Freight Company.

14. Government has sold assets too cheap?

[Heavy oversubscription for British Aerospace, Cable and Wireless, Amersham International, followed by large increases in prices when shares first traded.]

Not in Government's interest to see shares underpriced, given the loss to the PSBR, but also risks in pitching price too high. Getting balance right not easy - especially when company's shares have not previously been traded. Government will continue to consider alternative forms of sale eg tender, but critics should note that sale by tender could make it harder for small investor to buy shares.

S NORTH SEA AND UK ECONOMY

1. Is Government underestimating North Sea revenues?

[FSBR projections (in money of the day) of Government revenues from North Sea: £6.4 billion in 1981-82, £6.2 billion in 1982-83, £6.1 billion in 1983-84, and £8.0 billion in 1984-84. Lower than last year's projections, principally because of downward revision to oil price expectations].

Projections of oil revenues and crucially dependent on inherently uncertain cost, price and production assumptions. Prospects for North Sea revenues have improved since FSBR published because of higher than assumed oil prices. Higher recent estimates of Scott, Goff and Hancock and the Midland Bank Review are based on higher expected future production and lower expected future capital expenditure.

2. Onerous tax system damaging future field developments?

[Shell/ESSO have shelved plans for Tern partly because of tax system; Phillips postponing T-block complex and BP their Andrew field; BP statement issued with their interim results criticised fiscal regime.].

Other adverse factors - falling oil prices earlier this year; high development costs - much more important. Detailed study has shown that under new tax structure, levels of profitability should still be sufficient to make exploration and development attractive. Hope that present structure will provide more secure and stable tax regime.

3. Taxation of petrochemical feedstocks

[Government has announced that new rules on valuation of ethane for petrochemical use in interaffiliate transfers (Finance Act Section 134) should be extended to mixed streams of gas with a large ethane component. ICI complain that the extension and the rules themselves give unfair advantage to their integrated oil company competitors and have taken out writ against the Government.]

Government convinced that new formula will give fair valuation. New valuation will not have effect of providing subsidy to ICI's competitors. Have done best to reassure ICI. Will resist ICI's legal action.

4. Government should do more to promote UK Continental Shelf oil production in 1990's?

[Select Committee on Energy's Report on Depletion Policy published 18 May: emphasised development of fields entering production in 1990s by increasing pace of licensing rounds and overhauling fiscal regime. Recommended reserve powers to impose production cuts. Energy Secretary and Chancellor replied in joint memorandum on 29 July].

HMG agrees with general conclusions encouraging North Sea exploration and development, thereby maximising economic oil production over time; eg decision recently announced not to impose production cuts before 1985. Agree uncertainties in oil markets too great to justify deferring new field developments in foreseeable future. Cannot accept Committee's criticism of North Sea fiscal regime - opposed to another fundamental review; industry does not want a structural upheaval.

5. Benefits of North Sea should be used to strengthen economy?

[Contribution of North Sea to GNP estimated at 4 per cent of GNP in 1981. Not projected to rise before 1985.]

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve lower level of interest rates to benefit of industry and economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Less than 6 per cent of total General Government receipts in 1981-82.

6. North Sea revenues should be channelled into special fund?

North Sea revenues are already committed. Setting up special Fund would make no difference. More money would not magically become available.

7. Future North Sea oil prices?

A matter for commercial negotiation between oil companies and BNOC.

8. Are we really any better off for our North Sea oil?

We are better off with oil - at current oil prices - than we would have been without it. We have been spared fall in real national income that other industrial countries have suffered following oil price rises. But North Sea oil costly to produce, so we are not necessarily any better off than we would have been had oil prices not risen. No need therefore for possession of oil to require a contraction in our industrial base.

T WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Prospects for world recovery?

[IMF, London Business School and Bank of England Quarterly Bulletin all gloomy about immediate prospects. No overall growth seen in major countries in 1982, and only weak recovery next year. Press reports suggest OECD will also revise its previous forecasts this autumn.]

Output in the major economies appears to have recovered slightly in the spring after the downturn last winter. Latest estimates suggest further growth in US economy in the most recent period. The major European economies, however, remain depressed, and it is too early to say that a broad upturn has started. Lower inflation and interest rates however offer prospects for better growth next year.

2. Why don't major industrial countries together expand demand?

Leaders of the major countries agreed at the OECD, Summit and IMF meetings on the need to continue the fight against inflation. As the OECD's Economic Outlook explains, Governments are convinced 'a significant part of any stimulus to demand would increase public sector deficits, and dissipate itself rather quickly as an increase in inflation'.

3. ~~Anti-inflation~~ policies are working

[Inflation down from a year ago in all 7 major economies on latest available figures: US (from 10.7 to 5.9 per cent), UK (11.6 to [8.0] per cent), Japan (3.8 to 3.1 per cent), Italy (18.3 to 17.2 per cent), Canada (12.7 to 10.5 per cent) France (13.8 to 10.2 per cent), Germany (6.5 to 4.9 per cent).]

Inflation has fallen in all major countries in the past year. Firm fiscal and monetary responses to 1979-80 oil price rise vindicated. UK close behind US and Germany in bringing down inflation, and ahead of some other European countries. Realism in wage settlements is growing; US, Germany and Japan all have wage settlements in single figures.

4. International financial collapse?

Concern about effects of over-borrowing noted at Toronto IMF meeting. But should not exaggerate alarm. Important of course to sustain system's stability. Lower interest rates should help, as should IMF programmes to restore countries' credit-worthiness. Further progress needed on banking supervision including risk assessment and prudential standards; also watertight allocation of supervisory responsibilities.

5. What about US ideas for emergency IMF assistance to countries heavily indebted to the international banking system?

The IMF must certainly be endowed with the resources it needs to carry out its present role. There is widespread agreement that a substantial increase in its quotas is necessary. Its resources may need to be supplemented even further. The US ideas are only one of a number which need to be studied carefully.

6. French government 'seen the light' over reflationary policies?

[After prices and incomes freeze announced in June and F.Fr 10 billion economies in social security spending announced July, budget for 1983 was announced 1 September. Borrowing ceiling set at 3 per cent of GDP. Government has also announced increases in duties on tobacco and alcohol, and delays in planned increases in some social payments, including pensions].

Strength and stability of world economy will benefit if all countries can control inflation. So we welcome French government's commitment to reduce inflation and to rein in Government borrowing.

7. Japanese reflation?

[Japanese Government have introduced reflationary package of £4½ billion (Y 2020 trillion) or just under 1 per cent of GDP. Mainly consists of increased expenditure upon public works in current fiscal year.]

Inflation in Japan only 3.1 per cent; unemployment 2.3 per cent; savings high. Different conditions from UK.

8. US Budget?

[Despite package of tax increases totalling $98.3 over next three years, passed in August, US budget deficit for 1982 expected to be about $109 billion; deficit for 1983 forecast to be even larger].

Welcome Congress approval of tax package. US has won a battle but long campaign lies ahead to put deficits on convincing declining path in medium term.

9. US monetary policy

[US interest rates have fallen and Federal Reserve has reduced its discount rate from 9½ to 9 per cent. Chairman Volcker has said US authorities will be 'attaching much less than usual' weight to M1 over period ahead].

Accept that monetary indicators in US must be interpreted flexibly in light of financial innovations. Federal Reserve Chairman, Mr Volcker has made clear that reduction of inflation remains a priority and that monetary targets have not been abandoned.

10. US economy?

[US GNP rose slightly in Q2 after falls of more than 1 per cent in preceding two quarters. Preliminary indications suggest that GNP may show a further small rise in Q3. Unemployment has risen above 10 per cent. Consumer price inflation has fallen to 5.9 per cent. Tax cuts effective, July were expected to boost consumer demand but retail sales and industrial production remain flat. Interest rates, however, have fallen 4½ per cent since July].

US output rose slightly in Q2 and preliminary indications suggest that there may be a further rise in Q3. Still too early to say that a strong recovery is under way, but falls in interest rates and infaltion hold out better prospects for growth over the next year.

11. Another oil energy crisis looming?

[Latest World Energy Outlook from International Energy Agency raises possibility that tight oil market could reappear in late 1980's].

Always difficult to foresee future oil prices. But they are weak at present and likely to remain so in near future. In longer term, energy conservation should permanently reduce countries' dependence on oil.

Aide Memoire on Recent Economic Developments and Statistics: 15 October 1982

Summary comment

Financial developments in UK generally favourable but both nationally and internationally gloomy statistics have been published on "real" variables over last few months.

World Economy - expectations held by most forecasters for an upturn in activity this year have not been fulfilled; the 1 per cent expected recovery has not materialised.

. world trade has been more or less flat since the middle of last year.

. total industrial production in the twelve months to June fell 4.8 per cent in the OECD Major 7 and by 10 per cent in the US.

. inflation (major 7) around 7 per cent in August: ranging from 17 per cent in Italy to 3 per cent in Japan.

. three month interest rates for the "world basket" stood at 11.35 in October a fall of 4 per cent on the 1981 Q3 average; Real interest rates remain clearly positive.

. OECD 7: unemployment increased from 6.4 per cent in 1981 Q2 to 7.8 per cent in Q2 this year.

UK Balance of Payments - the non-oil trade balance has deteriorated quite sharply but because of oil exports, the current account is just in balance.

. OPEC and Third World countries are cutting back on imports because of low commodity prices and debt problems in some countries. UK exports are substantially down in the last three months.

. imports rose sharply as activity recovered last year and import penetration rose too. it remains high this year.

. capital account: identified capital movements were roughly in balance in the second quarter; a turnround of £80 million on the first quarter.

. the effective exchange rate has been steady at around 90 for a year now; currently 91.8.

Financial Developments: monetary targets and PSBR are within the target ranges; interest rates down 6½ points since October.

.M1, £M3, PSL2 within target range for 1982-83, M1 highish.

.interest rates down 6½ points since last October;

.PSBR remains within the FSBR forecast of £9½ billion for 1982-83.

Inflation: inflation responding favourably (but it is in other major OECD countries too).

.retail price inflation 7.3 per cent in September. Forecast 6½ per cent before Xmas;

.WPI also behaving well; 12 monthly increase 3¼ per cent to September; (but not susceptible to specific influences, like mortgage rates, influencing RPI;)

.TPI increase in 12 months to September was 7.9 per cent.

Gross Domestic Product and Output

.money GDP growth slowed by 1 per cent to 8½ per cent per annum in the first half of 1982; during 1981 the rate of increase was about 9½ per cent;

.GDP has been broadly flat since 1981 Q4 as has the underlying level of industrial production;

.increased North Sea oil and gas production is offsetting a 1 per cent reduction in manufacturing output since 1981 Q4.

Demand Components

.consumer spending has remained broadly unchanged since 1979, over a period when other components of final demand fell some 4-5 per cent. Retail sales in July and August were a little higher than in previous months but slowed again in September.

.gross fixed investment fell back by 4 per cent in 1982 Q2 - from a strong first quarter - to a level similar to that in 1981 H1 and 10 per cent below the level in 1979. Manufacturing investment has been weak. Plant and machinery investment, however, has held up quite well in relation to output.

.the massive destocking of 1980 H2 and 1981 is over but the 1982 Q2 figures show no return to positive stockbuilding. September CBI survey suggests some further scope for destocking;

.government consumption as a proportion of GDP is on-plan.

.there has been some fall in the volume of exports in recent months reflecting both loss of competitiveness and the slow-down in expected world trading activity;

.imports rose very sharply between the two halves of 1981, reflecting both the increase in activity and increased input penetration (this remains high in 1982).

Productivity and Competitiveness

.manufacturing productivity continues to rise strongly - a 5 per cent annual rate so far this year, following 8-10 per cent last year. Still high by historical standards;

.unit wage/salary cost up only 5 per cent in last 12 months;

.during 1981 our external price and cost competitiveness improved at least 10 per cent but this year little or no further improvement has emerged.

Company Sector

.after falling in the first quarter of 1982 gross trading profits (net of stock appreciation) of ICCs rose by 5 per cet;

.non-North Sea profits in 1982 H1 were 22 per cent above their level in 1981 H1;

.gross profits of North Sea oil companies rose only 10 per cent over the same period;

.ICC's financial position (ex North Sea) in 1982 Q1 suggests a reduction in borrowing requirements compared to the second half of last year.

Personal Sector

.in 1982 H1 RPDI was about 1½ per cent lower than the average for 1981;

.wage settlements in 1981-82 were on average around 7 per cent, 2 per cent lower than in the previous round;

.underlying rate of increase in average earnings in year to July was about 9-9½ per cent.

Labour Market

.UK employment fell 2.2 million (10 per cent) between 1979 Q2 and 1982 Q1 (two-thirds concentrated in manufacturing); betwee 1981 Q1 and 1982 Q1 employers in employment fell by 800,000.

.first indications are that total employment fell more in the second quarter of 1982 than in the previous quarter.

.total registered unemployment rose by 50,000 to 3.3 million (14 per cent) in September;

.UK adult unemployment rose by 49,000 to 3 million (12.7 per cent) in September; trend since June is accelerating.

.vacancies have not altered much in recent months;

.other labour market indicators - short time, overtime - continue to suggest some flattening out on last year's improvements.

Forward Indicators

.seasonal falls in school leavers registrations occur after October but a sharp seasonal rise in unemployment occurs in January;

.the volume of new construction orders, which increased strongly in the first half of 1981, hs subsequently remained broady flat. Within the total, orders for new housing, particularly in the private sector, have weakened since last spring. Engineering orders have also failed to pick up during 1982.

ro

PRIVY COUNCIL OFFICE
WHITEHALL, LONDON SW1A 2AT

15 October 1982

Dear Private Secretary

GUIDANCE NOTES ON POLICY PRESENTATION

... On 4 March 1982 the then Lord President of the Council wrote to his colleagues (a copy is attached) informing them that the Prime Minister had approved the production of a series of guidance notes for Ministers on policy presentation. That letter enclosed the first note in the series - on economic policy - and subsequent notes have covered, respectively, the 1982 Budget; law and order; housing policy; and education. More are in course of preparation. Notes are issued by the Lord President of the Council's office through the Cabinet Office distribution machinery.

There has recently been evidence that in one Department at least these notes, although received by the Cabinet Minister, have not reached junior Ministers in his Department. Hence this letter. Under the Cabinet Office distribution system sufficient copies of notes are produced for all Ministers. Those notes intended for junior Ministers in Departments are sent to the relevant Secretary of State in the expectation that the Private Office will transmit the other copies to their Departmental Ministers.

May I ask all recipients of this letter kindly to ensure that these arrangements are operating effectively in their Department? The Prime Minister attaches importance to every Minister having a personal and complete set of these guidance notes. If difficulties are being encountered, I should be grateful to know so that I can look into the reasons.

Andrew Ward

ANDREW WARD
Lord President of the
Council's Office

Distribution: Private Secretaries
to all Cabinet Ministers

PRIVY COUNCIL OFFICE
WHITEHALL, LONDON SW1A 2AT

4 March 1982

Dear Willie,

PRESENTATION

The Prime Minister has agreed that it will be helpful for Ministers to have some central guidance on the presentation of the Government's approach in major policy areas. This guidance is intended to provide Ministers with source material on which to base their own policy presentation; and on which they can draw in writing articles and speeches, and in deciding the emphasis to be put by their Departmental information staffs on particular policy initiatives.

The guidance will take the form of a series of papers dealing with specific policy areas. Each paper will re-state the Government's broad policy objectives, and its achievements; will illustrate the public perception of the Government's policies and successes; and will identify the main themes which Ministers should seek to emphasise. The papers will be distributed from my office and are for Ministers' personal use. They should not be given any wider circulation. Papers will be sent individually to all Ministers and to the Chief Whip.

.../...

The Rt Hon William Whitelaw CH MC MP
Home Secretary
Queen Anne's Gate
London SW1

... The first such paper is enclosed with this letter. It deals with the presentation of economic, employment and industrial policy. This paper will provide the basis on which those Ministers particularly concerned will approach the presentation of Budget decisions and which Ministers generally should use for speeches they may be called on to make in this policy context.

I am copying this letter, and enclosure, to all our Cabinet colleagues, to all Ministers in Departments, to the Chief Whip, and to the Prime Minister's Chief Press Secretary.

Yours ever

Francis

FRANCIS PYM

INSTITUTE OF DIRECTORS
From the Director General

Director General
Walter Goldsmith

cc Press Econ Pol

The Rt Hon Margaret Thatcher MP
Prime Minister
First Lord of the Treasury and
Minister for the Civil Service
10 Downing Street
LONDON SW1A 2AL

5 October 1982

Prime Minister (2)

I have acknowledged on your behalf.

MCS 6/10

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Dear Prime Minister

1. I am writing to express the views of the Institute of Directors on the policies Her Majesty's Government should pursue during the next Session of Parliament.

2. The Institute is acutely conscious of the importance to you and to the whole country of the next twelve months - the last full parliamentary Session of your Administration. It therefore seems an appropriate time to focus on your Administration's achievements, to examine the opportunities which exist within the next Session for continuing to create a solid foundation for further achievement in the next Parliament and beyond, and in particular to prepare the ground for growth in opportunities for employment.

3. Self-sufficiency in energy, continued progress towards self-sufficiency in temperate foodstuffs, and the apparent beginning of a virtuous economic spiral of lower inflation, lower interest rates, higher productivity and a stable balance of payments and exchange rate, unfortunately catch the headlines less than reduced manufacturing output and reduced employment. But they are a solid foundation on which to build a more stable economic and social future and you and your Cabinet colleagues deserve great credit for the steadfast manner in which you have pursued them.

THE SHORT TERM: ECONOMIC POLICY

4. For the short term therefore, the IOD's message is once again to hold firm. Even the most extreme shift in economic policy could not now create any significant increase in employment over the next two years, and that only at the expense of much increased inflation very shortly afterward, with higher unemployment to follow. There is, therefore, no reason why the Government should not use this year's parliamentary time to continue its programme of reducing the institutional constraints on the free operation of the economy. It should select priorities for legislation which demonstrate to the largest possible number of people the soundness of your policies and the benefits they derive from them.

5. The elements which require attention seem to be:-

a) More Money in Individual Hands

The first and essential condition for this is the most rigorous control of public expenditure, permitting a substantial reduction in income tax. We acknowledge that the Chancellor will wish to continue the present additional reduction in the National Insurance Surcharge into the next fiscal year. Thereafter all the fiscal freedom he can achieve should be devoted to raising the income tax threshold to alleviate the poverty trap, reducing the rates of tax to increase incentives and abolishing the Investment Income Surcharge to remove bias against saving and investment.

b) Further Privatisation and Deregulation

We would not wish to see any of the sales to the public at present in contemplation delayed, but spectacular public offerings of shares are only part of this story. The deregulation of long distance coach services is a perfect example of the way in which the Government's policies confer an obvious benefit on a large number of people. Possible candidates for action this year include local bus services, air fares, the letter post monopoly, shop opening hours, and implementing the Erroll Committee's recommendations on the opening hours of licensed premises.

c) Local Government

We recognise the Government's desire to see the domestic rate burden reduced; and we wish to see an equal or greater reduction in the burden borne by business. However, any reduction in the business rate should not be at the expense of domestic ratepayers - the customers of business. It should arise from greater efficiency, abolition of the metropolitan second tier authorities - for instance, the Greater London Council - and the widest possible privatisation of local services, including a statutory right to tender for the supply of any service.

d) Trade Unions

Privatisation and deregulation must go hand in hand with further measures to ensure that opportunities for the irresponsible use of trade union power are reduced. The Institute warmly welcomes the prospect of the 1982 Employment Act and recognises that there may be a desire to see how the new legislative provisions work before further legislation is introduced. However, the 1982 Act does little to contain the power of trade unions operating in the public sector. In many cases they are monopoly bodies operating quite lawfully but within organisations which are themselves monopolies. Collective bargaining in much of the public sector is therefore immune from the kind of market forces which condition negotiations in the private sector. To correct this situation, further employment legislation is not necessarily the answer. Rather, where privatisation is not in prospect, immediate plans should be made to offset the effects of the trade union monopoly in much of the public sector by decentralising negotiating arrangements.

THE MEDIUM TERM: EMPLOYMENT

6. For the medium term rather different considerations apply. A Government which has explicitly abandoned the formal priority accorded to full employment by other postwar governments can easily be accused of callousness if it does not pay, and is not seen to pay, particular regard to the immediate victims of such a change. We can see no evidence to refute the contention that the continuation of present trends in the economy and of government response to them at the macro level will ultimately increase opportunities for paid work throughout the UK economy. But to pretend that there will not have to be massive changes in the work people do, and the way that they do it, is to risk wasting public resources. Worse, it is cruel in that it raises expectations only for them to be dashed.

7. The Institute is concerned that too many self-fulfilling prophecies are being made about future levels of unemployment, and are thereby diverting attention from the measures that should be taken to prepare everyone for the changing opportunities of the future and the removal of the obstacles which stand in the way of such change. The preservation of a flexible capacity to respond must be a high priority. Some of the areas which appear to combine medium term benefits with the alleviation of short term problems include:-

Preparing for change

Self employment

a) stimulating self employment and creating a favourable attitude to it. The Institute is convinced from the reception of its proposals that the chief barrier to progress in this field is the almost instinctive antipathy on the part of the bureaucracy, particularly the Inland Revenue, to policies which would require it to deal with a large number of small units rather than a small number of large units. National effectiveness is more important than Departmental efficiency: we believe that the weight of your Government should be put firmly behind a campaign to remove institutional barriers to self employment, and to devise means for making it more attractive. The Institute would be more than happy to assist in this endeavour;

Reformrm of education

b) a far reaching reappraisal of education and training, with a major shift towards an increased vocational content, especially for those aged between fifteen and eighteen. In this context the New Training Initiative assumes a primary role, but will be all the more effective if combined with changes in the approach to secondary school structure, which would recognise the equality of status between those who will pursue a technological career, a skill, or self employment and those equipped to pursue further academic study.

Recognition of the service sector

c) an examination of the elements of public policy and administration which discriminate against the service sector in favour of manufacturing. This could range from such weighty items as the tax treatment of commercial buildings to such minor items as the treatment of the aptly named "invisibles" in the presentation of government trade statistics;

Removal of obstacles

d) removal of other obstacles to the most effective deployment of human resources, whether these are geographical (eg rent control) or economic (eg Wages Councils).

THE LONG TERM: PUBLIC SPENDING

8. In spite of your Government's deep conviction and commitment to the contrary, the proportion of the Gross National Product passing through government hands has shown no sign of falling over the past few years. Moreover there is no reason to doubt the projections which suggest that unchanged policies and demographic trends will increase this proportion to unacceptable levels unless substantial changes in government policy are made. The Government will need courage in addressing itself to this problem, and we believe that the Government would be justified in drawing attention to these issues, unpalatable though their public consideration may be to some. We do however believe that an opportunity has been missed to emphasize the objectives we consider appropriate to reduced government involvement in these areas.

9. The objectives are:

a) concentration of government attention and resources on its legitimate function of helping those unable to help themselves, and,

b) the progressive transfer of responsibility for providing services to the private sector thus promoting:

- greater efficiency

- greater freedom of choice

- higher standards of service.

10. We believe that changed methods of provision which increase consumer choice could have a substantial effect in increasing demand for these services and therefore increasing job opportunities in the service sector. Far from reducing expenditure on health and education such a change would almost certainly bring about a voluntary increase.

FREE TRADE AND EUROPE

11. Turning from the purely domestic perspective, the Institute is concerned that you and your colleagues should continue to struggle to maintain freedom of international trade in the face of ever growing demands for protection both here and abroad. We see demands for protection as an elevation to an international scale of the fears of those faint hearts who say that there should not be more money in individual hands because it would all be spent on imports. We believe that wholehearted support for the economic principles underlying the Eureopean Economic Community is a key feature in this struggle, since a Europe only dubiously trading freely internally and sheltering behind external tariff walls is of no value to anyone.

12. We therefore urge the Government, in its relations with the Community to emphasise its continued support for the fundamental concept of a common market based on the principles of free trade. Such a stance is entirely consistent with the most steadfast rejection of the dissipation of the Community's resources on social and political issues (such as employment practices), activity only at best questionably sanctioned by the Treaty of Rome.

CONCLUSION

13. Contrary to assertions elsewhere, we believe that business leaders have a high level of confidence in the future, and rightly so. Members of the Institute of Directors continue to stand firmly behind this Government's policies. They do so with a better knowledge than most have of the transitional difficulties those policies present, and they firmly urge you not to weaken in your resolve to see them through.

Yours sincerely

WALTER GOLDSMITH

1/1

PPS/CHANCELLOR

file no TEB/CA/01

copied to:

Mr Salveson (for transmission to No.10)
PS/CST
PS/FST
PS/EST
PS/MST(C)
PS/MST(R)
PS/Home Secretary
PS/Lord Chancellor
PS/Foreign Secretary
PS/Secretary of State for Education and Science
PS/Lord President of the Council
PS/Secretary of State for Northern Ireland
PS/Secretary of State for Defence
PS/Minister of Agriculture, Fisheries and Food
PS/Secretary of State for Environment
PS/Secretary of State for Scotland
PS/Secretary of State for Wales
PS/Lord Privy Seal
PS/Secretary of State for Industry
PS/Secretary of State for Social Services
PS/Secretary of State for Trade
PS/Secretary of State for Energy
PS/Secretary of State for Transport
PS/Chancellor of the Duchy of Lancaster
PS/Secretary of State for Employment
PS/Paymaster General
and officials in HMT, Revenue Departments and other Departments in Whitehall

TREASURY BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 23 August, are sidelined. During the Parliamentary Recess, this Brief is being circulated approximately once a month instead of once a week. The next will be dated 18 October, the day the House of Commons resumes after the Recess.

M M Deyes

M M DEYES

RA

R I G ALLEN

21 September 1982

EB Division
H M Treasury
01-233-3364

ECONOMIC BRIEF: CONTENTS

1/1

A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

Main objectives are to achieve, over a period, a sustained improvement in the economy through reduction of inflation and promotion of enterprise and initiative. Reduction of inflation requires maintaining steady but not excessive downward pressure on monetary variables, and complementary fiscal policies. Improvement of supply side depends on restoration of flexible and competitive market economy and better incentives.

2. Fiscal boost desirable?

If there were some quick and easy solutions we would have adopted them. What is needed now is to sustain steady economic policies designed to reduce interest rates and inflation, and to create climate in which industry can invest and sell its products. That does not mean, of course, that possible fiscal measures cannot be debated on their merits. But it does mean keeping in mind also their total effect on borrowing and interest rates, and on the economy generally.

3. 'Pact' with CBI?

[Press reports of Chancellor's bridge-building overtures.]

No question of any formal pact. But there is now a closer understanding between Government and CBI. Always had been a good deal of common ground. Industry's confidence remains unsettled by the high interest rates experienced towards the end of last year, and the limited extent of the recovery that has taken place. This makes it all the more important that encouraging pointers should not be ignored. Keep balance between trying to talk ourselves into economic revival - which would be naive - and undermining prospects of recovery by wilfully ignoring all signs of progress.

4. TUC attitude to NEDC

See P1.

5. Economy still in recession?

Natural for people to be concerned about present levels of industrial activity and employment. Output likely to be somewhat lower than forecast at time of Budget - partly because world markets are less buoyant than initially forecast. Recent figures (industrial production, GDP, fixed investment, cyclical indicators) disappointing. But clear that turning point was reached in first half of last year, and that, despite recent flatness, output is now higher - and recovery is projected to continue. Of course recovery so far has been slow and patchy, with some industries remaining in great difficulty. It will probably continue to be so. Most encouraging pointers for future are progress against inflation (12-monthly RPI increase down to 8.0 per cent in August) and lower interest rates (down 5½ points since autumn 1981).

6. Chancellor's forecast of 6½ per cent inflation by end-year?

See K1.

7. Latest CBI assessments

See B3.

8. CSO's leading cyclical indicators

See B5.

9. Government policies have caused recession by deflating demand?

No. Output had fallen more strongly than demand during the current recession. At same time import penetration has continued on rising trend. Essential problems of economy lie on 'supply side' - lack of competitiveness etc. Government policies aimed at helping industry to redress these problems by : deregulating, restoring incentives and implementing a financial strategy under which inflation and interest rates can fall over the medium term.

10. What factors caused recent flattening out in recovery?

Recovery is slow and fragile. Number of factors - last summer/autumn's temporary rise in interest rates and pause in progress on reducing inflation; slower, and later than expected, world recovery - all probably weakened confidence and activity. These factors now working the other way, and will contribute to future recovery.

11. Tighter than expected fiscal policy to blame?

[Latest published estimate of 1981-82 PSBR £8.8 billion compared with Budget time estimate of £10.6 billion. PSBR 1982-83 June quarter, seasonally adjusted, £1.6 billion. IMF Annual Report stresses size of deficit reduction in UK in last year.]

Fiscal policy stance 1982-83, so far as can be judged at this stage, consistent with Budget judgement. Monetary aggregates also on target. Firm control of Government borrowing essential to maintain downward pressure on interest rates; latter have fallen five and a half percentage points since last autumn and this can only improve prospects for recovery. (See also Section H).

12. Falklands costs and the economy?

See E22-25.

13. Is there an impending world financial crisis?

Problem debtors (both corporate and sovereign) represent serious strain upon world financial system. System is able to cope, however, and is fundamentally sound. Furthermore, public authorities cannot be expected to protect debtors from necessity of economic adjustment. Nor can public authorities act as substitutes for application of prudent commercial lending criteria by the commercial banks.

14. IMF Meeting? US developments?

See Section T.

15. Recent interest rate/monetary developments?

During early part of 1982, UK interest rates fell despite high and volatile US rates. Steady reduction in UK rates made possible by satisfactory developments in main monetary indicators - monetary aggregates, exchange rate, and progress on inflation. (For further material on monetary developments, including bank lending, see section J.)

16. Record unemployment levels? Under-recording?

See Section C.

17. Report on Budgetary Reform by the TCSC ('Armstrong' Report)

[Government's reply published 5 August. Will involve some changes in Budgetary procedure in current year. But these will not go all the way towards implementing Committee's recommendations.]

Government intend to take full account of Committee's proposals in continuing to build on significant progress already made towards greater integration of economic decision-making (eg MTFS) and involvement in it of Parliament and public. In particular, Government will advance these developments by publishing around late November/early December an Autumn Statement which will allow fuller and better-informed discussion of monetary and fiscal prospects than in past. Structure and contents of Autumn Statement will build on what is already published and can be expected to evolve over time.

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BULL POINTS As at 20. 9.82

(i) Activity. Recovery has begun: industrial and manufacturing output above levels spring 1981. [But NB, underlying level of output broadly flat since last Autumn.] Most recent major independent forecasts, see prospect of continuing, but gradual recovery later this year and next.

(ii) Interest rates. Short-term rates have fallen 5½ points since last autumn (now about 10½ per cent). Lowest level for almost four years. Recent falls reflect several factors:- single figure inflation, M1, £M3 and PSL2 developing favourably in relation to 8-12 per cent target, Government borrowing under control, exchange rate firm.

(iii) Inflation. 12-monthly increase in RPI now well inside single figures - 8.0 per cent in August - compared with spring 1980 peak (21.9 per cent). Inflation in August lowest since October 1978; trend now downwards not upwards as then. RPI index unchanged in August - third time no change in index in 1982. Prospect of inflation significantly below budget projection of 7½ per cent by end of 1982. Manufacturers' subject prices up 7¾ per cent in year to August.

(v) Costs.

- Increase in average earnings halved in 1980-81 pay round. Public sector pay in line. Further moderation in average level of settlements in current round. CBI pay databank for manufacturing settlements suggests average now around 7 per cent compared with 9 per cent in previous round.
- Manufacturers' unit wage and salary costs up only 5½ per cent up in year to 2Q 1982, below average of major competitors.
- Manufacturers' input prices up just 3 per cent in year to August.
- CBI July survey shows lowest degree of unit cost pressures for 15 years.

(v) Manufacturing productivity. Output per head has risen about 12 per cent since end 1980. Output per head and output per hour now about 6 and 8 per cent higher than previous peak in 1H 1979.

(vi) Competitiveness. Cost competitiveness improved by 10-15 per cent during 1981 reflecting pay moderation, higher productivity and exchange rate fall, but remains 1/3 worse than in 1975.

(vii) Profits: Industrial and commercial companies gross trading profits (net of stock appreciation, excluding North Sea) risen 40 per cent since 1Q 1981. Recovery in profits from very low base: ICC's pre tax real rate of return just 2½ per cent in 1981.

(viii) Housing starts (total) - up over a quarter in first seven months of 1982 compared with average for 1981 as a whole.

(ix) Exports have held up better than many feared following 50 per cent loss of competitiveness between 1975 and 1Q 1981. In 11 months to July 1982 non-oil exports (excluding erratics) slightly higher than in 1980, despite earlier substantial loss of competitiveness.

(x) Special employment measures. Total provision for special employment schemes planned to reach £1½ billion in 1982-83. Further measures announced end-July - new community work programme to start October, job splitting subsidy schemes from January 1983.

(xi) Overseas investment in UK: US direct investment in Britain amounted to stock of over $14 billion in 1980. Nearly 60 per cent of all US outward non-oil direct investment now takes place in EC - over half of that in UK. Half of all Japanese investment in the EC also comes to Britain. Investment intentions survey of 231 German owned companies in the UK shows great majority intend to expand here in the near future.

(xii) Overseas debt repayments. Official external debt reduced from over $22 billion in May 1979 to around $12½ billion at end-August 1982.

Economic Briefing Division, HM Treasury, 01-233 5514/5503

B ECONOMIC ACTIVITY AND PROSPECTS

1. Recent output figures

[Latest GDP figures (all three measures) suggest any growth in economic activity in H1 1982 over H2 1981 was slight, but about 1 per cent higher than in Q2 1981. Industrial production in three months to July unchanged compared with previous three months (a ½ per cent fall in manufacturing production being offset by a 4 per cent rise in oil and gas extraction). Trend in manufacturing activity at best flat and may be deteriorating.]

Total output, particularly manufacturing, in 1982 likely to be somewhat lower than forecast at Budget time, particularly because world markets are less buoyant than previously expected. However, rapid progress on inflation and interest rates plus higher productivity. Prospect remains one of continuing modest growth this year and next. View shared by most outside forecasters.

2. Other evidence of improvement in economy?

See Bull Points (following Section A).

3. Latest CBI assessments?

[CBI Monthly Trends Enquiry shows little overall change in total order books since November, but a deterioration of export order books since March of this year. Net balance of firms expecting to increase output in next four months has fallen (to minus 8) and net balance of firms reporting excess stocks has risen. Also further decline in net balance of firms expecting to increase prices in next four months. Latest forecast suggests only marginal rises in GDP (output) in Q3 and Q4 leaving GDP on 1982 ½ per cent up on 1981].

CBI August Monthly Trends Enquiry and latest forecasts is further confirmation of temporary hesitation in activity since last autumn. Government always maintained recovery would initially be modest, slow and patchy. It will continue to be so particularly given more depressed world outlook. As with most outside forecasters the CBI expect gradual recovery over next 18 months and future financial developments to be favourable.

4. Fall in investment and reduction in stocks?

[Capital expenditure by the manufacturing, distributive and service industries in Q2 1982 4 per cent lower than level in previous quarter. Investment in manufacturing in H1 1982 was 3 per cent lower than in Q4 1981. Stocks fell by £30 million ('75 prices) in Q2; but in the first half of 1982 stocks increased by £100 million compared with destocking of £520 million in second half of 1981.]

Figures another manifestation of hesitation in economic activity. Despite this, investment in private sector, especially in plant and machinery, has held up well relative to output over last two years. [IF PRESSED: latest DOI investment intentions survey shows slight fall in manufacturing investment between 1981 and 1982; Q2 figure not inconsistent with this.]

5. CSO's index of leading cyclical indicators?

Longer leading index rose in August reflecting further falls in interest rates and an increase in share prices. Shorter leading index also fell between April and July. Implications of recent values of these leading indices for future movements in economic activity will not become clear until some more later data are available. The co-incident index has continued to increase from its low point in April 1981, with upward effects from most components.

6. FSBR forecast now looks too optimistic?

[Several independent forecasts have revised down their forecasts of growth in 1982 marginally (from around 1½ per cent to about 1-1¼ per cent), largely reflecting the recent disappointing output figures. Despite this most groups have not altered their assessment of the strength of the recovery during the course of 1982 and in 1983, and most are more optimistic about financial developments, inflation and interest rates.]

Output growth for 1982 is likely to be less than expected at Budget time, in face of less buoyant world activity, but we have been doing rather better than expected on inflation. Clearly there are uncertainties and dangers, not least of which will be the international environment - though there are some recent indications that worst of recession is over in US. At present there is no reason to doubt the broad shape of gradual recovery into 1983 as forecast at Budget time. Certainly the majority of outside forecasters do not doubt it.

7. Latest Treasury forecasts?

Next publication of Treasury forecasts will be in Autumn Statement.

8. Outside forecasts

[GDP profile in recent major assessments:

	NIESR (May)	LBS (June)	St James (Aug)	Phillips & Drew (September)	CEPG (April)	CBI (August)	OECD (July)	FSBR (March)
Per cent change 1982 on 1981	+1	+1	+1¼	+¾	-½	+½	+1¼	+1½]

Nearly all see prospect of continued recovery (as always, a range, with Cambridge forecast (CEPG) being the more pessimistic) and lower inflation. [See also C4 (unemployment)).]

C LABOUR MARKET

1. Recent unemployment figures and other labour market indicators?

[UK seasonally adjusted unemployment excluding school leavers was 3,087,000 (12.7 per cent) in September. Total UK registered unemployed rose by 59,000 to 3,343,000 (14.0 per cent). Underlying increase in Q3 was 42,000 per month compared with 30,000 a month in Q2. Trend is deteriorating but no sharp rises now likely until January. UK seasonally adjusted vacancies decreased by 7,000 to 107,000 in September. Number unemployed for over 1 year was 1.071 million in July. Number unemployed for over 1 year was 1.071 million in July. Recent unemployment/vacancy figures shown below:

	1980 Q4	1981 Q1	Q2	Q3	Q4	1982 Q1	Q2	Q3
Unemployment (UK adult sa) increase	+105	+77	+62	+51	+33*	+21*	+30*	+42*
Vacancies level	99	98	89	96	104	112	107	110.9

*After allowing for over 60's transferring to supplementary benefit.

Other labour market indicators (overtime, short-time, hours worked in manufacturing) also suggest some flattening out in improvement observed last year.]

Figures are tragic but problems took a long time to build up will also take a long time to check or reverse. Recent figures reflect the hesitation in activity since autumn. Only long term cure for unemployment is through sustainable recovery. However Government is doing a great deal to meet special difficulties and improve training. (see 7 below).

[IF PRESSED Apparent general weakening of labour market indicators can be interpreted as consistent with hesitation in recovery since last autumn. Cannot draw implications from July figures about future levels of unemployment.]

2. Unemployment higher than in other countries?

[On standardised definitions in Q1 1982 UK unemployment was 12.4 per cent compared with 7.4 per cent OECD rate; a UK doubling compared with an OECD rise of almost one half since 1979.]

Whole world affected by rising unemployment. In our case we have additional self inflicted wounds of high pay awards and low productivity. Unemployment now rising very fast in some countries eg Germany.

3. True unemployment figures really much higher?

[Sunday Times 19 September suggests 700,000 'hidden' jobless.]

No one seeks to deny there are unregistered unemployed but reliable estimates of their numbers are difficult to obtain. Available estimates vary quite widely. Figures of registered unemployed are based on accurate counts, have been accepted by successive administrations and provide reasonable estimates of trend.

4. Unemployment expected to continue rising rapidly?

Unemployment forecasts uncertain; independent forecasters encompass differing views for 1983 - several projecting stabilisation, some [a slight] decline. Though there has been some worsening in the underlying trend in unemployment this year, rise for year as a whole has only been some 40 per cent of rate over same period last year. Employment situation will benefit from some further recovery in activity this year and next (see B6). [IF PRESSED: Government has not sought to deny 3 1/3 million a likely figure this summer.]

5. What is Government's own forecast of unemployment?

Government does not publish such a forecast. However it was assumed for expenditure planning purposes in Cmnd 8494 that unemployment (GB, excluding school leavers) would average 2.9 million in 1982-83, and for rest of survey period. Current (August) figure is 2.9 million - same as PEWP figure.

6. Employment continuing to fall?

[Total employment declined 2.2 million (9½ per cent) between mid 1979 and Q1 1982.]

Decline in Q1 1982 about one-third that in H1 1981. Best help for permanent jobs is sustainable recovery.

7. Recent productivity gains inimical to higher employment/lower unemployment?

[Output per head in manufacturing up 12 per cent since end-1980.]

This may be true in the short run. But in the longer term, as experience in UK and many other countries clearly demonstrates, higher productivity essential for growth and employment opportunities.

8. What is Government doing to provide more jobs?

Government pursuing balanced fiscal and monetary policies to curb inflation and creating conditions for enterprise - only measures that will ensure sustainable increase in employment. Nevertheless Government expanding schemes to meet special difficulties and improve training - eg plan to spend £1½ billion in cash on 1982-83 (40 per cent more than in 1981-82) on special employment and training measures; new Youth Training Scheme costing £1 billion a year from 1982-84; the new community programme which is designed to provide up to 130,000 places for the long term unemployed; and the new Job Splitting Subsidy which will be open on 1 January next year to encourage the extension of part time work and provide additional opportunities for productive jobs for unemployed people.

D **TAXATION**

1. Burden of taxation

[Total taxation (i.e including for example income tax, indirect taxes, corporation tax, rates and NIC) in 1978-79 was 34½ per cent of GDP (at market prices), 36 per cent in 1979-80, 37½ per cent 1980-81. It is forecast to be 40½ per cent in 1981-82 and 39½ per cent in 1982-83. Corresponding figures excluding NICs are: 1978-79 28½ per cent, 1979-80 30 per cent, 1980-81 31½ per cent, 1981-82 34 per cent, 1982-83 33 per cent.]

This has inevitably increased during a time when the recession has been adding to public spending. Changes proposed in Budget will reduce total burden in 1982-83 compared with 1981-82. [NB: Not true of burden on persons.]

2. Burden of tax has risen for most households/real weekly net income fallen since 1979?

Slow growth of output and difficulty of restraining public expenditure have inevitably meant higher tax burden. But aggregate real personal income after direct taxes still higher than under last Government [although not true of all sections of population]. And more honest to raise taxes to finance necessary higher expenditure than to increase borrowing, with the increased interest rates and inflation that would bring.

3. Burden has fallen for the rich?

Abolition of absurdly high marginal rates and raising of thresholds in 1979 essential to remove disincentives. Reimposition of an 83 per cent top rate of income tax would finance a reduction of less than one quarter of 1p in the basic rate.

4. Burden has risen most for the poor?

Proportion of income paid in income tax and NICs has fallen in 1982-83 for lowest paid taxpayers. And low paid with children entitled to benefits such as FIS.

5. Personal tax burden increased by last Budget - when NICs taken into account?

The real increase in personal allowances and tax thresholds reduced income tax as a percentage of income at all levels of incomes. Those over pension age who are taxpayers benefited from income tax changes and were unaffected by NIC rise - and, of course, State pensions are being uprated from November. [IF PRESSED: In immediate cash terms, increases in personal allowances etc compensated for NIC increase for majority of taxpayers. Taking into account increased earnings in 1982-83 (for example using the Government Actuary's 7½ per cent assumption) percentage of income paid in income tax plus NIC rose for most people, but fell for the lowest paid, ie below about ½ average earnings (married) and below about 1/3 average earnings (single).]

6. No improvement in incentives?

There will be 1.2 million fewer taxpayers in 1982-83 than if allowances had remained at 1981-82 levels, and ½ million fewer higher rate taxpayers. For the substantial number taken out of tax or with reduced marginal rates, incentives will improve.

7. Further cut in NIS?

[Called for by CBI].

Reduction that came into operation on 2 August (equivalent one percentage point cut for whole of 1982-83) will benefit private sector by £640 million in 1982-83 - on top of decisions to shield employers from increases in National Insurance contribution rates over last 2 years. Acknowledge desirability of further reductions. But expensive. Right time to consider this is autumn.

8. Excise duties increases inflationary/harmful to industries

Increases in excise duties as a whole slightly less than broadly compensate for past year's inflation. Variations between duties take account of industrial considerations e.g supplementary increase last July on tobacco/Scotch whisky industry/help for industry by smaller increases on e.g derv - mainly used by industry.

9. How has Government used fiscal incentives to encourage wider share-ownership?

Total of over 460 profit-sharing and share option schemes now approved by Inland Revenue. Compares with less than 30 in May 1979. Reflects liberalisation and extension of arrangements to promote profit-sharing and share-option schemes contained in 1980 Finance Act. Further fiscal encouragement on way from 1982 Finance Bill.

10. PAC report proposes new measures to curb 'black economy'

Government has read report with interest and will respond in due course in the usual way.

E PUBLIC EXPENDITURE AND FINANCE

[Public Expenditure White Paper (Cmnd 8494) published 9 March. Gives planning totals of £115.2 billion in 1982-83, £121.1 in 1983-84 and £128.4 in 1984-85. About £5 billion higher than last White Paper in 1982-83 and £7 billion in 1983-84. Net effect of changes announced in Budget is to reduce totals to £114.9 billion, £120.4 billion and £127.6 billion].

1. Public expenditure too high?

Spending in 1982-83 planned to be about £5 billion (4½ per cent) lower than intended by last Government even if higher than planned when this Government first took office. Decisions to increase spending represent flexible but prudent response to changed circumstances e.g additional spending to help young unemployed. Drive to improve management in public sector and reduce administration expenses continues.

2. Ratio of public spending to GDP is getting back to peak levels of mid 1970's?

Ratios in 1980-81 (43 per cent) and 1981-82 (44½ per cent forecast) remain below level of 1974-75 and 1975-76 (46 per cent in both years). Rise in ratio in 1981-82 mainly reflects higher expenditure on social security at a time when real GDP falling. Ratio expected to fall in next few years: assumptions in MTFS would mean figures of 44½ per cent in 1982-83, 42½ per cent in 1983-84 and 41 per cent in 1984-85. Reflects assumed GDP growth and curbing of public expenditure.

3. Longer-term outlook for public expenditure?

[Economist 18-24 September reports radical CPRS proposals to cut public spending in the longer term were tabled but not discussed at special Cabinet on longer term 9 September, and predicts they will re-surface.]

There is a problem in that public expenditure has an inherent tendency to creep ever upward - though this Government has been more successful than most in putting the brakes on. Government is looking seriously at various options. Not necessarily question of 'decimating' services; rather of finding best ways of financing better quality with wider choice. No specific decisions have been taken as a result.

4. Increase spending in recession?

No good trying to spend way out of recession. Any benefits would be short-term. If increased spending not financed responsibly, would soon lead to more inflation. If financed prudently, would lead to higher interest rates and/or higher taxes. We are responding, within limits of prudence, to needs of current circumstances.

5. Spending Ministers seeking extra public expenditure in 1983-84?/Treasury once again seeking cuts in public expenditure?

Bids for additional expenditure have been put forward in usual way as part of annual public expenditure survey. Ministers collectively will have to decide which are to be allowed and, depending on size of any increase, to what extent the increase should be met by savings elsewhere.

6. Not enough 'productive' public investment/needs being jeopardised?

Government is not cutting 'productive' investment. Partly question of definition - within figures for capital expenditure totals, council house sales count as a negative item and defence procurement counts as current expenditure. Furthermore, nationalised industries are financing an increasing proportion of investment out of own resources. Also since mid-1970's needs have been declined; future standards and public amenities will not be jeopardised.

7. More capital projects in public sector to help private industry?

Government prepared to give priority to worthwhile capital projects within overall spending totals. However, no question of an artificial and inflationary stimulus to demand a new projects must be considered on their merits. Nationalised industries investment in 1982-83 planned to be about a quarter higher than in previous year. Real answer: to provide private sector with prospect of higher rates of return on investment by continuing policies to lower interest rates and increase incentives.

8. Cash planning means concentration on first year, not enough on services in later years?

Government recognise case for medium-term planning. But planning must be related to availability of finance as well as prospective real resources. Cannot accept unconditional commitment to forward plans for services. Volume plans formerly had to be cut when conflicted with financial constraints - e.g after IMF intervention in 1976.

9. End-year flexibility?

Possibility of end year flexibility is being looked at again. There could be some managerial advantages in such a scheme. But we also have to consider question of cost.

10. Why so much underspending on Central Government voted cash limits 1981-82?

[Provisional outturn figures published 29 July].

Though rather more in 1981-82 than in each of previous three years, this is natural consequence of treating them as limits and not as targets. Extent of underspending on individual cash limits varies and is governed by a range of factors - which can differ markedly from one cash limit to another. In general, moderation in rate of inflation, which departmental managers may not have fully anticipated, made it easier to remain within cash limits.

11. Why so much underspending by local authorities on capital expenditure?

Number of reasons. Authorities got off to slow start because of 'knock-on' effect of the housing moratorium at the end of 1980-81; severe weather; lower tender prices working through. But overwhelming reason was success in selling council houses and unused land.

12. Cut public sector pay bill/administrative costs of central government?

Only one third of current expenditure is on wages and salaries and much of that is for nurses, teachers, members of armed forces, police and so on. Provision for public service pay increases 1982-83 limited to 4 per cent. Administrative costs are not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain drive for more efficient management throughout public sector.

13. What allowance will Government make for pay increase in public services next year?

Government attaches great important to realistic wage settlements next year, in both public and private sectors. Provision for public service pay will be made from within cash plans for 1983-84. (See also K8.)

14. Will Government's operation of cash limits for civil service [and NHS] pay change as result of Megaw Inquiry Report?

Government is committed to policy of using cash limits to control public expenditure. We will consider and discuss the implications of Megaw report in due course.

LOCAL GOVERNMENT

15. Overspending in 1982-83

Local authorities planning to spend some £1½ billion above Government's plans in 1982-83. In response, Secretaries of State have announced intentions to penalise over-spending by reducing the amount of grant to be distributed to them. (For details, refer to statements in Parliament 27/28 July by Secretaries of State.)

16. Local government finance 1983-84?

Because local authorities are spending so much this year, Government recognise they will spend more in 1983-84. So current expenditure provisions have been increased to ensure that they remain realistic. (For details refer to statements by Secretaries of State in Parliament 27/28 July). Figures announced are subject to consultation with local authorities, but Government is determined that they should be held to levels consistent with objectives for public expenditure and macro-economy.

17. Rate increases in 1983-84?

Spending in line with Government plans would imply only very modest increases overall, and in some areas no need for any increase at all. Of course, in areas where rating authorities overspend, ratepayers will bear a greater burden.

18. Lower rates for industry?

See P6.

19. Government's plans imply enormous job losses?

Not necessarily. Government's plans for local authority expenditure are realistic and achievable. Local authorities could do a lot to help themselves by moderating pay and improving efficiency.

20. Green Paper on Domestic Rating System: Government response?

Government is considering carefully all representations received. We wish to produce proposals for a scheme that will remedy shortcomings of present system while commanding wide support.

FALKLANDS EXPENDITURE

21. Falklands defence costs?

Preliminary assessment of broad order of defence costs (excluding garrison costs) is about £570 million in 1982-83, and £200 million in each of the following two years. Non-defence costs (compensation, rehabilitation) are expected to be minor in comparison. Totals should represent only a very small proportion of total public expenditure.

22. What will be costs of repairing damage and reconstructing the Islands' economy?

Too soon to say what these costs will be. Work has begun on restoration of essential services and on implementing Civil Commissioner's recommendations for priority action (accommodation, inter-Islands air service, education). Up to £10 million is being made available. Not yet clear whether these costs will require additions to existing FCO and ODA funds and how far additional sums will be needed.

23. Cost of paying compensation for war damage?

Too soon to say what total will be. Claims are being processed, and further claims may be received. About £250,000 has so far been paid out, but this is no guide to what the final total might be. Not yet clear whether the compensation scheme will require an addition to existing FCO programme.

24. How will the various costs be met?

Intention is to try to absorb 1982-83 costs within the Contingency Reserve - and to some extent within existing budgets. Remains to be seen how far feasible. How future years' expenditure is to be funded will depend on decisions in forthcoming Public Expenditure Survey. Extra costs to defence budget (costs of the operation eg fuel ship chartering, and equipment replacement) will be met out of monies additional to the 3 per cent annual rate of real growth already reflected in sums currently provided for defence. Decisions have yet to be taken on other programmes. In any case, the costs will be met in a way consistent with the Government's economic strategy.

25. Cost of proposals in Lord Shackleton's report?

[Published 13 September.]

The Report will need careful study, both in the UK and in the Falklands, before decisions on all these proposals are reached. In advance of these decisions not possible to say what cost might be.

[Background which can be drawn upon: Estimates of cost given in the Report are:

£31-36 million for new development aid;

£40 million for offshore fishing;

up to £12 million for additional housing/infrastructure

Total estimate of £83-89 million (at 1982 prices) excludes aid for rehabilitation and compensation for war damage already being made available.]

F CIVIL SERVICE STAFFING AND PAY

1. Civil Service too big/does too much/is over staffed?

Since Government came to office, Civil Service has been reduced by 10 per cent to 659,300. Results from reduction in functions, privatisation and improvements in efficiency. On course to achieve aim of having Civil Service of 630,000 by April 1984. This is 102,000 fewer staff in post than in April 1979, and will mean smallest Civil Service since end of Second World war.

2. Civil service pay: non-industrial civil servants

Civil Service Arbitration Tribunal awarded pay increases ranging from 4.75 per cent to 6.25 per cent - worth 5.9 per cent overall - and increases in annual leave. Government accepted award which is being implemented. Increases (announced 12 May) for higher civil service (under-secretary and above) were larger; they were decided in light of recommendations of Top Salaries Review Body. Cash limits and manpower targets not being adjusted. (See also E13 and K8).

3. Megaw Inquiry

Report of Megaw Inquiry into arrangements for deciding civil service pay in future (Cmnd 8590) contained number of important recommendations which are now being considered. (See also E14.)

4. Civil Service pay: industrials

Agreement reached for increases of about 6 per cent in pay year from 1 July 1982. Cost to be met from within existing cash provision.

5. Scott Report/Public sector pensions?

See K 16.

G SOCIAL SECURITY

1. Restore abatement of Unemployment Benefit?

[Uprating in November 1980 was abated by 5 per cent; this foreshadowed in Budget Speech announcing plans to bring UB into tax.]

Abatement of unemployment benefit has been extensively discussed in House of Commons. We undertook to review when the benefit was brought into tax. We did not, however, commit ourselves to restoration of the abatement. We have undertaken the promised review, and have decided that we cannot afford to restore the abatement.

2. But abatement was a proxy for tax?

Always made clear when decision to abate was announced that it was not solely a proxy for tax but also part of a public expenditure savings package, and a measure likely to improve work incentives.

3. Cost of restoration substantially less than tax revenue?

[Cost of restoration £20 million first year, £60 million full year. Revenue from taxation now estimated at £650 million.]

Wrong in principle to hypothecate money from taxing benefits. But if MPs want to make such a comparison I would draw attention to cost of restoring shortfall in November 1981 uprating - £525 million in full year - this and other increases in social security expenditure more than accounts for the additional revenue.

4. Abatement hits at poorest section of the community?

Only one quarter of the unemployed are solely dependent on UB and hence affected by the abatement. All those affected will have been unemployed for no more than a year and are primarily single people or childless married couples.

5. Increase National Insurance contributions because of NI Fund deficit?

The higher deficits for earlier years do not make inevitable an increase in contribution rates for 1983-84. A decision on the level of these rates will not be made until late autumn and will take account of forecasts made at that time of Fund income and expenditure for 1983-84.

6. Burden of State pension scheme too high?

[Government Actuary's Department Quinquennial Review of National Insurance Fund, published Wednesday 21 July, analyses possible future (up to forty years) cost of contributory benefits and levels of contributions needed to pay for them. Most important factor is increasing expenditure on earnings-related pension. Conclusions depend on assumptions about growth in earnings, prices, unemployment etc over period, but on certain assumptions contributions could change from present relationship to earnings - 16.5 per cent combined employees' and employers' contributions - to 15.4 per cent by 1985-86, but rise to 16.7 per cent by 2005-6 and 21.9 per cent by 2025-6.]

Government Actuary's conclusions not firm predictions but illustrations of possible future burden on certain assumptions. We shall be considering report carefully before reaching any conclusion. In meantime DHSS will be consulting widely with interested organisations and would welcome comments by end of this year.

7. Death grant - increase to realistic level?

[Consultative document about death grant published 3 March, deadline for comments 30 July.]

Social Services Secretary grateful for comments received on consultative document on death grant published in spring and is considering them carefully. As document made clear, aim is to redistribute in more sensible fashion resources now devoted to death grant - cannot afford to add to those resources.

H FISCAL POLICY AND THE PSBR

1. Progress on Fiscal Policy?

[Aim is to achieve reduction in PSBR as percentage of GDP over run of years, so as to achieve lower inflation and interest rates.]

Have made progress; Government has succeeded in reducing PSBR as percentage of GDP, and further reduction is projected. Inflation has fallen fast and is expected to fall further (see K1). Apart from brief period in 1977, long term interest rates lower than at any time during last Labour Government. Benefits seen in recovery of debenture market. [IF PRESSED: excellent success in reducing interest rates, but state of economy makes it important to secure further reductions.]

2. How does UK fiscal stance compare with other countries?

[IMF Annual Report noted that among major industrial countries by far the largest 'restrictive shift' over past two years, equivalent to more than 3½ per cent, was that of UK.]

Many countries reducing borrowing; UK budget deficit now well below average of OECD countries. US experience shows that failure to bring fiscal and monetary policy into line can put excessive pressure on interest rates.

3. How much was PSBR undershoot in 1981-82 and why?

[PSBR for last year turned out £1.8 billion lower than estimate of £10.6 billion given in 1982-83 FSBR.]

Information is still incomplete, but higher debt interest receipts, better receipts from Inland Revenue and lower 'supply' issues contributed to the undershoot. Some factors went the other way - deficit on National Insurance Fund for instance turned out higher than expected. The civil service dispute added considerably to uncertainties at time of Budget, and was main factor in most of the errors.

4. 1981-82 undershoot shows fiscal policy too tight?

Last year's undershoot probably does mean fiscal policy somewhat tighter than planned, but must examine strategy as a whole. Firm control of Government borrowing one factor responsible for fall in short term interest rates (5½ percentage points) since last autumn. Recovery of debenture market shows how lower PSBR creates room for investment.

5. Why treat PSBR as crucial statistic when prone to very substantial forecasting error?

[Margins of error are wide: plus or minus £4 billion.]

Although forecasting PSBR is hazardous, this in no way diminishes importance of achieving better balance between Government spending and income. Recognised by all Governments, whatever the difficulties of forecasting.

6. Isn't 1982-83 PSBR likely to undershoot too?

[Budget forecast for 1982-83 was £9.5 billion. PSBR for June quarter £2.8 billion (£1.6 billion seasonally adjusted) - broadly consistent with forecast for 1982-83 as a whole.]

Rash to jump to conclusions about this year's PSBR. PSBR turned out higher than expected in 1979-80 and 1980-81. Last year, many people expected this to be repeated in 1981-82. PSBR figures for April-June quarter consistent with Budget forecast.

[IF PRESSED: Some of reasons for undershoot last year may imply lower PSBR this year (eg higher tax receipts). But other factors (pressure on Contingency Reserves from Falkland spending, changes in estimated NI contributions) could go other way. Unwise therefore to conclude £9½ billion forecast for this year's PSBR particularly high. Risks in both directions.]

7. Implications of CGBR outturn in August for PSBR in 1982-83?

[CGBR for August £1.5 billion; for April-August inclusive £5.3 billion. In 1981-82 CGBR for April-August was £9.3 billion.]

Last year's figures severely distorted by Civil Service dispute so comparisons can be seriously misleading. CGBR outturn to end August broadly consistent with Budget forecast of £9.5 billion PSBR in 1982-83, so far as can be judged at this stage. [NB: CGBR for September to be published 11 October; PSBR for September quarter to be published 21 October.]

8. If PSBR higher in 1982-83 than in 1981-82 won't interest rates have to rise?

As percentage of GDP, outturn for 1981-82 is more or less equal to the forecast for 1982-83 i.e around 3½ per cent. The 1982-83 forecast is still a low figure both by comparison with deficits abroad and in relation to size of deficits over past decade.

9. Unadjusted PSBR misleading guide to fiscal action?

Cyclically-adjusted PSBR may have some merit as indicator but poor guide to fiscal policy. It is actual Government expenditure and revenue that determines the level of interest rates to be financed and influences level of aggregate demand.

10. <u>Inflation-adjusted or 'real' PSBR in surplus - isn't fiscal policy too tight?</u>

['Real' PSBR subtracts from actual PSBR erosion by inflation of real value of Government debt. Calculations by Bank of England and others produce a surplus 'real' PSBR in most years since the 60's].

Policy of this Government is to fight inflation, not to accommodate it. If 'inflation-adjusted PSBR' is in surplus, this calls for cut in inflation, not expansion of actual PSBR.

J MONETARY AND FINANCIAL POLICY

1. Monetary growth in 1982-83 on target

[The target aggregates M1, £M3 and PSL2 grew by 1.2, 1.4 and 1.1 per cent respectively in banking August. These changes bring rates of growth in the 1982-83 target period to 8½, 11½ and 8¾ per cent per annum respectively, compared with target range of 8-12 per cent (all figures seasonally adjusted).]

Actual August increases in money supply higher than those of past few months, but rates of growth of all three target aggregates are within Government's target range. Together with behaviour of exchange rate and progress in reducing inflation, they indicate sound domestic monetary conditions.

2. Prospects for further reductions in interest rates?

[Last reduction in bank base rates made on 31 August to 10½ per cent. Have come down by two points since early July.]

Substantial interest rate reductions this year reflect sound monetary conditions. Government would like to see rates lower still, so long as further reductions do not seem likely to endanger progress on inflation.

3. Effect of US interest rates on ours?

[US rates fell substantially during July/August, but firmed a little mid-September.]

The falls in US rates were helpful and facilitated reductions in our own. But of course US rates are not sole determinant of UK's, and this spring progress was made in reducing ours at a time when US rates were rising. UK rates are determined in the light of domestic monetary conditions generally, including the behaviour of the exchange rate.

4. Monetary conditions too tight - stifling recovery?

No. Behaviour of exchange rate and money supply suggest financial conditions moderately restrictive, as intended. Interest rates reductions have cut companies' cost and should promote climate for investment.

5. Bank lending growing too fast?

[Lower growth rate in May/June not maintained in July/August. Increased by £1.3 billion in banking August (seasonally adjusted).]

Rapid rate of growth has been partly the result of structural changes, such as move by banks into home loans market, replacing lending by building societies. But to the extent that the increases are additional, they may add to inflationary pressures. An argument for caution with regard to interest rate falls. Too early to expect figures of actual disbursements by banks for house purchase to reflect the bank s' declared intention to go easy on this side of their business. Not expected that removal of HP controls in July will have led to a surge in other personal lending.

6. Prospects for reactivation of corporate bond market?

[Tax treatment of zero coupon and deep discount stocks and removal of embargo on company issues of this type of stock announced 24 June. BOC announced issue of £100 million conventional bond 10 September.]

Zeros broaden options available to companies, though not expected to transform captial market. Best hopes for resurgence of market provided by lower interest rates and inflation, for which we are on course.

7. Why has Bank of England been providing such large-scale money market assistance?

The rapid growth of bank lending has caused problems for conduct of monetary policy. By selling long-term Government debt on a larger scale outside the banking system it has been possible to contain the rapid growth in money which could otherwise have taken place. This in turn has created shortages of liquidity in the money markets. If the Bank had not intervened to relieve these, short-term interest rates would have been forced up to unnecessarily high levels. The measures announced in June [ie variable rate loans facility made available to local authorities etc from the National Loans Fund/Public Works Loans Board; companies allowed to issue zero coupon and deep discount stocks] should reduce rate of growth of bank lending, by encouraging LAs etc to borrow from the NLF instead and by broadening options available to companies issuing their own debt, and so reduce levels of assistance required.

K PRICES AND EARNINGS

PRICES

1. How low inflation by end 1982?

[Budget time forecast Q4 1981 to Q4 1982 9 per cent and Q2 1982 to Q2 1983 7½ per cent.]

Chancellor has recently predicted [in Washington 20 September] that inflation could be as low as 6½ per cent by end 1982.

2. Inflation lower than under previous Government?

[Average year-on-year rate of inflation between February 1974 and May 1979 was 15.4 per cent; average level of inflation since May 1979 has been 13.2 per cent.]

Year-on-year rate of inflation was 10.3 per cent and rising when previous Government left office in May 1979. Now (August 1982) 8.0 per cent and falling. We will be first Government for quarter of a century to achieve a lower average rate of inflation during its term of office than the previous Administration.

3. Inflation still not as low as competitors?

[UK inflation in July 8.7 per cent compared with 6.5 per cent in US, 5.6 per cent in West Germany, and 1.7 per cent in Japan.]

UK inflation now lower than Western European (OECD Europe) average, and well below many countries - such as France and Italy. Still some way to go to match US, West Germany and Japan, but good progress being made in right direction.

4. Long term inflation objective?

Recent developments encouraging. But inflation rate still higher than some competitors e.g Germany. Must not let up. Have always made it clear that price stability not unattainable.

5. TPI now shows pay increases need to be 1 per cent higher than RPI to maintain living standards?

[Increase in TPI over 12 months to August 8.7 per cent, compared with RPI increase of 8.0 per cent].

The gap between the RPI and the TPI (now 0.7 percentage points) widened in July when benefits paid to the unemployed became taxable. Pay increases go to people in work, who will not pay any more tax as result of the change - except for the minority who have a spell of unemployment during the year.

6. Nationalised industry prices

[Increase over 12 months to August 13.6 per cent, compared with RPI increase of 8.0 per cent].

Gap between nationalised industry price increases and RPI due in large measure to cumulative effect of years of artificial price restraint. World oil price rises of 1979 and 1980 have also played important part. Increases regrettable, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so. The differential between RPI and NI prices (including water charges and London Transport fares) is now 5 per cent compared with 14 per cent in January 1982. But sustained improvement only possible if industries succeed in holding down current costs, particularly pay. (See also R1.).

PAY

7. Zero pay norm in next round?

This Government is not in the business of setting pay norms. Individual pay bargains need to take realistic account of the particular circumstances, and of the fact that the greater the restraint, the better prospect for jobs. No right to automatic pay increases every year.

8. Will there be a new pay factor for public expenditure?

[Press reports suggest 4 per cent to be prescribed for public service pay in next round.]

Not yet been decided whether plans for next financial year will be calculated on basis of an explicit 'pay factor'. However, Government finances large proportion of country's pay bill; will have to ensure its own actions are compatible with overall needs of economy.

9. What pay settlements does Government now want?

Low enough to be consistent with improved job prospects in the industry concerned. The lower the better. Certainly lower than in the past year.

10. What has been average over past year/pay round?

[CBI Databank suggests 7 per cent average for manufacturing in last (1981-82) pay round].

Average has been in single figures, and moving downwards, in each of past two years. We need a substantial further reduction, with really low settlements, and thus a better outlook for jobs, in the year ahead.

11. Government exhortations on pay imply aiming to cut living standards?

[Real earnings show some improvement over past two years; in July 1982 2 per cent higher than July 1981 and 3 per cent higher than July 1980.]

Lower pay settlements have not in fact cut real earnings in either of the past two years; prices have also come down. This fact casts doubt on the wilder claims about the effect of pay moderation on living standards.

12. Incomes Policy

Proposals for incomes policies, including recent refinements, do not avoid many of the familiar problems of norms, administrative costs, and interference with market forces. Experience gives no encouragement to the idea that incomes policy can be made to work on a permanent basis. They always succumb to the distortions they create.

13. NHS pay

Social Services Secretary announced 23 June that a further £90 million should be made available for increased pay offer in Health Service. This would allow increase in average pay for nurses of 7½ per cent, ambulance men and hospital pharmacists 6½ per cent, and other staff 6 per cent. Government believes this provides sound basis for settlement.

14. Top Salaries Review Board increases too large?

[Government announced on 12 May increases of 14.3 per cent for senior civil servants and senior members of the Armed Forces, and 18.6 per cent for the judiciary.]

Government believes these increases are fully justified. Essential to ensure adequate supply of candidates of sufficient calibre for the Bench, and to provide adequate career structure and differentials in higher levels of Civil Service and Armed Forces. TSRB are only group whose present salaries are below those recommended for April 1980.

15. Average earnings index

[Year on year growth 10.9 per cent in June compared with 9.8 per cent in June. However, underlying (unpublished) increase slightly lower than in June at around 9¼ per cent.]

Encouraging that underlying rate of growth continues to fall. July index inflated because of back pay and delayed settlements paid in July 1981 (eg civil servants). Further moderation in settlements can only be helpful in maintaining jobs and getting inflation down.

16. Index-linked pensions and Scott report?

The Government is considering whole question in light of Scott Report. Our aim is to ensure that public servants' pensions are fair to taxpayers, as well as to current employees and pensioners and their dependants.

L BALANCE OF PAYMENTS

1. Trade Figures and Current Account

[July trade figures show trade account in broad balance though non-oil trade has shown increasing deficit; projected invisibles surplus of £260 million a month in Q2. Cumulative current account surplus of £1.6 billion in first half of year.]

Signs are that the current account continues in substantial surplus, albeit reduced from last year's levels.

2. Export Trends

Exports during 1982 have been very erratic. The underlying trend seems to have been fairly flat following some rise during 1981; export volumes now at around 1980 level. Manufacturing exports in Q2 were lower than expected around Budget time, due largely to lower than forecast growth in world trade.

3. Import Trends

Manufactured imports fell back in June and July from their high May levels. Hard to discern trend in imports. But underlying level of manufacturing imports has probably not altered since end-81 reflecting levelling off in manufacturing activity.

4. Figures for 1981

Only the 1981 July and August export figures now remain to be published. These should become available over the next two months.

5. Will dispute with Argentina affect UK trade figures?

Volume of UK-Argentine trade negligible (£20 million a month on either side).

6. Overseas investment takes jobs away from UK?

30 per cent of UK exports are bought by overseas firms connected with UK companies. By increasing links between UK and overseas companies, overseas investment helps UK exports and production, so producing more jobs. If UK does not take profitable opportunities to invest overseas, others will.

M EXCHANGE RATE AND THE RESERVES

1. Policy towards the exchange rate/falling £?

[Since last autumn sterling has remained broadly stable. The average £ effective rate in Q1 1982 was over 10 per cent lower than in Q1 1981. Rates at noon on 17 September were $1.7084, DM 4.2727 and an effective of 91.44. Previous lows were $1.6870 on 9 August, DM 4.098 on 21 May. Highs were $1.97 on 30 November, DM 4.407 on 9 February. Reserves at end August stood at $18.1 billion, compared with $17.9 billion at end July.]

Government has no target for exchange rate. The rate is taken into account in interpreting domestic monetary conditions and taking decisions on policy. Sterling's effective exchange rate has continued to show the stable pattern of recent months.

2. Bank of England intervening to support the rate?

Policy is unchanged. Bank do intervene to smooth excessive fluctuations and preserve orderly markets particularly when conditions unsettled. But, as Chancellor has already stated, we have no target - undisclosed, secret or otherwise - for the exchange rate. Most recent reserves figures confirm that policy is unchanged.

3. Concerted intervention to reduce value of dollar?

All experience in recent years that exchange rates for major currencies cannot be manipulated by intervention alone. Intervention can help to steady markets, but not counter major exchange rate trends. That takes changes in real policies, affecting interest rates, monetary conditions and fiscal policies. Lower US inflation is in everyone's interest: matter for real concern is US fiscal/interest rate mix, a problem all countries are familiar with.

4. Improve UK competitiveness by devaluing exchange rate?

Experience shows that exchange rate cannot be manipulated by Government against underlying market trends. Any attempt to lower it by intervention or by relaxing monetary control leads to higher inflation. For example the effective exchange rate depreciated by over a quarter between 1972 and 1976 without leading to any improvement in UK competitiveness.

5. Debt repayments

We have made excellent progress with our plans to reduce the burden of external debt substantially during this Parliament. We aimed to reduce official external debt to $14 billion by end of 1981. This has been more than achieved - external debt is now around $13 billion, compared with over $22 billion when the Government took office.

N EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. 1982 Budget - Parliament/Commission dispute

An agreement between the Parliament and the Council was signed on 30 June and ratified by the European Parliament on 8 July. It will provide the basis for settling the 1982 budget dispute, and also contribute to avoiding such disputes in future.

2. UK budget settlement

Foreign Ministers agreed on 25 May to a settlement for the UK budget contribution for 1982. The settlement provides for a basic refund of £490 million ecus in respect of 1982, with provision for changes to this figure if our unadjusted net contribution varies from the Commission estimate of £880 million. It was also agreed that the problem for the longer term would be settled by the end of November.

3. UK objectives for longer-term negotiations?

Government has made it clear that, in spite of our relative economic position, UK is prepared to remain a net contributor - but only on a very modest scale.

4. Implementation of budget settlement

Details still under discussion in Brussels. The 25 May agreement envisaged partial rebates to Germany, Italy, Greece and Ireland for their share in financing UK refunds, making France bear a larger burden - but France will remain a substantial net recipient from the budget.

5. Luxembourg Compromise

We made clear in Foreign Affairs Council on 20 June that we wished to have clarity about the EC's decision-making procedures. Four other member states shared our wish to re-establish the principle of unanimity when vital national interests are invoked. This is an improvement on 1966, though it is still an agreement to disagree.

6. Commission's ideas for changes to 'own resources' system

Understand that Commission are considering measures to diversify Community's revenue sources. If they put forward proposals we will consider them. Our opposition to any increase in the 1 per cent VAT ceiling is well known.

7. Policy for CAP reform

Key measures are price restraint, curbs on surplus production and strict control of the growth of guarantee expenditure.

8. Costs of CAP to UK consumers

The Minister of Agriculture has dealt with a number of questions on this. Costs to consumers of the CAP as such depend on nature of alternative support system that is envisaged. Arrangements leading to a reduction in the cost of food to the consumer could well involve increased costs to taxpayers.

EUROPEAN MONETARY SYSTEM

9. What is the current attitude of the UK Government?

We fully support the EMS, and acknowledge the contribution which it has made to stability in the exchange markets. However, we do not yet feel able to join the exchange rate mechanism. We must wait until conditions are right for the system and for ourselves.

10. Join the EMS for exchange rate stability?

There is no reason to suppose that by the simple act of joining the EMS exchange rate mechanism we would guarantee exchange rate stability. This has not been the experience of the current participants. Genuine stability requires a return to low inflation rates throughout the Community.

EXPORT CREDITS 'CONSENSUS'

11. Progress on Export Credit Consensus negotiations

In October 1981 participants of OECD-sponsored 'Consensus' reached an interim agreement on the new terms to be applicable for export credits. These terms were to be effective until 15 May 1982. Further proposals were discussed at an EC Council of Ministers on 30 June. They included reclassification of some countries and increase in interest rates charged to 'rich' and 'intermediate' country borrowers. These proposals have now been agreed.

P INDUSTRY

1. NEDC - TUC attitude

[On 8 September, at TUC Conference, TUC debated whether it should withdraw from the NEDC. The motion was defeated.]

Glad TUC voted to remain in NEDC. Believe the Council is a most useful forum for exchanging views on economic and industrial matters. In addition, little Neddies - the EDCs and SWPs - do a first rate job in helping to improve industrial performance at sector level. It would have been most unfortunate if all this had been undermined by TUC withdrawal.

2. Prospects for industry-recovery?

See A5 and B1.

3. Companies' financial position?

[

	1979	1980	1981 Year	H1	H2	£bn 1982 Q1
Net borrowing requirement (+)/repayments (-)	+6.1	+5.7	+4.4	-1.2	+5.6	+3.5
Financial surplus (+)/deficit (-)	-2.7	- 1½	+1.2	+1.5	-0.3	-0.5]

Financial position of industrial and commercial companies (excluding North Sea) improved last year, relative to 1979 and 1980. Improvement in part reflected companies' efforts to cut costs, for example by de-stocking. Some apparent deterioration in second half 1981 financial position due to slowdown in de-stocking and unwinding of delays in tax payments because of the civil service dispute. Figures for H1 1982 suggest reduction in companies' borrowing requirements relative to H2 1981; but borrowing needs still high.

4. Profits rate of return still too low?

[Gross trading profits of industrial and commercial companies (ICCs) (net of stock appreciation) rose 40 per cent to Q1 1982. But increase was from very low base: ICC's real pre-tax rate of return just 2½ per cent in 1981 - half the previous lowest figure in 1975.]

Government can help best by getting inflation down and setting sound basis for sustained recovery. Fundamental improvements in ICC's rates of return depend on better performance by companies. Some encouragement from recent productivity gains and trend towards moderate pay settlements.

5. High interest rates damaging for industry and investment?

Banks' base rates have fallen 5½ percentage points since last October, and 2 points over last three months. Outside analysis suggests that a 1 per cent reduction in interest rates improves the net financial position of the company sector by about £150 million over a full year. Lower interest rates reflect Government's firm fiscal and monetary stance and will help industry and investment.

6. Lower rates for industry?

De-rating one of a number of possible ways of assisting industry and business, but in last Budget preference given to other forms of relief, notably reductions in NIS. De-rating would be expensive, though less so if applied to industry alone - even so, 10 per cent de-rating would cost about £140 million per annum. Legislation would be required.

7. Government help for small firms

Budget provided further help for small businesses, increasing the number of measures taken so far to over ninety. Enterprise package included further reduction in weight of corporation tax; further increases in VAT registration limits; increase in global amount available for loans under Loan Guarantee Scheme (see below); and doubling of investment limit under Business Start-Up Scheme to £20,000 a year. New measures will encourage start-ups and existing firms.

8. Response to Loan Guarantee Scheme?

[Over 6,000 guarantees already issued - about half to new businesses. Total lending under scheme just over £200 million. Budget provided for lending ceiling in first year (to May 1982) to be raised from £100 million to £150 million and for further £150 million to be available in second year (to May 1983). Thirty financial institutions now participating. (Report on sample survey of borrowers placed in Library of House by Parliamentary Under Secretary of State for Industry (Mr MacGregor) on 12 July).]

Scheme operating successfully. Too early to assess overall cost . After first year, of 6000 guarantees issued, only 150 have so far been 'called'. Cost has been covered by the premium income received over the period. Scheme is kept under continuous review.

9. Enterprise zones

Chancellor announced Tuesday 27 July eleven new Enterprise Zones to be created: 7 in England; two in Scotland; one each in Wales and Northern Ireland. All first eleven zones now in operation. Response has been very encouraging. Many new firms are setting up in the zones, existing firms are expanding their activities and vacant land has been brought into use. Too early to assess success of zones.

R NATIONALISED INDUSTRIES

NATIONALISED INDUSTRY PAY AND PRICES

1. Nationalised industries' prices

[Having risen approximately in line with retail prices for several months, the latest figures show bigger 12 months increase in nationalised industry prices, water charges and London Transport fares than all items RPI (13.6 per cent in August compared 8.0 per cent). This differential reflects March increase in LT fares. Removal of these temporary distortions confirms that nationalised industry prices are still increasing somewhat faster than RPI, largely because of increases in energy sector.]

Gap between nationalised industry price increases and RPI has been due in large measure to cumulative effect of years of artifical price restraint. World oil price rises of 1979 and 1980 have also played an important part. We greatly regret the need for these increases, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so. The differential between RPI (all items) and NI prices (including water charges and London Transport fares) is now 5 per cent compared with 14 per cent in January 1982. But sustained improvement will only be possible if the industries succeed in holding down their current costs, particularly pay.

2. What is Government doing to improve Nationalised industries' efficiency?

We continue to press for greater efficiency within NIs. We are setting realistic financial targets and performance aims. A rolling programme of Monopolies and Mergers Commission investigations has been set up. The introduction of market forces provides greatest incentive to efficiency.

INVESTMENT

3. Nationalised industries' investment should be stepped up to/improve infrastructure/provide orders to private sector/as boost to economy

Government has not prevented the industries from carrying forward a large number of profitable investment programmes. It would be wasteful to provide funds for public sector projects with lower returns than those in the private sector. Unfortunately, the pre-tax rate of return on nationalised industries' capital (including subsidies) in 1980 (latest available figures) was minus one per cent, compared with 3 per cent for industrial and commercial companies.

4. Finance more nationalised industry investment by cutting current spending?

As in private sector, moderate pay settlements and control of other costs are essential.

Ability to finance new investment in nationalised industries bound to diminish if excessive pay settlements agreed. Each 1 per cent off wages saves about £140 million this year; and each 1 per cent off total costs saves £330 million this year.

5. Take nationalised industry investment out of PSBR?

Real problem of pressure on resources cannot be solved by changing statistical definitions. Since nationalised industries are part of public sector, their borrowing - for whatever purpose - must by definition form part of public sector borrowing requirement.

6. Private finance for NI investment?

In discussions in NEDC and elsewhere, we have indicated our willingness to consider new financing proposals, provided they can be structured so as to induce improvements in efficiency at least sufficient to offset the extra cost, and provided the finance is raised in fair competition with the private sector.

7. Investment plans unlikely to be attained?

No Government can unconditionally guarantee a level of investment by the nationalised industries. Approved levels set out in last White Paper (Cmnd 8494) are consistent with the industries' agreed external financing requirements, on the basis of their internal resource forecasts. But perfectly possible that plans might need to be revised, for example if the industries fail to restrain their current costs, including pay.

EXTERNAL FINANCING LIMITS

8. EFLs for 1982-83 and future years?

Nationalised industries' total external finance increased by £1.3 billion in 1982-83 (£1.2 billion after allowing for NIS cut and other changes). Increase in 1982-83 was roughly half what the industries bid for. Government has given full recognition to problems faced by the industries in a period of recession. EFL's for 1983-84 will be announced later this year, as usual.

PRIVATISATION

9. Special asset sales in 1981-82

Gross sales in 1981-82 totalled £481 million, so target published in 1981 Public Expenditure White Paper of £500 million nearly met. Pleasing result - included two large sales - Cable and Wireless (£182 million) and Amersham International (£64 million). True that delivery of

BNOC oil in 1981-82 paid for in 1980-81 and taken into account in special disposals figure for that year reduced 1981-82 receipts by £573 million to total of -£92 million. But it is gross figure which is true measure of success of Government's privatisation programme. As Chancellor said in Cambridge 3 July, 'Public utilities and the so-called "natural monopolies" cannot be allowed permanently and without challenge to remain within State ownership'.

10. What further sales expected?

Special sales of assets in 1982-83 forecast at around £700 million and around £600 million in each of the later years. These figures well above those in last White Paper. This reflects primarily very large sales of energy assets - Britoil and the British Gas Corporation's major offshore oil assets - to be made possible by Oil and Gas (Enterprise) Act (which received Royal Assent in June). Industry Secretary announced 19 July plans to sell 51 per cent of British Telecom - but not before next Election.

11. Will Government postpone Britoil sale in view of the weak oil market?

Government intends to sell majority of Britoil shares by end of 1982, if market conditions permit. Will take decision on whether to go ahead when the time comes.

12. Contribution to giving people satisfaction of property ownership?

Exercise of returning enterprises from State ownership to ownership by the public has included measures to promote employee share ownership in the enterprise they work for; for example free offers of shares (British Aerospace, Cable and Wireless, Amersham); preference in allocation of shares (B Ae, C & W, Amersham, BP); provision for matching shares - one for each share subscribed for - (B Ae, Amersham, BP). Most radical initiative taken by consortium of managers and employees who bought National Freight Company.

13. Government has sold assets too cheap?

[Heavy oversubscription for British Aerospace, Cable and Wireless, Amersham International, followed by large increases in prices when shares first traded.]

Not in Government's interest to see shares underpriced, given the loss to the PSBR, but also risks in pitching price too high. Getting balance right not easy - especially when company's shares have not previously been traded. Government will continue to consider alternative forms of sale eg tender, but critics should note that sale by tender could make it harder for small investor to buy shares.

S NORTH SEA AND UK ECONOMY

1. Is Government underestimating North Sea revenues?

[FSBR projections (in money of the day) of Government revenues from North Sea: £6.4 billion in 1981-82, £6.2 billion in 1982-83, £6.1 billion in 1983-84, and £8.0 billion in 1984-84. Lower than last year's projections, principally because of downward revision to oil price expectations].

Projections of oil revenues very uncertain and crucially dependent on cost, price and production assumptions. Prospects for North Sea revenues have improved since FSBR published. Lower recent estimates of Scott, Goff and Hancock and the Midland Bank Review are based on higher expected future production and lower expected future capital expenditure.

2. Onerous tax system damaging future field developments?

[Shell/ESSO have shelved plans for Tern partly because of tax system; Phillips postponing T-block complex and BP their Andrew field; BP statement issued with their interim results criticised fiscal regime.].

Other adverse factors - falling oil prices earlier this year; high development costs - much more important. Detailed study has shown that under new tax structure, levels of profitability should still be sufficient to make exploration and development attractive. Hope that new structure will provide more secure and stable tax regime.

3. Taxation of petrochemical feedstocks

[Government has announced that new rules on valuation of ethane for petrochemical use in interaffiliate transfers (Finance Act Section 134) should be extended to mixed streams of gas with a large ethane component. ICI complain that the extension and the rules themselves give unfair advantage to their integrated oil company competitors and have taken out writ against the Government.]

Government convinced that new formula will give fair valuation. New valuation will not have effect of providing subsidy to ICI's competitors. Have done best to reassure ICI. Will resist ICI's legal action.

4. Government should do more to promote UK Continental Shelf oil production in 1990's?

[Select Committee on Energy's Report on Depletion Policy published 18 May: emphasised development of fields entering production in 1990s by increasing pace of licensing rounds and overhauling fiscal regime. Recommended reserve powers to impose production cuts. Joint memorandum from Energy Secretary and Chancellor replied on 29 July].

HMG agrees with general conclusions encouraging North Sea exploration and development, thereby maximising economic oil production over time; eg decision recently announced not to impose production cuts before 1985. Agree uncertainties in oil scene too great to justify deferring new field developments in foreseeable future. Cannot accept Committee's criticism of North Sea fiscal regime - opposed to another fundamental review; industry does not want a structural upheaval.

5. Benefits of North Sea should be used to strengthen economy?

[Contribution of North Sea to GNP estimated at 4 per cent of GNP in 1981. Not projected to rise before 1985.]

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve lower level of interest rates to benefit of industry and economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Less than 6 per cent of total General Government receipts in 1981-82.

6. North Sea revenues should be channelled into special fund?

North Sea revenues are already committed. Setting up special Fund would make no difference. More money would not magically become available.

7. Future North Sea oil prices?

A matter for commercial negotiation between oil companies and BNOC.

8. Are we really any better off for our North Sea oil?

We are better off with oil - at current oil prices - than we would have been without it. We have been spared fall in real national income that other industrial countries have suffered following oil price rises. But North Sea oil costly to produce, so we are not necessarily any better off than we would have been had oil prices not risen. No need therefore for possession of oil to require a contraction in our industrial base.

T WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Annual meeting of IMF/IBRD

[Annual meeting of IMF and IBRD held in Toronto 6-9 September.]

UK contributed valuably to useful discussions in Toronto. Meeting considered the grave current economic situation and strains upon the world's financial system. Discussion emphasised the need to continue the fight against inflation and also the basis soundness of the financial system. Progress also made towards 8th general review of quotas.

2. IMF gloomy about world economic prospects?

[IMF Annual Report generally gloomy about immediate prospects: 1982 shaping up as another year of weak expansion.]

IMF does not foresee strong recovery in 1982. However stresses the importance of continuing the fight against inflation, and not giving way to pressure for inflation. IMF also pointed to rigidities in wage-bargaining system in the UK as elsewhere, as important causes of unemployment.

3. Why don't major industrial countries together expand demand?

Both IMF and OECD have stressed need for continuing fight against inflation. As the OECD's Economic Outlook explains, Western Governments are convinced 'a significant part of any stimulus to demand would increase public sector deficits, and dissipate itself rather quickly as an increase in inflation'. Furthermore, there is 'the possibility of re-igniting inflationary expectations, which became firmly established over a decade or more...'

4. Anti-inflation policies are working

[Inflation down from a year ago in 6 or 7 major economies on latest avaialble figures: US down (from 10.7 to 6.3 per cent), UK (11.5 to 8.0 per cent), Japan (4.3 to 1.7 per cent), Italy (19.2 to 17.2 per cent), Canada (13.0 to 10.8 per cent) France (13.4 to 11.9 per cent).]

Yes. Firm fiscal and monetary responses to 1979-80 vindicated by events. UK still some way to go to match US, Germany or Japan in bringing down inflation, but moving in right direction and ahead of some other European countries. Realism in wage settlements is growing; US, Germany and Japan all have wage settlements in single figures. Other policies also working: oil savings have helped cut OECD oil demand. All point towards basis for sustainable recovery.

5. French government 'seen the light' over reflationary policies?

[After prices and incomes freeze announced in June and F.Fr 10 billion economies in social security spending announced July, budget for 1983 was announced on 1 September. Some details have still to be announced but borrowing will again be kept below the 3 per cent of GDP ceiling. French Government also raised $4 billion over 10 years on international capital markets to defend present parity of the franc.]

Strength and stability of Western economies will benefit if all countries [particularly France and Italy] can control inflation. So we welcome French government's recognition that inflation is as serious a threat as unemployment and that reining in public sector borrowing is essential part of counter-inflation strategy.

6. Comparison of French Socialist Government 1981-82 with Labour Government in 1974-76?

Many similarities. After oil price shock both governments gave fight against inflation low priority and sought immediate economic growth. In both cases unemployment rose strongly - in UK's case it doubled - inflation and rates of increase in earnings rose, current accounts ran substantial deficits and currencies were depreciated. Important differences, though: French economy fundamentally more healthy, French labour force less unionised, France committed to EMS, but no prospective North Sea oil to help out current account.

7. US Budget?

[Congress agreed in August on package of tax increases totalling $98.3 over next three years, and some spending cuts. Still discussing further spending cuts.]

Glad Congress has acted to reduce deficits. Even so, US deficit remains high. Hope that Congress will continue with firm resolve to reduce deficits.

8. US interest rate developments

Rates fell considerably through July and August - though have turned up recently. Prime rates have fallen 2½ percentage points since mid-July and now stand at 13½ per cent. Growing concern over the Fed's intentions towards buoyant monetary growth ay block any further fall in interest rates in the short term.

9. Prospects for US economy?

[Q2 GNP show small rise in GDP after falls of more than 1 per cent in Q4 and Q1. Seasonally adjusted unemployent is 9.8 per cent. Consumer prices and manufacturing earnings both rising at 6-7 per cent. Tax cuts, effective 1 July, expected to boost consumer spending in Q3 and 4.]

Some indications that worst of US recession may be over. However recovery may be hesitant. Encouraging signs on the recent fall in interest rates and long term downward shift in nominal wage settlements [noted by Chairman Volcker in testimony to Congress].

Recent settlements in manufacturing have been around 6½ per cent. If combined with productivity improvements these could lead to lower inflation rate in US.

AIDE MEMOIRE ON THE UK ECONOMY 21 September 1982

RECENT DEVELOPMENTS AND INDICATORS

(i) Activity. GDP fell by 6 per cent between 1979 H2 (last cyclical peak) and 1981 Q2 (trough of current recession), rose about 1 per cent between 1981 Q2 and 1981 4Q then declined by ½ per cent in 1982 Q1. Weakening at turn of year in part reflects impact of severe weather and strikes. 1982 Q2 GDP rose slightly, returning to its level in Q4 1981. Output nearly 1 per cent above its low point in the Spring of last year.

Underlying level of output broadly flat in first half of 1982, index of industrial production unchanged in 3 months to July compared with previous 3 months implying an increase of 2% per cent on total output since the trough in the Spring of 1981. Oil and gas extraction increased by 4% per cent between 1Q and 2Q 1982 while manufacturing production fell ½ per cent. Most independent forecasts expect resumed and continued recovery.

Volume of new engineering and construction orders in 1981 up 14 and 12 per cent on 2H 1980. Whilst the level of engineering orders has shown no further improvement in the first five months of 1982 construction orders rose 2 per cent in 1H 1982 compared with their average 1981 level. Private housing starts up over one third between 2H 1980 and 1981 and total housing starts in first seven months of 1982 up over a quarter on 1981 average.

Recovery in 1981 largely reflected sharp fall in rate of destocking. Consumers' expenditure and Government consumption broadly flat. Fixed investment broadly flat in 1981, up 4 per cent between 1981 Q4 and 1982 Q1 (though with some weakening in some areas in 2Q 1982); DOI investment intentions survey suggests rise of 2 per cent in MDS fixed investment in 1982.

(ii) Lack of complete trade figures for 1981 and changed documentation procedures make recent figures a little difficult to interpret. Exports have held up better than many had feared. In 11 months to July non-oil exports (excluding erratics) fractionally above the level of 1980. Non oil imports (excluding erratics) have risen - up 12 per cent in same period - in part reflecting reduced rate of destocking and further rise in import penetration ratio. Current account estimated to be £2.0 billion in surplus in first seven months of 1982 following £6 billion surplus in 1981.

(iii) Employment and unemployment. UK employment fell 2.2 million (10 per cent) between 2Q 1979 and 1Q 1982 (about two-thirds concentrated in manufacturing), though rate of decline has slowed down. UK adult unemployment risen by 1.8 million since 2Q 1979 (less than fall in employment) and stood at 3.04 million (12.7 per cent) in September. Total unemployment (including school leavers) was 3.34 million (14.0 per cent). Underlying rate of increase in unemployment was 105,000 per month in 4Q 1980, cf 31,000 per month in first nine months of 1982. Other labour market indicators improved during 1981; eg short-time working down by ¾ during 1981, overtime up by over 10 per cent during 1981, and vacancies - despite slight weakening since February - up by 1/5 in 2Q 1982 on 2Q 1981, and with more rapid turnover. Little or no further improvement in other labour market indicators since turn of year.

(iv) Wages and prices. Increase in earnings in 1980-81 pay around 10 per cent (settlements averaged about 9 per cent), half that of previous pay round. Settlements well inside single figures are now widespread (CBI average for manufacturing 7 per cent) suggesting further moderation in current pay round. 12-monthly increase in RPI 8.0 per cent in August; well inside single figures. Recent progress suggests outturn to end-1982 could well be less than 7½ per cent. Manufacturers' input prices up only 3 per cent in 12 months to August. Corresponding rise in manufacturers' output prices 7¾ per cent.

(v) Productivity and Competitiveness (manufacturing). Output per man risen about 12 per cent since end-1980. Output per man and output per man hour about 6 and 8 per cent respectively higher than previous cyclical peak (1H 1979). Together with pay moderation, resulted in little increase in unit wage and salary costs during 1981, and up by only 5½ per cent in year to 2Q 1982. Competitiveness (relative normalised unit labour costs) improved by 10-15 per cent during 1981, but remains about 1/3 worse than in 1975.

(vi) Company finances. Gross trading profits of ICCs (net of stock appreciation excluding North Sea) rose about 40 per cent in year to 1Q 1982. But real pre tax rate of return just 2½ per cent in 1981. Despite rise in company borrowing and return to financial deficit in 9 months to 1Q 1982 (largely reflecting reduced rate of destocking, rise in fixed investment in 1Q 1982, and unwinding of civil service dispute which delayed companies' tax payments), company finances healthier in 1981 as a whole than in 1979 and 1980. Company liquidity improved in 1Q 1982.

(vii) Monetary aggregates. £M3 grew at an annual rate of 13 per cent in 1981-82 target period (from mid-February 1981 to mid-April 1982) compared with target range of 6-10 per cent. At least part of excess reflected increased market share of banks in mortgage lending. Over the same period, M1 and PSL2 grew at rates of 7 and 12 per cent per annum respectively. In recent months monetary aggregates have grown more slowly; in first 6 months of 1982-83 target period M1, £M3 and PSL2 grew by 8.4, 11.2 and 8.8 per cent at annualised rates respectively of target range of 8-12 per cent.

(viii) Interest rate/exchange rates. Interest rates have fallen since turn of year; 3 month inter-bank rate has fallen from 16 per cent in December to about 10½ per cent. After falling over 10 per cent during spring and summer 1981, effective exchange rate broadly constant at around 90 since August 1981.

(ix) Government borrowing. PSBR £8.8 billion in 1981-82 (3½ per cent of GDP, compared with 5 3/4 per cent in 1980-81) about £1¾ billion lower than estimated at Budget time. CGBR (unadjusted) estimated to be £5.3 billion in the first 5 months of 1982-83.

File

10 DOWNING STREET

From the Principal Private Secretary

SIR ROBERT ARMSTRONG

ECONOMIC STRATEGY AND THE SUPPLY SIDE OF THE ECONOMY: MINISTERIAL MEETINGS

The Prime Minister has seen your minute (A09489) about earlier discussions of strategic measures to improve the supply side of the economy, for which she was grateful. She will want to take account of the points in your minute when considering how to handle the paper which the Secretary of State for the Environment was invited to prepare at the Cabinet meeting on 9 September.

F.E.R.B.

16 September 1982

Prime Minister 2

The time to act on this information will presumably be when the Secretary of State for the Environment produces the paper which you asked him to submit to you.

FERB 15.9.

Ref. A09489

PRIME MINISTER

MT

Economic Strategy and the Supply Side of the Economy: Ministerial Meetings

At Cabinet on 9th September the Secretary of State for the Environment suggested that the Cabinet, or the Ministerial Committee on Economic Strategy, should give greater attention to strategic measures to improve the supply side of the economy. You asked me to let you know the occasions on which they had discussed subjects of this sort, in a general way rather than focussing on particular measures, in the past.

2. The Ministerial Committee on Economic Strategy discussed the 'supply side' on four occasions during 1979, and 1980 (E(79)6th and 13th Meetings; E(80)1st and 36th Meetings: minutes attached). In addition the Cabinet has held a number of macro-economic discussions, including a discussion before this year's Budget on 28th January (CC(82)3 and Conclusions Item 5).

3. The main work in the area falls to the Ministerial Steering Group on Government strategy (MISC 14), which the Secretary of State for the Environment attends. The Group has so far met three times this year. It will be considering later this year the subjects of employment legislation and small firms; the wider responsibilities of financial institutions; education and training; and regional economic policies.

RA

ROBERT ARMSTRONG

15th September 1982

Original on Manpower Special Employment Measures

SUBJECT a Master Set

Note of a Meeting held by the Prime Minister at 10 Downing Street on 13 September 1982 to discuss some aspects of Government Strategy

NS

Those present

The Prime Minister

The Secretary of State for Education and Science	Professor Alan Walters 10 Downing Street
The Secretary of State for Energy	Mr David Wolfson 10 Downing Street
Mr John Wakeham Minister of State, Treasury	Mr John Sparrow Central Policy Review Staff
Mr John MacGregor Parliamentary Under-Secretary Department of Industry	Mr A M Bailey "
	Mr G Hart "
Mr John Selwyn Gummer Whips Office	Miss E Mackay "
Mr David Young Manpower Services Commission	Mr C B B Beauman "
	Mr M J Elliott "
Mr Ferdinand Mount No 10 Policy Unit	

The Prime Minister welcomed those attending the meeting. The strategic problems of the Government were not what to do, but how it should be done. The discussion should concentrate on ways of curing unemployment (a subject on which both the CPRS and the No 10 Policy Unit had recently completed reports). There were a number of blockages to the creation of new jobs in the economy which it was most important to identify and remove. Some of those blockages were non-financial and related to over-regulation; others were more directly concerned with levels of taxation and benefit. The Government had introduced a Business Start-Up Scheme to encourage the provision of equity capital, but there was evidence that its implementation had been so hedged around with restrictions that it was not making the intended contribution; the Treasury was looking into this in consultation with the Department of Industry. There were similar problems with the scheme to encourage private housebuilding for rent.

2. Our social security system represented a major disincentive to the creation of new jobs, by making the difference between wages and what it was possible to receive in benefit too small. Few if any other

countries provided such a generous or comprehensive safety net as our supplementary benefit system. Many of those drawing benefit already worked in the black economy (on which the CPRS had also produced a report). There was a need for people to perform many jobs for the benefit of the community, and it was important to explore whether benefit might be payable only to those who accepted offers of such work. Other countries had developed such schemes with some success. Jobs, especially for young people, would be created in greater numbers if the differential between youth and adult wages were greater - this was seen in West Germany. Wages Councils and trade unions, with the unthinking co-operation of some employers, were impediments to the development of lower youth wages.

3. It was essential that the message that lower real pay would create more jobs was put across to the country; the Government's supporters had an important role to play here. But it must also be remembered that lower unit labour costs were only half the story; industry's products must also be made more competitive.

4. In discussion, the following were among the main points made:-

(a) The black economy might be reduced by granting a tax allowance for home improvement. This would require vouchers which would be traceable for VAT, and would thus bring some black economy service workers into the white economy. But the Exchequer effects of such a scheme would have to be carefully calculated, and it might be that black economy workers would only offer to undertake certain work if no allowance were claimed. There might be additional drawbacks if the effect of the allowance were to encourage over-investment in property to the detriment of industry. On the other hand, it was recognized that there was substantial scope for households to offer low paid service work, and it was noted that some agencies were now specializing in providing that work. But there was some evidence that the Inland Revenue and DHSS had not made life easy for these schemes; more should be done to exploit their potential.

(b) The Youth Training Scheme had already gone some way to depressing the level of young people's wages. There was evidence that many firms were starting to negotiate those wages down to the £25 per week

Youth Training allowance, and that wages paid to young workers after they left the Youth Training Scheme (YTS) would be correspondingly lower. YTS also represented the best opportunity of shaking up the apprenticeship system. The Manpower Services Commission (MSC) was committed to reforms here but there might be difficulty in convincing union members on the shop floor of the benefits. The Government should make a determined effort to secure progress in this area.

(c) There might be scope for introducing changes to the benefit system, perhaps by capping benefit by reference to the level of wages last received. It might also be possible to increase incentives to work by increasing tax thresholds and the levels of child benefit (though these would be expensive) and Family Income Supplement. It was noted that only about 600,000 of the unemployed had dependent children. A large majority of the unemployed had no dependents; although their benefits were not high in relation to prevailing wages, there was evidence that the level of benefits influenced their job seeking behaviour. Changing the benefits so as to encourage the young and single to seek work more actively could not be easily stigmatized as being "unfair". This suggested that any reduction in the level of benefit should be targeted at young people without dependents.

(d) There was a good case for tightening the rules for receiving supplementary benefit, especially for the young, eg by adopting a less selective definition of "suitable work" and by requiring evidence of active job seeking. Such changes would address the fact that young unemployed appeared to search for jobs less actively than older workers. There were attractions, especially with regard to the young, in the American idea of "workfare" whereby benefit recipients were expected to work enough hours to "earn" their benefits. Some would claim that this would amount to "compulsion", but those concerned would still have a choice whether to work or not, and the benefit system had never been intended to give an unqualified right to cash in all circumstances. There were, however, formidable difficulties in moving towards this from our present position, as experience with the Budget community work proposal had shown. The task of organization would be a large and expensive one.

The local authorities would be in the best position to provide such jobs, but their co-operation in such a scheme could not be guaranteed.

(e) Lowering the retirement age might release many jobs, but would, in all likelihood, place an intolerable burden on the working population, unless early retirement could be linked with a reduced pension. On the other hand, many of those approaching retirement might be interested in sharing their jobs, and it would be useful to discover if the Job Release Scheme or some other special employment measure could encourage more flexible arrangements. A scheme of early retirement and lower retirement pensions might be specially useful in helping to get over the "demographic hump" (caused by the unusually large excess of young workers over older workers approaching retirement). Reform of the system of occupational pensions might be relevant to the development of such a policy.

(f) There was also concern about the unemployed, now in their twenties, who had largely missed the opportunities provided by special employment measures and training schemes. It might be possible to develop a voucher system for training on a part-loan, part-grant basis, designed to encourage the development and increased use of training provision in the private sector. The Manpower Services Commission were looking at such a proposal.

(g) The education system might play a role in creating an enterprise minded society in which the creation of jobs and wealth would be promoted, and in encouraging individual responsibility. Standards of education and the employability of those who completed it needed constant attention. The Department of Education and Science would shortly be bringing forward proposals for the introduction of a voucher scheme in schools, and student loans in higher education. (The MSC scheme for training vouchers could fit in well with this approach.) It was also important to look at the position of teachers. This might involve putting them on 5-year contracts and giving real responsibility, coupled with clear duties to head teachers. And there was a need to consider what children were taught; the case for a core curriculum, previously rejected, might need to be reviewed. The case for increased parental control and more autonomy for head teachers, when coupled with the strong central interest in strategic issues, pointed to some structural redrawing of the responsibilities of central Government, local authorities and teaching staff; it was vital that initiatives in this field were not stifled by educational authorities or the teachers' unions.

(h) There was a reservoir of training and educational skills in the armed forces that should be tapped, perhaps by a voluntary scheme for young people to be trained in the armed forces for a year or fifteen months. Other European countries used their armed forces in this way, and the potential for such a scheme here should be examined. But the skills taught to the young people taking part would have to be carefully identified, and there might be some opposition to such a programme from the forces themselves.

(i) There was scope for further work on increasing share ownership; this had been somewhat discredited by the earlier share option scheme for management, but the aim should be to encourage share issues as incentives to employees.

(j) There was some concern that parts of the voluntary sector had lost touch with the tenets of voluntarism. Those who had the responsibility for solving "problems" too often created additional ones, and removed the individual's ability to run his life in a responsible and confident way. The work of the CPRS on family policy would include an examination of the growth of professionalism especially in the public services. There might be scope here for an initiative designed to restore consumer choice to individuals in some key areas of the public sector.

5. In conclusion, the Prime Minister asked those present to note the points that had been made and to pursue work on practical proposals to remove impediments to a wealth and employment creating society. She would herself follow up the proposal to use the armed forces in a training capacity. The CPRS, as a follow-up to its unemployment study, should now develop proposals for reforming the system of benefits for unemployed people, especially the young, so as to do more to encourage employment. It would be particularly useful to draw on international experience.

Prime Minister
Do you want a seating plan for this occasion?
If so, will this do?
FERB 8.9.

MR. BUTLER

Buffet Supper on Monday, 13 September

I attach the list of guests attending the buffet supper on Monday together with a draft seating plan.

If you agree the seating plan, please could it go into the Prime Minister's box?

Sue Goodchild

They will choose own places for buffet supper – no

8 September 1982

LIST OF GUESTS ATTENDING THE BUFFET SUPPER ON MONDAY, 13 SEPTEMBER 198
AT 8.00 PM

The Prime Minister	
Rt. Hon. Sir Keith Joseph, MP	
Rt. Hon. Nigel Lawson, MP	
Mr. John Wakeham, MP	
Mr. John MacGregor, MP	
Mr. John Selwyn Gummer, MP	
Mr. David Young	
Mr. John Sparrow	CPRS
Mr. Alan Bailey	"
Dr. Robin Nicholson	"
Mr. Graham Hart	"
Miss Eileen Mackay	"
Mr. Michael Elliott	"
Mr. Chris Beauman	"
Professor Alan Walters	
Mr. Ferdie Mount	
Mr. Robin Butler	

DRAFT SEATING PLAN FOR BUFFET SUPPER ON MONDAY, 13 SEPTEMBER 1982

Mr. Robin Butler

Mr. Michael Elliott	Mr. Graham Hart
Dr. Robin Nicholson	Mr. David Young
Mr. ~~Brian~~ John Sparrow	Mr. John Wakeham
PRIME MINISTER	Rt. Hon. Sir Keith Joseph
Rt. Hon. Nigel Lawson	Mr. John MacGregor
Mr. Alan Bailey	Professor Alan Walters
Miss Eileen Mackay	Mr. John Selwyn Gummer

Mr. Chris Beauman   Mr. Ferdie Mount

ENTRANCE

COMPETITIVENESS AND DEMAND

A - Demand went up by 3 per cent in the year ending in March [ie the six months ending March 1982 compared with the same period a year before]

- In the 1970s, only £5 of every £100 of extra demand went into increased output. The rest went in higher prices or higher imports.

B Cost In Jobs: The CBI estimate that every 1 per cent gain

in the UK share of world exports of manufactures) means 250,000 jobs gained; and

in the UK share of the home market for manufactures) means 80,000 jobs gained.

C Import Penetration

Imports as a percentage of Home Demand: (CSO figures)

Total manufacturing	17.1% in 1971	25.4% in 1981:	an 8.3% increas
e.g. vehicles	15%	39%	: a 14% increase
textiles	17%	35%	: an 18% increase
electrical engineering	18%	37%	: a 19% increase

D Loss of Export Markets

UK share of 12 main export markets for manufactures (CBI figures):

1960	15.9%
1970	10.6%
1980	9.7%
1982	8.3%

[NB: Exports make up 29% of UK GDP compared with 9% in the USA, 12% in Japan, and 26% in the FRG (OECD figures)]

A loss of 2.3% since 1970

E This 10% increase in import penetration, and 2½% loss of export markets, mean a loss of almost 1½ million jobs in the last 12 years.

F Labour Costs as a Cause of uncompetitiveness

Unit Wage/Salary costs (manufacturing) between 1975 and 1980

UK: almost doubled (an increase of about 90%)
USA: went up by one third (33%)
Japan: stayed almost level (up about 4%)
FRG: went up about one sixth (up about 15%)

Income from Employment as a Proportion of Total Net Domestic Income (CBI figures)

UK:	1960	73%
	1970	77%
	1980	81%
	1981	82%

compared in 1980 with

USA	:	78%
France	:	73%
FRG	:	72%
Japan	:	68%

G Cutting NIS, and Derating, as a Cure?

- Revenue raised through NIS	:	1981/82	:	£3.9b.
		1982/83	:	£2.7b.

- The effective reduction of 1% made in the Budget will be worth £640m. to industry in 1982/83.

- The cost of a 10% derating for industry would be £140m.

H Interest Rates

The 5% drop since last Autumn should be worth about £1.25b. p.a. to industry (CBI figures)

OPPOSITION POLICIES OF REFLATION

Quotes

A: John Maynard Keynes (1919)

"Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose..."

B: Labour Government's Letter of Intent to the IMF (15 December 1976)

"... an essential element of the Government's strategy will be a continuing and substantial reduction over the next few years in the share of resources required for the public sector. It is also essential to reduce the public sector borrowing requirement (PSBR) in order to create monetary conditions which will encourage investment and support sustained growth and the control of inflation."

C: Mr. James Callaghan at the Labour Party Conference (28 September 1976)

"We used to think that you could just spend your way out of a recession, and increase employment by cutting taxes and boosting Government spending. I tell you, in all candour, that that option no longer exists, and that, insofar as it ever did exist, it worked by injecting inflation into the economy. And each time that happened, the average level of umemployment has risen. Higher inflation followed by higher unemployment. That is the history of the last 20 years."

/ D:

D: Mr. Joel Barnett (his memoirs, printed in Sunday Times, 31 January 1982)

Speaking of the last Labour Government:

"All in all there can be little doubt that we planned for too high a level of public expenditure, in the expectation of levels of growth that never materialised."

"...the quaintly titled "social contract", supposedly enshrining a new relationship between Government and unions. To my mind, the only give and take in the contract was that the Government gave and the unions took."

Extra Points

In addition to the usual anti-inflation points:

- the last Labour Government's policies did not prevent unemployment from rising, and indeed doubling during their term of office.

- the debt interest that the Government has to pay has risen from £2 billion in the early '70s to perhaps £15 billion this year. It has risen at a faster rate than inflation. It has risen at a faster rate than public expenditure as a whole. This year it is likely to cost as much as the whole of the National Health Service.

Unemployment

Link with suicide rates ?

No causal relationship:

- Average number of suicides in 1961-65 : 5879

  " " " " in 1980 : 4829

  Unemployment in 1961-65 substantially lower than in 1980

- Sweden, Japan, and FRG show about twice the UK suicide rate, yet lower unemployment.

Two million below poverty line ?

Number of people in families with incomes below supplementary benefit level (DHSS figures):

1975 :	1.840 m.	end year
1976 :	2.280 m.	end year
1977 :	2.020 m.	end year

1977 :	1.9 m.	average over year
1979 :	2.1 m.	average over year

Econ Pol

ECONOMIC, EMPLOYMENT AND INDUSTRIAL POLICY AND ITS PRESENTATION

PART I - PERCEPTIONS AND PRESENTATION

Summary of Public Perceptions Versus the Facts and Policies (A fuller analysis is given in Part II).

1. Few voters have a clear view of the government's overall economic strategy, its objectives and how it is meant to work. On the other hand, the government's and Prime Minister's sense of purpose is widely recognised and respected. This underlying strength can only be exploited as the electorate's weak understanding of our goals is remedied and they see the first signs of progress towards them.

2. Misconceptions about unemployment are particularly damaging. About half the voters think the government is deliberately making unemployment high to curb union pay demands. Few voters could think of any government measures which were intended and likely to help cure unemployment - at least before the Employment Bill and Training Initiative.

3. Few people see inflation and unemployment as alternatives. In this their perceptions are closer to the government's view than to its critics'. Voters want both unemployment and reflation to be tackled simultaneously. Even fewer people perceive the connection between prices, money and borrowing - but they approve of measures to reduce government borrowing, even higher taxes.

4. Trades union reform is potentially the most popular and credible element of our policy. Not only does a large majority support steps in that direction, even some of those hostile to it believe union reforms will help reduce inflation and unemployment. It is important that the union measures do not become seen, jointly with unemployment, as an attack on the working class.

5. Nationalisation has long been unpopular but until recently privatisation was not recognised as an option and has not yet had time to acquire much positive electoral support. Some see privatisation as part of the sterile ding-dong between Labour and Conservative. They do not recognise that in fact no major industry was returned to private ownership between 1951 and 1981.

6. Investment is universally thought a 'good thing' of which there is too little. The substantial increase in investment by nationalised industries after five years of decline is not publicly appreciated. Most people think private investment is inadequate and falling. Few realise that private sector investment reached an all time record level in 1980 or that an increase is likely this year.

7. A majority probably think national output is falling despite the predominently rising trend since last spring. The balance of payments is still widely believed to be an important measure of national well being but it is doubtful whether the majority recognise the size of the current surplus.

8. Too few are aware how closely our problems and solutions, are being mirrored abroad: that unemployment is now rising faster in Germany, that inflation is worse in the rest of Europe than in the UK and that many countries plagued with budgetary problems similar to ours are cutting even items of welfare spending like pensions and health which the British government has protected.

PRESENTATIONAL APPROACH

(i) Presentation of our strategy was bound to be very difficult in the first phase of government. Many of the measures necessary were initially painful, their potential benefits lay in the future, and the causal relationship between the measures and their eventual benefits was not always initially obvious or easily explained.

(ii) Now it is vital to convince people that we have a strategy and that it will in due course deliver the goods. Since many of our policies are now embodied in law or government actions, and some are showing their first fruits, it should become easier to 'sell' the strategy convincingly.

(iii) Many of the misconceptions about our objectives have arisen to fill the vacuum left by failure to appreciate what government strategy is. As we succeed in presenting it effectively those illusions will be dispelled. But some are sufficiently deep-rooted to require a specific effort to dispel them.

(iv) **The Presentational Framework**

(a) Our objective is to reverse the long term decline in:-

- the relative living standards of the British people,
- the value of our currency,
- the competitiveness of our industry,
- and, eventually, the number of viable jobs.

(b) This decline has come about because in the past British governments shrank from tackling fundamental long term problems and exacerbated them by:

- subsidising resistance to change (directly and through a falling £)
- short-lived consumer booms to purchase popularity at the expense of savings, investment in the future and the value of the £.

(c) We are tackling the fundamental long term problems of the British economy which other governments shrank from e.g.:

- trades union immunities,
- uncompetitive and overmanned nationalised industries,
- the burden of borrowing and foreign debt,
- inflation,
- training,
- obstacles to new business.

(d) The task of tackling these problems was made more difficult by the recession.

(e) The blame for much of the tragic rise in unemployment lies with

- those who encouraged overmanning or resisted changes in working methods until enterprises were on the brink of collapse and faced with the grim choice between shedding large numbers of workers or losing them all in bankruptcy.

- those who, verbally or through previous bursts of inflationary spending, incited wage claims which could only have been financed by another round of accelerating inflation.

(f) The government is doing all it can to alleviate the short-term unemployment problem without aggravating the longer term problem and where possible (e.g the Training Initiative), to make a permanent contribution to employment prospects.

- YOPS, TOPS etc.

The government is planning to spend £4 billion on training by 1984 - not the mark of an 'uncaring' government.

(g) There are no simple, cheap, quick, safe ways of curing unemployment. If there were the government would have implemented them not only for humanitarian reasons but also from electoral self-interest.

(h) The most frequently canvassed 'easy' option is some sort of reflation (i.e. pumping more money into circulation). In the past this never produced more than a temporary alleviation of the problem - which on every occasion gave way to increased unemployment.

Nowadays those involved in foreign exchange markets, financial markets and in negotiating wages have learned that reflation begets inflation. As a result a reflationary package would, as soon as announced, almost certainly result in a foreign exchange crisis, devaluation, rising living costs and a wage explosion. This would abort any economic recovery before it had generated any new jobs and probably intensify the squeeze. That is why virtually every major government in the world has abandoned reflation as an option.

(i) The government believes that it will be possible permanently to reverse the trend in unemployment (which has been upward for two decades) and to bring unemployment down to levels reflecting normal job changes.

But a long term up trend can only be reversed by the sort of fundamental measures which the goverment is taking. These inevitably take a long time to work.

(j) The deliberate creation of unemployment plays no part in the government's strategy as our opponents allege. It would be politically suicidal as well as wicked.

The idea that unemployment is necessary to curb wage increases is the reverse of the truth. The reason the government wants wage increases to moderate is to stop people being priced out of jobs.

(k) The preconditions of curing unemployment and restoring prosperity are:

- curbing inflation and
- improving productivity and competitiveness.

(l) The first unmistakeable signs of success on both inflation and productivity are becoming apparent.

- Inflation is down to half its last peak level and is expected to fall further. Many forecasters believe that for the first time since the war this government will bring inflation over the life of the parliament below the level experienced under its predecessor. We are on the path back to sound money.

- Productivity per man rose last year at Japanese rates and evidence abounds of improvements in competitiveness, development of new products, changed attitudes at work, success in export markets.

(m) Entirely new jobs in both manufacturing and services will be generated particularly by exploiting the new technologies. The government is systematically accelerating this process by:-

- increasing awareness of the opportunties created by these technologies in industry, schools etc. (IT82, Micros in schools etc),

- opening up substantial new areas for commercial development in the fields of communications, entertainment electronics and computer links as a result of the liberalisation of British Telecoms and of satellite communications; also reviving new opportunities for gas exploration by removing BG's monopoly of gas purchase and transmission,

- channelling substantially increased government funds - particularly for R&D, new product development etc. - into the high technlogy fast growth sectors.

(n) The adjustment required in the private sector has been aggravated by the burden of the public sector which has been slower to adapt because of lack of competition and reliance on public funds. Hence:

- increasing emphasis on measures to bring more competition and private ownership into nationalised industries,

- the support given to top class management in rationalising BSC, BL, BA etc.,

- authorising sharply increased nationalised industry investment while reducing subsidies to sustain overmanning,

- the slimming down of the civil service so that by 1984 it will be the lowest since 1948.

(o) The government's aim is the positive one of expanding the private sector not, as often portrayed, the negative one of reducing the public sector. Every pound less spent by government is a pound more, freely spent by the private individual.

(p) The measures which will help bring unemployment down in the long term will also:-

- improve living standards,
- enable us to improve the quality of our social services,
- increase people's freedom of choice,
- reduce political interference in people's lives,
- spread more widely the freedom and responsibility which come from private property ownership.

MAIN FALLACIES, MISUNDERSTANDINGS AND POSITIVE POINTS

Our communications effort needs, among other things, to concentrate on promoting the following positive points and dispelling the following fallacies and misconceptions.

CRD will produce succinct guidance notes on each point.

Positive Points

1. That we are the only party/government prepared to tackle the fundamental problems which have hamstrung the UK economy.

2. That inflation is now set on a decelerating trend after increasing in each previous Parliament.

3. That all our actions, not least the battle against inflation, are designed to create the conditions for a return to sustainable high employment and prosperity.

Fallacies

1. Reflation - that extra borrowing or more money can painlessly reduce unemployment without sparking off a worse cycle of inflation and unemployment.

2. That money spent on the unemployed could be used to create jobs with minimal cost to the budget.

3. That interest rates are set purely by world or US forces and not much affected by the PSBR.

Misunderstandings

1. That we are deliberately creating unemployment to curb wage increases.

2. That nationalised industry investment is being curbed and private sector investment depressed.

3. That privatisation is not a fresh approach but a regular feature of adversary politics.

PART II: THE VOTER'S PERCEPTIONS VERSUS THE FACTS

These notes mainly single out areas where perceptions are unfavourable to us, mistaken and need dispelling. Where appropriate we analyse

- first, perceptions of trends or developments in the relevant aspect of the economic situation e.g. what people think is happening to the level of unemployment.

- second, perceptions of the causes e.g. what causes unemployment.

- third, perceptions of the policies e.g. what people think government ought to do or is doing.

Alongside this we contrast the 'facts' or more rigorous interpretations of trends, causes and policies.

Polling data are drawn from a variety of CRD and published studies notably: "Public Understanding of Economic Affairs", Marplan May 81: "Survey on Unemployment," ORC, March 81; "Attitudes Towards Unions", MORI, Nov 81; Tracking Studies Jan 82.

UNEMPLOYMENT - Perceptions

Trends: Overwhelmingly (73%) expected unemployment to increase but fewer now expect a large increase.

A substantial minority believes high unemployment is here to stay (because of new technology).

Facts

Trends. New technology may result in transitional unemployment from rapid change but should not automatically mean permanent loss of jobs. We could easily consume many time more than we now produce. So we should need as many workers as now until average output increases to several times its present level. Even in Japan the new technologies are barely compensating for other factors slowing down productivity growth.

In any case we need to adopt the new technologies to avoid losing jobs to our competitors.

- Perceptions (cont'd)

Causes World recession is most widely accepted as an important cause (52%) and most often considered the most important cause (17%).

But Government's Policies are not far behind (37% and 14%). Moreover, half the electorate think there is at least some truth in the allegation that Government is making unemployment rise on purpose to keep down wages or break the unions.

Only a small minority (7%) spontaneously blame unemployment on excessive wages (relative to productivity). When prompted, the majority accept there is at least some truth in this.

Very few people think there is a trade-off between unemployment and inflation. Indeed two-thirds accept that curbing inflation is a precondition of reducing unemployment. Generally people want unemployment and inflation to be tackled simultaneously.

Policies Reducing interest rates, reducing the retirement age and channelling more money into investment are each seen as cures for unemployment by nearly half the electorate.

Nearly a third mention reducing union power, cutting taxes, import controls, or wage moderation as possible remedies.

However, voters are very hazy about what the Government is doing to reduce unemployment. Cutting Government spending used to be most often mentioned (34%) but rarely thought effective; reducing union power was the only other widely recognised Tory policy (30% in 1981, probably higher since the new Employment Bill). Youth training and other special measures might now be gaining recognition as Government measures.

Nearly a third of voters could not think of any government policies to cure unemployment even when prompted.

The notion that it would cost less or little more to employ people than keep them on the dole is probably gaining ground.

Most (60%) believed the Government was not doing enough to help the unemployed before the latest initiatives.

- Facts (cont'd)

Causes The world recession is a useful label for the factors explaining the worldwide rise in unemployment though it provides no explanation.

The main underlying factor is that money rates of pay have risen more rapidly than money spending in most countries. If an individual firm's revenues rise 5% but its employees' wage rates rise 10%, almost inevitably the number of jobs will be cut. The same is true nationally. Britain's problem is particularly severe because of accelerating pay increases from 1977 onwards (9%, 13%, 16%, 21%). These rises were conceded by employers in the expectation that this government, like its predecessors, would pump in the extra money to pay for them - even though this government was committed to slow down the rise in money spending.

It is disappointing that although employees increasingly recognise the connection between pay and jobs at their own shop floor, few as yet place the blame for the nation's unemployment on the explosion of pay, in excess of productivity, between 1977 and 1980.

Policies To the extent that people price themselves back into jobs, by moderating pay and increasing productivity (which is beginning to happen) the government is not seen to be instrumental and can only claim indirect credit.

Emphasis has therefore to be placed on measures directly implemented by government:

- the training initiative which will guarantee a place or job for every school leaver by Christmas,
- measures to encourage new business: enterprise zones, small business programme, tax reliefs etc.
- measures to improve the working of the labour market: Young Worker Scheme, sale of Council houses, etc.

INFLATION - Perceptions

Trends The number expecting prices to rise sharply in the next year has halved. But most are pessimistic about inflation being reduced a lot. Most (75%) recall that inflation was lower when we were elected.

Causes Most people think inflation is caused by businesses putting up prices to increase profits or because of wage increases. Few perceive the connection between prices and money supply or borrowing. The exchange rate is more widely understood to affect prices.

Policies Direct controls of prices and/or wages seem the obvious cure to most people though their popularity has declined over the years. The Government's policy of reduced borrowing, though not recognised as anti-inflationary, is considered wise by a large majority (68%).

- Facts

Trends For the first time since the war inflation could well be lower over this parliament than during its predecessor. This represents an historic change of trend back towards sound money.

Causes Where inflation is concerned people are more interested in results than causes.

Policies At present it is almost inconceivable that any attempt to introduce an incomes policy could result in a lower level of pay settlements than is taking place. It might well result in a 'norm', higher than the going rate, which would prove to be a floor rather than a ceiling. This is worth reiterating.

UNIONS/INDUSTRIAL RELATIONS - Perceptions

Trends The improvement in labour relations is probably not fully recognised. Pessimism about strikes remains high.

Causes Unemployment has been thought the main cause of industrial relations peace.

Policies The large majority favours Union reforms and before the latest Bill most people thought the government was not doing enough. That majority favouring reform has declined somewhat (13%) with, and probably due to, rising unemployment which has aroused suspicions that the working class (rather than oppressive union powers) are under attack.

Facts

Trends The level of industrial disputes has been the lowest for 40 years.

Causes Recognition that the government will not intervene to bail out companies brought to their knees by strikes will prove a more enduring cause of industrial peace than unemployment.

The absence of Government intervention and '11th hour talks at No. 10' has depoliticised labour disputes and helped secure peaceful settlements especially in the public sector.

PRIVATE INDUSTRY & COMMERCE

- Perceptions

Developments There is a widespread feeling within the private sector that they have born the brunt of the recession.

Cause This is often felt to have been aggravated by the burden of rising nationalised industry charges, energy prices, exchange rates, interest rates, local rates and cuts in public sector capital spending.

Policies All the above tend to be blamed on the government. Since the government is, nonetheless, generally still recognised as in principle favouring the private sector, it is assumed, particularly outside the South East, to have lost touch with industry's problems.

- Facts

Causes The government accepts that the public sector has been a burden on the private sector. That is because the natural response of public bodies to financial stringency is to pass on the problem by raising charges and cutting spendings on outside suppliers - rather than becoming more efficient and competitive as the private sector must.

Policies In fact the central purpose of government strategy is to increase the competitiveness and profitability of the private sector and to extend the scope for private enterprise into fields from which it was previously precluded. The government is helping private industry in four ways:

(i) Increased direct assistance - particularly for R&D and new product development in the high technology areas (aid nearly doubled from Labour's level) where growth and spin off potential is greatest.

(ii) Curbing the real burden imposed by the nationalised sector more vigorously than any previous government has done (BSC, BL, BA etc.). This admittedly painful and belated rationalisation of the nationalised industries has been achieved whilst increasing their investment most of which provides private sector orders.

The burden of the rest of the public sector is being contained by reducing the Civil Service to the smallest size since 1948; by proper cash limits; and by a major reform of Local Authority to finance introduce much needed penalties for overspending.

The real burden imposed on the private sector by the public sector can only be reduced by increased efficiency. To subsidise charges as Labour did was purely cosmetic since it transfered the burden to taxation or interest rates via higher borrowing which hit the private sector at least as hard.

PRIVATE INDUSTRY & COMMERCE - Facts (cont'd)

Policies (cont'd)

Where possible, privatisation is the best guarantee of continuing cost effectiveness at no burden to the taxpayer. Privatisation also removes unfair competition by state subsidised concerns.

(iii) Opening up new opportunities for private enterprise. The liberalisation of British Telecommunications will open up enormous investment opportunities from which private industry was previously excluded. Literally billions of pounds will now be spent on or by private firms in recabling Britain (optical transmission networks, cable TV computer links, etc.), manufacture of microelectronic appliances and associated services linked to national networks, satellite production (where we have a lead) etc. Liberalisation of the British Gas monopoly will revive gas exploration which ceased under Labour.

(iv) Removing unnecessary obstacles and burdens on business e.g. abolition of exchange, price, pay and dividend controls; removal of IDC's, limits on planning delays and counter productive employee 'protection'; improving stock relief and allowances on industrial buildings.

No other party offers the private sector any coherent strategy for improving its growth prospects and reducing its burdens.

SMALL BUSINESS - Perceptions

Developments Most people think far more businesses are closing down than starting up.

Policies The battery of pro-business measures is gaining increasing recognition from businessmen. Wider public perception is probably still low.

Facts

Developments As many businesses are being formed as are closing down. This is probably unprecendented in a recession.

Policies Over 70 measures have been introduced either to remove obstacles and burdens or to improve the flow of finance to small business - existing firms as well as new firms.

INVESTMENT - Perceptions

Developments Investment is widely believed to be declining, particularly in the nationalised industries.

Causes The Government's cuts tends to be blamed for the supposed inadequacy of investment.

High interest rates, high taxes, trades union opposition and poor management also receive blame.

Policies A majority favours channelling government money into investment and encouraging new industries. It is widely believed that the UK government channels much less cash into new developments than do foreign governments.

- Facts

Developments Nationalised industry investment was cut in real terms by the Labour government every year from the 1976 cuts onwards. The fall was stopped in our first year and sharply reversed in the current year. The initially planned 15% increase in real terms in 1981/2 has since been augmented and will reverse all Healey's cuts 'at a stroke'.

Other public sector investment has been declining: largely because of cuts in housing, roads and schools. In housing and roads there has been a desirable switch from new building to renovation and maintenance - which happen not to be classified as investment. New schools are not needed because of declining numbers of pupils.

Private sector investment has been unusually buoyant during a recession of this severity. It reached an all time record in 1980 and a modest increase is likely this year. Company spending on new product development, which is generally not classified as investment in the published figures, seems to be rising strongly.

Causes The low level of UK profitability is the principal reason for lower investment in the UK than many of our competitors.

Policies Unlike its predecessors, this government is devoting an increasing share of public funds to new investment rather than to sustaining overmanning and outdated products or processes.

Government funds channelled into new industry probably represent a similar proportion of GDP to our competitors.

NATIONALISED INDUSTRIES - Perceptions

Developments The proportion of voters opposed to nationalisation has risen steadily since 1948 to a large majority. However, probably only a minority recognise how seriously the nationalised industries have exacerbated the nations financial and cost problems during the recession. Most of those who do see them as a burden (notably BSC and BL) probably expect them to remain so indefinitely.

Causes The large majority who dislike nationalisation attribute its failings largely to a lack of competition and only secondarily to the lack of profit motive.

Policies There is fairly widespread, if grudging, respect for the Government's backing to BL and BSC in their survival plans.

Although nationalisation is unpopular, privatisation is not correspondingly popular. Indeed it was not until recently seen as an option.

Particularly among SDP/Liberal inclined voters privatisation may be seen as a deplorable aspect of ding-dong politics.

Facts

Developments The likely improvement in the finances of BSC and BL will probably come as welcome surprise.

Policies The alleged ding-dong battle between nationalisation and denationalisation has been all ding and no dong. No major business was denationalised between 1951 and 1980 although seven major businesses were nationalised. (Even the 'denationalisation' of steel in 1951 is a misnomer: the incoming government aborted its predecessor's planned, but incomplete, nationalisation).

The current privatisation programme represents the reversal of a thirty year 'ratchet effect'.

Prime Minister
It is a pity that Professor Kingman now cannot make it, but I do not think that there is a suitable alternate.
FERB 6.9.

MR. ~~BUTLER~~

cc: Mr. Sparrow (CPRS)
Mrs. Goodchild

You asked me to set up a meeting to discuss strategy. I discussed a date with the Prime Minister and she agreed that Monday 13 September at 1800 hours, to include a buffet supper, would be the most convenient. The following will be attending:

Mr. John Sparrow + 6 from CPRS (names to be submitted)

Secretary of State for Education

Secretary of State for Energy

Mr. John Wakeham MP (HM Treasury)

Mr. John MacGregor MP (Department of Industry)

Mr. David Young

Mr. Ferdie Mount

Mr. Alan Walters

Professor Kingman (Chairman, Science and Engineering Council)

The Secretary of State for Employment is not able to attend as he is taking a late holiday and will be overseas.

MS.

CS.

P.S. Professor Kingman has since rung to say he has to be in Italy on a lecture tour. Anyone else suitable?

No

1 September 1982

010 Econ Pol Strategy

CONFIDENTIAL

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

12/8

11 August 1982

D.A. Edmonds, Esq.,
Private Secretary to the
Secretary of State for the Environment
Department of the Environment

Dear David,

MISC 14 : FUTURE DISCUSSION OF FINANCIAL INSTITUTIONS

At the meeting of MISC 14 on 29 ~~July~~ (*alt*), your Secretary of State expressed his concern that financial institutions were not properly discharging their wider responsibilities, and it was agreed after brief discussion that a paper should be prepared for discussion after the Recess.

It would be a great help in the preparation of a worthwhile paper if you were able to assist us by setting out your Secretary of State's concerns in a little more detail. For example, it would be helpful to know whether they involve financial institutions in general, or classes of institution (for example, wholesale or retail banks, building societies, insurance companies or pension funds) in particular. Examples of the particular shortcomings he has in mind, and of any remedies he might wish to suggest, would also be helpful.

I am copying this letter to the Private Secretaries to other members of MISC 14 and to Sir Robert Armstrong.

Yours ever,

Peter

P.S. JENKINS

10 DOWNING STREET

arranged for
Tuesday 31 August
at 12 Noon.

C.J.

10/8

Mr Wicks to see

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Prime Minister
Duty Clerk 9/8/82

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

We are meeting tomorrow morning to discuss the policy group work initiated at the last Cabinet. My main efforts have been directed so far at launching the idea with the colleagues involved (I have seen all involved except Norman Fowler), and am identifying possible Chairmen. We have all found it easier to think of reasons for rejecting names than to suggest alternatives! After much discussion we have come up with the possible names recorded on the attached list.

What I should now like to do it to agree with you those whom we can now approach. Once a Chairman is in place we can then fix terms of reference and membership and get each group under way. If we can agree on them tomorrow I should be able to start the process of contacting them before I leave for Portugal on Wednesday.

I have of course been keeping in close touch with Cecil Parkinson over all this till his departure on holiday, and plan to consult him again as soon as he and I are back.

GH

(G.H.)
9 August 1982

CONFIDENTIAL

POLICY GROUPS

Subjects	Possible Chairman
1. Unemployment	Tim Renton
2. Promotion of Enterprise	K Wickenden T Higgins T Sainsbury T Eggar
3. Family	Lady Young
4. Wider Choice in Education, Health, Pensions, etc	J Hoskyns
5. Education	Lord Beloff
6. Cities, Law and Order	M Stevens M Fox T Sainsbury
7. "Why work?"	A Prest T Higgins
8. Europe	Lord Hugh Thomas
9. Nationalised Industries and Privatisation	K Wickenden
10. Urban Transport	S Chapman M Neubert.

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(2)

Prime Minister

MCS 30/7

SECRETARY OF STATE FOR EMPLOYMENT

Caxton House Tothill Street London SW1H 9NF

Telephone Direct Line 01-213 6400

Switchboard 01-213 3000

MT

Michael Scholar Esq
Private Secretary
10 Downing Street
LONDON SW1

30 July 1982

Dear Michael

... I am enclosing a copy of the latest Pay Brief.

Copies also go to the Private Secretaries to Members of E, E(PSP) and E(EA).

Yours sincerely

Marie Fahey

MISS M C FAHEY
Private Secretary

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PAY BRIEF: POSITION AT MID-JULY

SETTLEMENTS

1 Since the June pay brief 158 settlements covering 569,000 employees have been recorded. In the private sector (147 settlements covering 366,000 employees) the weighted average level of settlements in the last month was just over 6½%. The average in the public sector (11 settlements covering 204,000 employees) was just under 6½%. The principal settlements in the private sector were ICI Ltd (63,000) at 8% and a 2 year staged agreement, linked to the RPI, for Footwear Manufacture (40,000) giving 2.4% in the first year. In the public sector Electricity supply power engineers (29,300) settled for 7.4% and University non-clinical academic staff (39,000) for 5%, also NHS doctors and dentists were awarded increases of 5.7% to 8.5% (6.2% average).

2 The cumulative average level of settlements for the whole economy this pay round 1,048 settlements covering 8,503,000 employees - is 7%, similar to the last two months About ¾ of employees about whom the Department expects to receive information have reached settlements.

3 In the Private sector the cumulative average remains unchanged at 7% for the fourth successive month (978 settlements covering 4,530,000 employees). For manufacturing the average level is just over 6% and in non-manufacturing is just over 7½%. About ¾ of settlements and of employees are covered by settlements in a 5% to 8% range.

4 In the Public sector (70 settlements covering 3,973,000 employees) the cumulative average is about 7%, similar to the previous two months. The average in the public trading sector is 7½% and in the services sector is just over 6½%.

5 About 2¾ million workers are covered by 27 separate Wages Councils. Twenty-six covering 2,784,000 workers have either made or agreed to make orders to come into effect during the current pay round. The average increase in representative minimum rate, which does not necessarily result in a corresponding increase in earnings, is 7½

6 Coverage: The limitations of the Department's coverage of settlements were explained in the March pay brief (para 5).

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NEGOTIATIONS

7 In the PUBLIC SECTOR, Gas Supply staff (1 June - 57,700) have rejected an offer worth about 6% on average earnings. The claim is for an increase to maintain living standards and a reduction in hours. Meeting arranged for 29 July. An offer to Water Supply staff (1 July - 35,300) of 7% plus minor holiday improvements has been rejected. A further meeting has been arranged for 4 August. All three unions representing British Rail clerical and conciliation grades (19 April - 150,000) rejected an offer of 5% from 6 September. The offer was subsequently withdrawn. The unions' claims have been referred to the Railways Staff National Tribunal under non-binding procedure. The claims are for increases in line with inflation and other benefits. An offer to London Transport rail supervisory and conciliation grades (19 April - 18,000) of 5% on basic rates and, if the offer is accepted, an undertaking to review relativities, holidays and bonus arrangements, with a 1 hour reduction in the working week has been referred to non-binding arbitration. The hearing is expected to begin 29 July. The Engineering and Maintenance and Ground Service groups of British Airways (1 January - 40,000), traditionally the most militant, have accepted offers of 11% from 1 October to last to 1 January 1984. Similar offers are to be made to the other groups. Industrial Civil Servants (1 July - 140,000) have submitted a claim for an increase in line with the cost-of-living, shorter hours and other benefits. Offer of just under 6% (1st year cost) including 1 hour reduction from 1 January 1983 and ½ day extra holiday is being put to union members without a recommendation. Response expected in mid-August. An offer of 5% on salary scales plus 0.25% for restructuring has been rejected by Local Authority APT & C grades (1 July - 590,000). The claim for an increase to protect living standards and a shorter week has been referred to arbitration. The hearing is unlikely to take place before September. In the National Health Service generally, the Secretary of State on 20 July reaffirmed that the global sum on offer was final. Co-ordinated industrial action is being taken by members of the TUC Health Service Committee unions. Support for the 3 day strike (19-21 July) was patchy and participation was no greater than in previous 1 day strikes. A further 5 days of intensified industrial action is proposed for 9-13 August. Two of the unions representing NHS nurses and midwives (1 April - 492,000) have rejected an offer of 6% for divisional nursing officers, 7.5% for grades up to and including senior nursing officer and 6% to 10.4% for tutorial grades - 7.5% overall on average earnings. The Royal College of Nurses is to ballot members without a recommendation. The result is expected on 26 August. The claim is for 12% increase in basic rates, reduced hours and extra holidays. NHS ancillaries (1 April - 211,000) have rejected an offer of 6% on rates (just under 6% on average earnings) and the staff side for the NHS admin and clerical

(1 April - 125,000) have refused to discuss a 6% offer. Extra funding has been made available for NHS Ambulancemen (1 April - 17,700) which will enable an offer of up to 6½% to be made - including about ½% for implementing a salaried structure, if found feasible. Management are to meet on 3 August to formulate proposals. All 3 NHS groups have presented similar claims to that for nurses. For the 1982/83 pay round, Coalmining manuals (1 November - 198,000) have lodged a claim for increases of £27.20 on rates (31% for surface workers) and other benefits.

8 In the PRIVATE SECTOR, British Sugar Corporation process workers (1 April - 4,000) have rejected an offer of 8% on basic rates, holiday bonuses and staff status, estimated to be worth 9.5% to 10% overall. With the craft workers accepting a similar offer the process workers may re-consider their position. In the Milk Industry (3 April - 94,500) an offer of about 7.4% on basic rates (8% on the wage bill) has twice been rejected following ballots of members. The unions will now re-submit the offer to members on 7 August with the alternative of industrial action. International Publishing Corporation clericals (1 April - 5,700) have submitted a claim for 20% on personal earnings or £30 per week on basic rates. An offer of a 2 year staged agreement of 8½% from 1 April 1982, with a further 8½% from 1 April 1983 may be put to union (NATSOPA) members soon. For the 1982/83 pay round Vauxhall Motors Ltd manuals (15 September - 15,600) have submitted a claim for £25 on basic rates, a shorter working week and staff conditions of service - estimated to be worth over 30%. Management are expected to reply at meetings on 25 and 26 August.

PRICES AND EARNINGS INDICES

PRICES

9 In June the year on year increase in retail prices was 9.2% compared with 9.5% in May.

EARNINGS

10 In May the year on year increase in average earnings for the whole economy was 10.3% compared with 10.2% in April. The underlying increase in May was 10% and this continues the steady downward trend in the underlying rate which began in January (11%

REAL DISPOSABLE INCOME

11 In April the real disposable income - taking account of the changes in earnings, prices and taxes - of a married man on average adult male earnings with a non-working wife and two children under 11 (with no other tax liabilities or allowances and not contracted out of the State Pension Scheme) remained at the same level as in April 1981.

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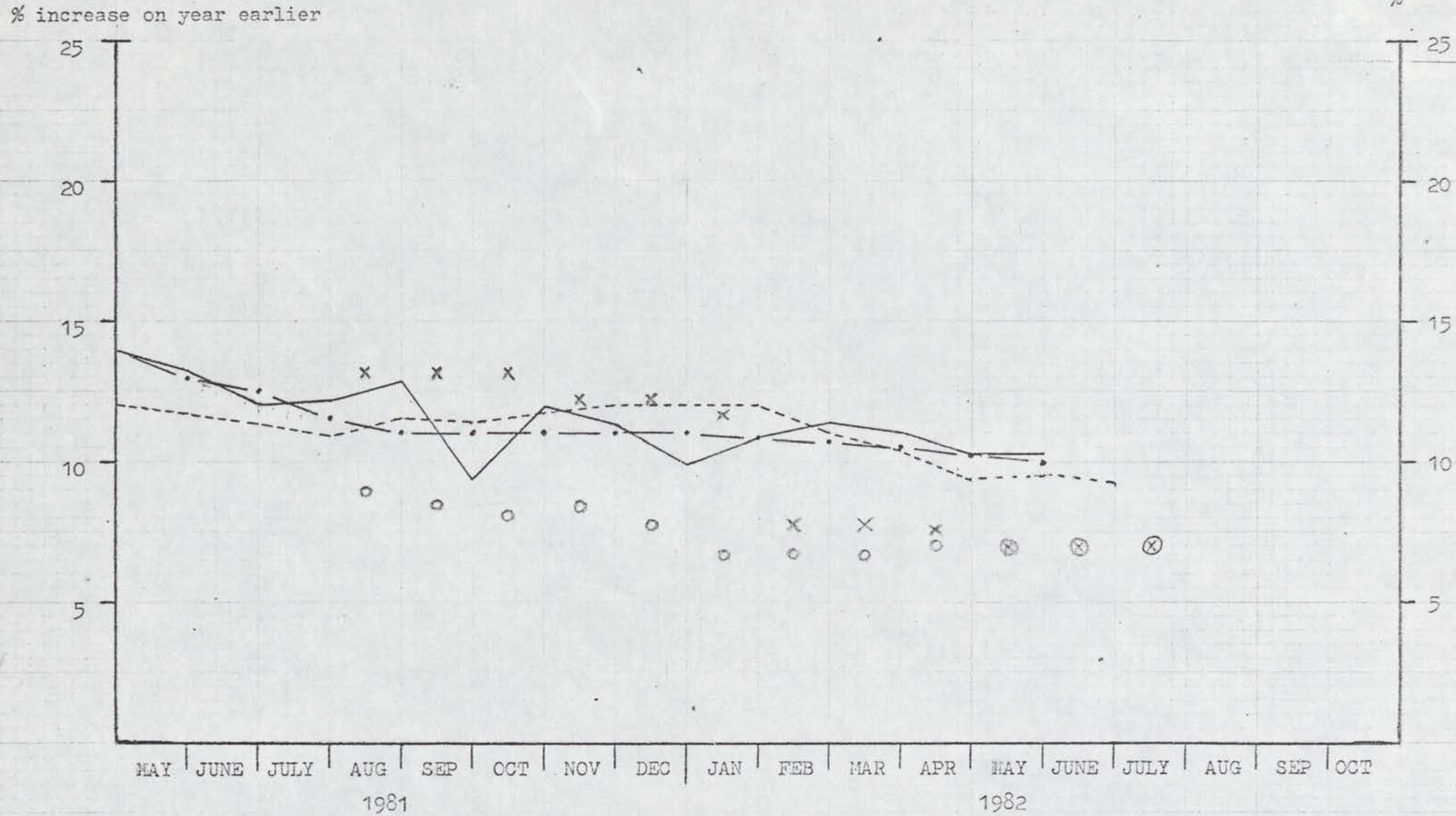
APPENDIX 4

TRENDS IN EARNINGS AND PRICES



- - - - Retail Price Index

——— Average Earnings Index (whole economy)

. ——— . Underlying rate of increase in earnings

× Public Sector Settlements)
○ Private Sector Settlements) Cumulative Average Increase in Earnings

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DISTRIBUTION OF SETTLEMENTS IN THE PRIVATE SECTOR BY LEVEL OF SETTLEMENT FROM 1 AUGUST 1981 — APPENDIX 2

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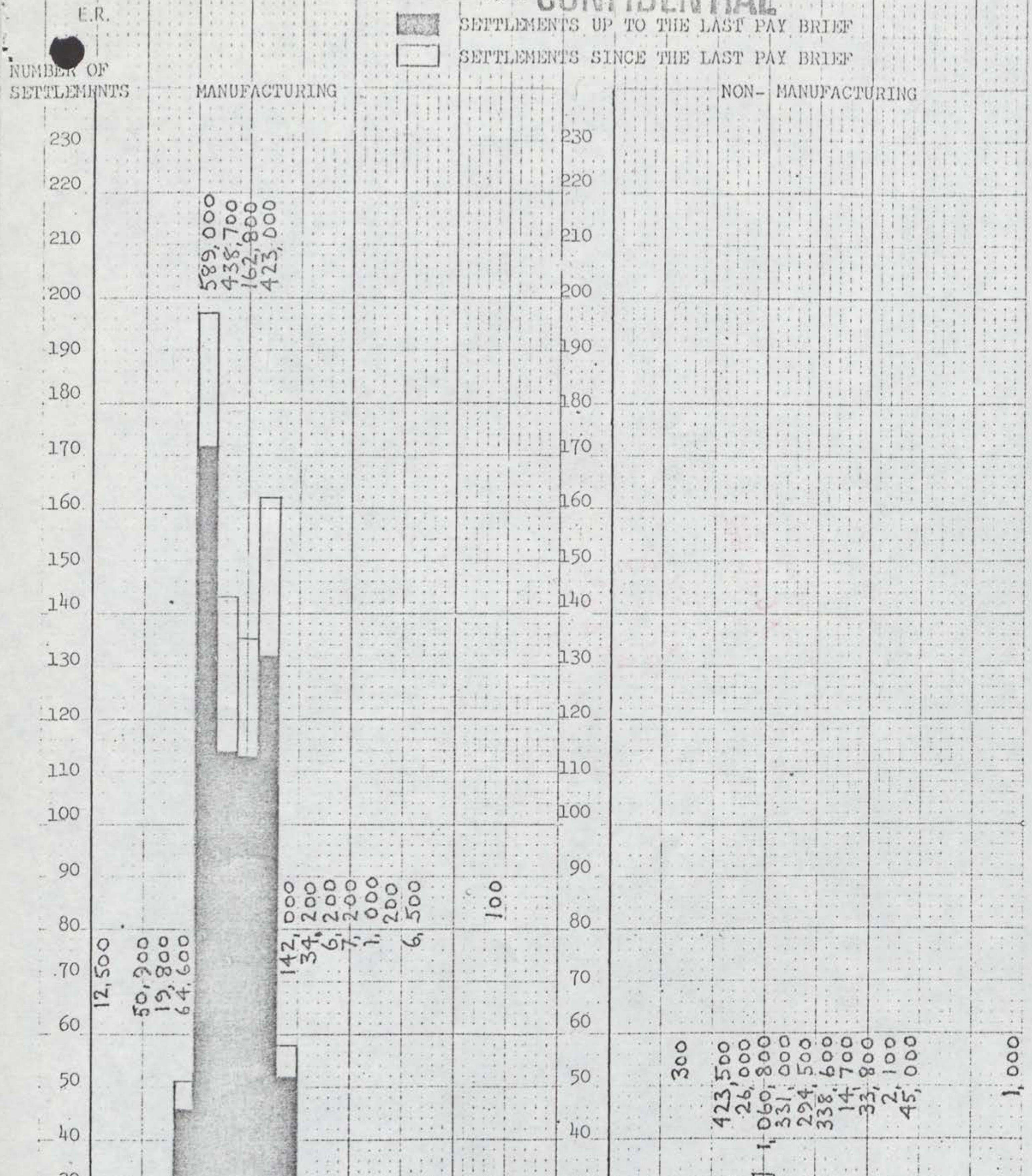
E.R.



NOTE - THE NUMBER OF WORKERS (TO THE NEAREST HUNDRED) INCLUDED IN THE SETTLEMENTS IS GIVEN ABOVE THE APPROPRIATE INDICATOR.

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MISC14(82)3rd.
29.7.82 Item 1

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1. REVIEW OF REGIONAL ECONOMIC POLICY

Econ Pol strat

The Group discussed an interim report from the Review of Regional Economic Policy, circulated under cover of a note by the Secretaries (MISC 14(82) 7). Also before the Group was a letter of 27 July from the Secretary of State for Education and Science to the Chancellor of the Exchequer.

The following were the main points made in discussion -

a. The main thrust of the review of regional economic policy clearly had to be related to the economic aspects of regional policy, but it was important that the review should also go on to consider the social aspects, including such matters as the incidence of deprivation in inner urban areas, and the political aspects, and that its final conclusions should be based on all three considerations. It was important that the review should not take it for granted that the economic case for a regional policy was well-established and widely accepted. It could be argued that regional policy had had an apparently beneficial impact on the local economies of the areas concerned only because the burden which the policy placed on the economy as a whole had had the effect of depressing economic activity elsewhere. This was an aspect which the review should consider carefully, and in framing its conclusions it was important that the review should, as was implied by the objective defined in paragraph 4 of MISC 14(82) 7, assess whether a regional economic policy could be constructed which demonstrably would not have an adverse impact on other regions or on the economy generally, while taking due account of social and political considerations

b. The interim report was right to draw attention to the fact that the institutional arrangements which applied in Scotland, Wales and Northern Ireland made it much easier there to develop coherent policies covering a number of issues than was the case in England. Of perhaps greater importance were the Scottish and Welsh Development Agencies, for which there was no comparable English counterpart, except in certain respects, for the Urban Development Corporations. The arrangements which applied in Scotland, Wales and Northern Ireland also allowed the respective Secretaries of State much greater freedom within their overall budgets to adjust the balance between the resources allocated to different areas than was the case in England. On the other hand, the point was made that because of the difference in scale no useful comparison could be drawn between the institutions appropriate for Scotland, Wales and Northern Ireland and those which were required in England.

THE CHANCELLOR OF THE EXCHEQUER, summing up the discussion, said that regional policy raised a number of fundamental questions which Ministers could only consider when the review had been completed. The Group was broadly content with the present thrust of the review as described in the interim report. The review should, however, take account of the points made in discussion and in the letter of 27 July from the Secretary of State for Education and Science, in the next phase of its work.

The Group -

Took note, with approval, of the Chancellor of the Exchequer's summing up of their discussion.

10 DOWNING STREET

Prime Minister.

Cabinet : 29 July.

You did not mention the proposed Policy Study Groups at Cabinet last week. You may wish to do so tomorrow.

[illegible]

28 vii

G.E.

Prime Minister

POLICY GROUPS

1. This is just to remind you that, at the end of today's Cabinet, you had in mind (without officials being there) to say a word to your Cabinet colleagues about the proposed Policy Study Groups.

2. After discussion with Cecil Parkinson you have asked Geoffrey Howe to assume overall responsibility for 10 (?) Policy Groups which will identify tasks for the next Conservative Administration and which will assist in the preparation of our Manifesto.

3. It is intended that these Policy Groups will report before the end of March 1983.

4. Geoffrey and Cecil have discussed the names of those who might become Chairman of each Policy Group. Geoffrey will want to discuss these names with Ministers concerned, before submitting a list of the Chairmen to you for your final approval. It will be up to the Chairman of each grpup, in conjunction with Geoffrey, to decide on the composition of each Study Group.

5. At present the subjects which are to be considered are:-

Unemployment
Enterprise
Family
Choice
Education
Cities
Why Work?
Europe
Nationalised Industries
Urban Transport

PPS/CHANCELLOR

file no TEB/CA/01

copied to:

Mr Salveson (for transmission to No.10)
PS/CST
PS/FST
PS/EST
PS/MST(C)
PS/MST(R)
PS/Home Secretary
PS/Lord Chancellor
PS/Foreign Secretary
PS/Secretary of State for Education and Science
PS/Lord President of the Council
PS/Secretary of State for Northern Ireland
PS/Secretary of State for Defence
PS/Minister of Agriculture, Fisheries and Food
PS/Secretary of State for Environment
PS/Secretary of State for Scotland
PS/Secretary of State for Wales
PS/Lord Privy Seal
PS/Secretary of State for Industry
PS/Secretary of State for Social Services
PS/Secretary of State for Trade
PS/Secretary of State for Energy
PS/Secretary of State for Transport
PS/Chancellor of the Duchy of Lancaster
PS/Secretary of State for Employment
PS/Paymaster General
and officials in HMT, Revenue Departments and other Departments in Whitehall

TREASURY WEEKLY BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 19 July, are sidelined. During the coming Parliamentary Recess, this Brief will be circulated approximately once a month instead of once a week. The next will therefore appear towards the end of August.

M M Deyes

M M DEYES

RA

R I G ALLEN

26 July 1982

EB Division
H M Treasury
01-233-3364

1/1

ECONOMIC BRIEF: CONTENTS SOURCES

A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

[Longer term economic policy objectives discussed by Chancellor in CPC lecture 3 July, and interview published FT 5 July.]

Main objectives are to achieve, over a period, a sustained improvement in the economy through reduction of inflation and promotion of enterprise and initiative. Reduction of inflation requires maintaining steady but not excessive downward pressure on monetary variables, and complementary fiscal policies. Improvement of supply side depends on restoration of flexible and competitive market economy and better incentives.

2. Fiscal boost desirable?

[CBI campaign for boost in autumn; media speculation about some Ministers favouring this].

Well aware that CBI are pressing for lower interest rates, lower National Insurance Surcharge, lower business rates for industry and £1 billion package of capital spending by 1984. However, as Chancellor of the Exchequer has made clear, we intend to continue with our present economic policies since these offer the only sure way to economic recovery. Understand a meeting between Chancellor and CBI is being arranged.

In view of present favourable monetary developments and fiscal policy on course for 1982-83, no reason to change Budget judgement at this stage. (See also D8, E8, J4, P6 on specific CBI points).

3. Economy still in recession?

Recession can be defined in different ways. What is quite clear is that a turning point was reached in first half of last year, and that a modest recovery has begun - and is projected to continue. Most encouraging pointer to sustained recovery is progress against inflation (12-monthly RPI increase down to 9.2 per cent in June.)

4. Government policies caused recession by deflating demand?

[Industrial production down 11 per cent; GDP (output) down 5 per cent; total final expenditure down 1 per cent since first half 1979.]

No. Output had fallen much more strongly than demand during the current recession. At same time import penetration has continued on rising trend. Essential problems of economy lie on 'supply side' - lack of competitiveness etc. Government policies aimed at helping industry to redress these problems by : deregulating, restoring incentives and implementing a financial strategy under which inflation and interest rates can fall over the medium term.

5. Economic recovery in doubt?

[GDP figures for Q1 1982 show little change on Q4 1981. Latest industrial production figures show production in March-May 3 per cent higher than underlying spring 1981 level.]

May industrial production figures the most encouraging for some time - though too much weight should not be put on single month's information. Prospect is for continuing though gradual recovery: increase in May index could be first tentative sign of this. (See also Section B).

6. What factors caused recent flattening out in recovery?

Recovery is slow and fragile.Number of factors - temporary rise in interest rates last summer/autumn; temporary pause in progress on reducing inflation; slower, and later than expected, world recovery - could all have weakened confidence and activity. But prospect is for continuing through gradual recovery.

7. Tighter than expected fiscal policy to blame?

[Latest published estimate of 1981-82 PSBR £8.8 billion compared with Budget time estimate of £10.6 billion. PSBR 1982-83 June quarter, seasonally adjusted, £1.6 billion.]

Fiscal policy stance 1982-83, so far as can be judged at this stage, consistent with Budget judgement. Firm control of Government borrowing essential to maintain downward pressure on interest rates; latter have fallen four percentage points since last autumn and this can only improve prospects for recovery. (See also Section H).

8. Implications of developments in the US?

Welcome Mr Volcker's remarks last week stressing need for greater fiscal tightness while reaffirming resolution to stick to monetary growth path around present target range for rest of 1982. Recent downwards movement in US rates and indications of slight pick-up in US economy also encouraging.

9. Recent interest rate/monetary developments?

For much of year UK interest rates falling in face of high US rates. Recent fall in latter should further improve prospects for ours. Steady reduction in UK rates made possible by satisfactory developments in main monetary indicators - monetary aggregates, exchange rate, and progress on inflation. Government borrowing also under control. Latest bank lending figures in May more encouraging but not yet sufficient to confirm improved trend.

10. Record unemployment levels?

[July figures show rise in UK (not seasonally adjusted) level to ~~3.06~~ 3.19 million; seasonally adjusted figure 2.93 million.]

See Section C.

11. Report on Budgetary Reform by the TCSC ("Armstrong" Report)

[Report published 17 June.]

Government considering its recommendations. We did draw attention in our evidence to the various practical and other constraints and also to the progress already made in the Armstrong direction under this Government (eg MTFS). Thinking carefully about recommendations to publish Green Book/PEWP in January etc. But cannot anticipate reply to the report.

BULL POINTS As at 26.7.82

(i) Activity. Recovery has begun: industrial and manufacturing output 2-3 per cent higher than spring 1981. [But NB, underlying level of output broadly flat for last 6 months.] Business opinion surveys, most recent major independent forecasts, and CSO's cyclical indicators see prospect of continuing, but gradual recovery.

(ii) Investment. Total fixed investment rose 4 per cent between 4Q 1981 and 1Q 1982. DOI investment intentions survey suggests 2 per cent rise in and services' investment in 1982. Suggests fall in investment all but over. Private sector investment, particularly in plant and machinery holding up well. Investment in plant and machinery in 1981 only slightly (1½ per cent) lower than 1980, 8 per cent higher than in 1H 1979.

(iii) Total housing starts up 37 per cent in five months to May 1982 on 1981 average.

(iv) Interest rates. Short-term rates have fallen 4 points since turn of year (now about 12 per cent). Process temporarily interrupted by Falklands dispute, now resumed. Recent falls reflect several factors:- single figure inflation, M1, £M3 and PSL2 developing favourably in relation to target, Government borrowing under control, exchange rate firm.

(v) Inflation. 12-monthly increase in RPI now in single figures - 9.2 per cent in June - more than halved since spring 1980 peak (21.9 per cent). Inflation in June lowest since December 1978, but trend now firmly downwards, not upwards as then. Manufacturers' output prices up just 8¾ per cent in year to June.

(vi) Costs.

- Increase in average earnings halved in 1980-81 pay round. Public sector pay in line. Further moderation in average level of settlements in current round. CBI pay databank for manufacturing settlements suggests average now around 7 per cent compared with 9 per cent in previous round.
- Little increase in manufacturers' unit wage and salary costs over last year - only 3 per cent up in year to 1Q 1982, below average of our major competitors and comparable to that of Germany and Japan.
- Manufacturers' input prices up just 5½ per cent in year to June.
- CBI April survey shows lowest degree of unit cost pressures for 15 years.

(vii) Manufacturing productivity. Output per head rose 12 per cent since end 1980. Output per head and output per hour 5 and 8 per cent higher than previous peak in 1H 1979.

(viii) Competitiveness. Cost competitiveness improved by 10-15 per cent during 1981 reflecting pay moderation, higher productivity and exchange rate fall, but remains 1/3 worse than in 1975.

(ix) Profits: Industrial and commercial companies gross trading profits (net of stock appreciation excluding North Sea) risen since 1Q 1981. In 1Q 1982 40 per cent higher than a year earlier. Recovery in profits from very low base: ICC's pre tax real rate of return just 2½ per cent in 1981.

(x) Exports have held up better than many feared following 50 per cent loss of competitiveness between 1975 and 1Q 1981. In 9 months to May 1982 non-oil exports (excluding erratics) slightly (about 1 per cent) higher than in 1980.

(xi) Special employment measures. Total provision for special employment schemes planned to reach £1½ billion in 1982-83, and to be £4 billion over current and next two financial years. 280,000 unemployed school-leavers last year found places on YOP by Christmas.

(xii) Overseas investment in UK: US direct investment in Britain amounted to stock of over $14 billion in 1980. Nearly 60 per cent of all US outward non-oil direct investment now takes place in EC - over half of that in UK. Half of all Japanese investment in the EC also comes to Britain.

(xiii) Overseas debt repayments. Official external debt reduced from over $22 billion in May 1979 to around $13.7 billion at end-May 1982.

Economic Briefing Division, HM Treasury, 01-233 3819/5809

B ECONOMIC ACTIVITY AND PROSPECTS

1. Recent output figures

[Underlying level of output broadly unchanged in six months to March. In part reflects impact of very severe weather and industrial disputes at turn of year. Latest figures show industrial (excluding North Sea) and manufacturing production rose some 1 and 1½ per cent respectively between April and May. But in latest three months underlying level of industrial production little changed from last autumn, 3 per cent higher than in spring of last year.]

Whilst recent output figures have been disappointing, prospect remains of continuing but gradual recovery. This view shared by CSO (index of leading indicators) and most outside forecasts (see 5-6 below). Whilst not too much should be made of one month's figures, May index of industrial production could be first tentative sign of this. Best help for sustained recovery is lower inflation and interest rates.

2. Other evidence of improvement in economy?

See Bull Points (following Section A).

3. Fall in CSO's shorter leading indicators suggests further hesitation in economy?

CSO index of shorter leading indicators based only on partial information. Care needed in interpretation month to month movements in this index. Longer leading indicators, outside forecasts, etc suggest continued gradual recovery.

4. Government's forecasts?

[FSBR forecast (9 March) assesses recovery to have begun. Main points are:

per cent increase on year earlier	1982	1983 H1
GDP	1½	2
Manufacturing output	3	2
Consumers expenditure	½	½
Investment (private sector and public corporation)	4¼	5
Exports	3½	3

Forecast expects some stockbuilding in 1982, Government expenditure flat.]

FSBR forecast sees prospect of some recovery continuing into 1983. (Last two Government assessments of economy were broadly correct). Healthy rise in private sector investment and exports. Inflation well into single figures (7½ per cent) by mid 1983. Further progress depends on continued moderation in domestic costs and restoration of competitiveness.

5. FSBR forecast now looks too optimistic?

[Recent press reports (eg FT 29 June) suggest latest internal Bank and Treasury forecasts put growth in 1982 less than FSBR forecast of 1½ per cent; inflation lower than FSBR forecast of 9 per cent. Several independent forecasts have recently revised down their forecasts of growth in 1982 marginally (from around 1½ per cent to about 1-1¼ per cent), largely reflecting the recent disappointing output figures. Despite this most groups have not altered their assessment of the strength of the recovery during the course of 1982 and in 1983 (NB but several groups forecast 2-2½ per cent growth in 1983 on the basis of some fiscal stimulus - a further cut in NIS or reductions in the standard rate of tax - in the 1983 Budget).]

Recent output figures are disappointing (though May more encouraging), but we have been doing rather better than expected on inflation. Clearly there are uncertainties and dangers, not least of which will be the international environment - though there are some recent more favourable indications of the beginning of recovery in the US. At present there is no reason to doubt the broad shape of gradual recovery as forecast at Budget time. Certainly the majority of outside forecasters do not doubt it.

6. Outside forecasts

[GDP profile in recent major assessments:

	NIESR (May)	LBS (June)	St James (Apr)	Phillips &Drew (July)	CEPG (April)	CBI (May)	OECD (July)	FSBR (March)
Per cent change 1982 on 1981	+1	+1	+1¼	+1½	-½	+1	+1¼	+1½]

Nearly all see prospect of continued recovery (as always, a range, with Cambridge forecast (CEPG) being the more pessimistic) and see single figure inflation through rest of 1982 - also in line with FSBR. [See also C3 (unemployment)).]

7. Latest CBI assessment?

[CBI Enquiry for June reports little change in order books or stocks since last April, and expectations of broadly flat output over next four months. S. Brittan (FT 5 July) suggests 'preliminary evidence' of more pessimistic July CBI enquiry and lower CBI forecast of growth.]

CBI June Enquiry disappointing: confirms recent indications of temporary flattening out in activity since last autumn. But encouraging signs of further moderation in inflationary expectations - necessary condition for improved growth. Latest CBI forecast believes modest recovery will resume in second half of this year, and predicts inflation rate below 8 per cent this autumn. [Results of July Survey expected 3 August.]

C LABOUR MARKET

[NB. Debate on mass unemployment (Opposition motion) 27 July.]

1. Recent unemployment figures and other labour market indicators?

NB Employment figures (May) to be released 29 July]

[UK seasonally adjusted unemployment, excluding school leavers, was 2,926,000 (12.3 per cent) in July. Total number UK registered unemployed rose by 129,000 to 3,191,000 (13.4 per cent). Highest post-war level, surpassing 3,071,000 recorded in January. Rise reflects usual large influx of school leavers (304,000 in July, up 76,000 on June) plus further seasonal rise of 35,000 and an underlying increase of 16,000. UK seasonally adjusted vacancies increased by 6,000 in July to 111,000. Recent unemployment/vacancy figures shown below:

	1980 Q4	1981 Q1	Q2	Q3	Q4	1982 Q1	Q2	Latest 3 months
Unemployment (UK adult sa)	105	77	62	51	33*	21*	30*	25*
Vacancies level	99	98	89	96	104	112	107	108

*After allowing for over 60's transferring to supplementary benefit.

Other labour market indicators (overtime, short-time, hours worked in manufacturing) also suggest some flattening out in improvement observed last year.]

Government deeply regrets both high level of unemployment and sharp increase in 'headline' total. But rise in first seven months this year only one third that in first seven months of 1981; vacancies in July around one-fifth higher than in Q2 1981.

[IF PRESSED Apparent general weakening of labour market indicators can be interpreted as consistent with hesitation in recovery since last autumn. Cannot draw implications from July figures about future levels of unemployment.]

2. Unemployment higher than in other countries?

[On standardised definitions in Q4 1981 UK unemployment was 12½ per cent compared with 7½ per cent OECD rate; a UK doubling compared with an OECD rise of almost one half since 1979.]

Whole world affected by rising unemployment. In our case we have additional self inflicted wounds of high pay awards and low productivity. Unemployment now rising very fast in some countries eg Germany.

3. Unemployment expected to continue rising rapidly?

[Speculation recorded total may rise to around 3¼ million in August reflecting seasonal rise of about 45,000 along with likely increase from upward underlying trend. No significant fall in 'headline' total expected until October.]

Unemployment forecasts uncertain; independent forecasters encompass differing views for 1983 - several projecting stabilisation, some [a slight] decline. Rise in unemployment so far this year less than half that of a year ago. Employment situation will benefit from some further recovery in activity this year (see B1). [IF PRESSED: Government has not sought to deny 3¼ million a likely figure this summer.]

4. What is Government's own forecast of unemployment?

[FT 23 July alleges Treasury sources expect 4 million will be reached.]

Government does not publish such a forecast. Quite wrong to extrapolate past unemployment increases when trend has been improving. However it was assumed for expenditure planning purposes in Cmnd 8494 that unemployment (GB, excluding school leavers) would average 2.9 million in 1982-83, and for rest of survey period. Current (July) figure is ~~3.01~~ 2.82 million and, though this is still rising, it is not inconsistent with PEWP figure.

5. Employment continuing to fall?

[Total employment declined 2.1 million (9 per cent) between mid 1979 and end 1981.]
Decline in H2 1981 about two-thirds that in H1. Best help for permanent jobs is sustainable recovery.

6. Recent productivity gains inimical to higher employment/lower unemployment?

[Output per head in manufacturing up 12 per cent since end-1980.]

This may be true in the short run. But in the longer term, as experience in UK and many other countries clearly demonstrates, higher productivity essential for growth and employment opportunities.

7. Higher rather than lower wage increases needed to stimulate higher productivity

[Discussion of productivity by D Blake The Times 21 July].

Causation is wrong: higher productivity should precede higher wages. Small wage increases, taking into account productivity of workforce, the need to rebuild profits, and the performance of competitors, provide the best prospects for more productive sustainable jobs.

8. What is Government doing to provide more jobs?

Government pursuing sensible fiscal and monetary policies to curb inflation and creating conditions for enterprise - only measures that will ensure sustainable increase in employment. Nevertheless Government expanding schemes to meet special difficulties and improve training - eg plan to spend £1½ billion in cash on 1982-83 (40 per cent more than in 1981-82) on special employment and training measures; new Youth Training Scheme costing £1 billion a year from 1983-84; and MSC working on proposed new community work scheme announced in Budget Speech.

9. <u>MSC Task Group proposals on youth training</u>?

Government has accepted Task Group's scheme as immense step towards setting standards and systems of training for young people as good as those anywhere overseas.

D TAXATION

1. Burden of taxation

[Total taxation (i.e including for example income tax, indirect taxes, corporation tax, rates and NIC) in 1978-79 was 34½ per cent of GDP (at market prices), 36 per cent in 1979-80, 37½ per cent 1980-81. It is forecast to be 40½ per cent in 1981-82 and 39½ per cent in 1982-83. Corresponding figures excluding NICs are: 1978-79 28½ per cent, 1979-80 30 per cent, 1980-81 31½ per cent, 1981-82 34 per cent, 1982-83 33 per cent.]

This has inevitably increased during a time when the recession has been adding to public spending. Changes proposed in Budget will reduce total burden in 1982-83 compared with 1981-82. [NB: Not true of burden on persons.]

2. Burden of tax has risen for most households/real weekly net income fallen since 1979?

[Parliamentary Written Answer 7 July col 111-2 showed that real weekly net income has fallen for manual workers.

Slow growth of output and difficulty of restraining public expenditure have inevitably meant higher tax burden. But aggregate real personal income after direct taxes still higher than under last Government [although not true of all sections of population]. And more honest to raise taxes to finance necessary higher expenditure than to increase borrowing, with the increased interest rates and inflation that would bring.

3. Burden has fallen for the rich?

Abolition of absurdly high marginal rates and raising of thresholds in 1979 essential to remove disincentives. Reimposition of an 83 per cent top rate of income tax would finance a reduction of less than one quarter of 1p in the basic rate.

4. Burden has risen most for the poor?

Proportion of income paid in income tax and NICs will fall in 1982-83 for lowest paid taxpayers. And low paid with children entitled to benefits such as FIS.

5. Personal tax burden increased by last Budget - when NICs taken into account?

The real increase in personal allowances and tax thresholds reduced income tax as a percentage of income at all levels of incomes. Those over pension age who are taxpayers benefited from income tax changes and were unaffected by NIC rise - and, of course, State pensions are being uprated from November. [IF PRESSED: In immediate cash terms, increases in personal allowances etc compensated for NIC increase for majority of taxpayers. Taking into account increased earnings in 1982-83 (for example using the Government Actuary's 7½ per cent assumption) percentage of income paid in income tax plus NIC rose for most people, but fell for the lowest paid, ie below about ½ average earnings (married) and below about 1/3 average earnings (single).]

6. No improvement in incentives?

There will be 1.2 million fewer taxpayers in 1982-83 than if allowances had remained at 1981-82 levels, and ½ million fewer higher rate taxpayers. For the substantial number taken out of tax or with reduced marginal rates, incentives will improve.

7. Government action needed to help those in poverty/unemployment traps?

[CST appear once before TCSC Sub-Committee Wednesday 21 July].

CST emphasised that problem of traps was serious, and that best way of solving it was by raising tax thresholds - but this must depend on economic growth. He stressed need to control and reduce public spending.

8. ~~Further~~ cut in NIS?

[Called for by CBI].

Reduction due to come into operation on 2 August (equivalent one percentage point cut for whole of 1982-83) will benefit private sector by £640 million in 1982-83 - on top of decisions to shield employers from increases in National Insurance contribution rates over last 2 years. Acknowledge desirability of further reductions. But expensive. Right time to consider this is autumn.

9. Excise duties increases inflationary/harmful to industries

Increases in excise duties as a whole slightly less than broadly compensate for past year's inflation. Variations between duties take account of industrial considerations e.g supplementary increase last July on tobacco/Scotch whisky industry/help for industry by smaller increases on e.g derv - mainly used by industry.

10. How has Government used fiscal incentives to encourage wider share-ownership?

Total of over 460 profit-sharing and share option schemes now approved by Inland Revenue. Compares with less than 30 in May 1979. Reflects liberalisation and extension of arrangements to promote profit-sharing and share-option schemes contained in 1980 Finance Act. Further fiscal encouragement on way from 1982 Finance Bill.

E PUBLIC EXPENDITURE AND FINANCE

[Public Expenditure White Paper (Cmnd 8494) published 9 March. Gives planning totals of £115.2 billion in 1982-83, £121.1 in 1983-84 and £128.4 in 1984-85. About £5 billion higher than last White Paper in 1982-83 and £7 billion in 1983-84. Net effect of changes announced in Budget is to reduce totals to £114.9 billion, £120.4 billion and £127.6 billion].

1. Public expenditure too high?

Spending in 1982-83 planned to be about £5 billion (4½ per cent) lower than intended by last Government even if higher than planned when this Government first took office. Decisions to increase spending represent flexible but prudent response to changed circumstances e.g additional spending to help young unemployed. Drive to improve management in public sector and reduce administration expenses continues.

2. Ratio of public spending to GDP is getting back to peak levels of mid 1970's?

Ratios in 1980-81 (43 per cent) and 1981-82 (44½ per cent forecast) remain below level of 1974-75 and 1975-76 (46 per cent in both years). Rise in ratio in 1981-82 mainly reflects higher expenditure on social security at a time when real GDP falling. Ratio expected to fall in next few years: assumptions in MTFS would mean figures of 44½ per cent in 1982-83, 42½ per cent in 1983-84 and 41 per cent in 1984-85. Reflects assumed GDP growth and curbing of public expenditure.

3. Ratio to GDP must grow unless big improvement in economic performance?

[David Blake article The Times 30 June on official study of long-term public expenditure.]

An official study prepared on long-term public expenditure as part of normal, and continuing, process of controlling public expenditure and monitoring longer term effects. Has yet to be considered by Government. But report may point too pessimistic picture of level of public expenditure in long term. Government's policies are designed to secure real and lasting improvement in our economic performance; evidence that they are succeeding. Inflation is already coming down faster than expected at budget time.

4. Study on longer term public expenditure concludes that unemployment could stay at 3 million for rest of decade?

This is not a conclusion of the study. Report does not make any forecast of future unemployment - it uses a purely hypothetical assumption, intended to show what might happen to public expenditure if the worst is assumed about unemployment.

5. Increase spending in recession?

No good trying to spend way out of recession. Any benefits would be short-term. If increased spending not financed responsibly, would soon lead to more inflation. If financed prudently, would lead to higher interest rates and/or higher taxes. We are responding, within limits of prudence, to needs of current circumstances.

6. Spending Ministers seeking extra £5,000 million public expenditure in 1983-84?/Treasury once again seeking cuts in public expenditure?

Bids for additional expenditure have been put forward in usual way as part of annual public expenditure survey. Ministers collectively will have to decide which are to be allowed and, depending on size of any increase, to what extent the increase should be met by savings elsewhere.

7. Not enough "productive" public investment/needs being jeopardised?

Government is not cutting "productive" investment. Partly question of definition - within figures for capital expenditure totals, council house sales count as a negative item and defence procurement counts as current expenditure. Furthermore, nationalised industries are financing an increasing proportion of investment out of own resources. Also since mid-1970's needs have been declined; future standards and public amenities will not be jeopardised.

8. More capital projects in public sector to help private industry?

[Current CBI campaign].

Government prepared to give priority to worthwhile capital projects within overall spending totals. However, no question of an artificial and inflationary stimulus to demand a new projects must be considered on their merits. Nationalised industries investment in 1982-83 planned to be about a quarter higher than in previous year. Real answer: to provide private sector with prospect of higher rates of return on investment by continuing policies to lower interest rates and increase incentives.

9. Cash planning means concentration on first year, not enough on services in later years?

Government recognise case for medium-term planning. But planning must be related to availability of finance as well as prospective real resources. Cannot accept unconditional commitment to forward plans for services. Volume plans formerly had to be cut when conflicted with financial constraints - e.g after IMF intervention in 1976.

10. End-year flexibility?

Possibility of end year flexibility is being looked at again. There could be some managerial advantages in such a scheme. But we also have to consider question of cost.

11. Cut public sector pay bill/administrative costs of central government?

Only one third of current expenditure is on wages and salaries and much of that is for nurses, teachers, members of armed forces, police and so on. Provision for public service pay increases 1982-83 limited to 4 per cent. Administrative costs are not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain drive for more efficient management throughout public sector.

12. What allowance will Government make for pay increase in public services next year?

Government attaches great important to realistic wage settlements next year, in both public and private sectors. Provision for public service pay will be made from within cash plans for 1983-84. (See also K8.)

13. Will Government's operation of cash limits for civil service [and NHS] pay change as result of Megaw Inquiry Report?

Government is committed to policy of using cash limits to control public expenditure. We will consider and discuss the implications of Megaw report in due course.

LOCAL GOVERNMENT

14. Overspending in 1982-83? Government response?

Local authorities are budgeting to spend some £1½ billion above Government's plans (£1¼ billion in England, £200 million in Scotland, £60 million in Wales). Government cannot ignore this large planned overspend. In ENGLAND, Environment Secretary intends to implement scheme for grant abatement announced last year and is considering further across-the-board grant cut. Secretary of State for SCOTLAND is seeking to reduce grants of Lothian Regional Council (by £45 million) and Stirling District Council (by £1½ million). Secretary of State for WALES has announced his intention to withhold grant. He also asked Welsh local authorities to submit revised budgets. Amount of grant to be withheld will be determined in light of these. Local authorities have only themselves to blame for these grant penalties.

15. Large rate increases this year are Government's fault?

Not at all. If local authorities had sought to spend in line with Government's plans, rate increases should be very low. Where they are high, it is because local authorities have chosen to overspend.

16. Local government finance 1983-84?

Refer to announcement by Environment Secretary Tuesday 27 July.

17. Lower rates for industry?

See P4.

18. Government's plans imply enormous job losses?

Not necessarily. Government's plans for local authority expenditure are realistic and achievable. Local authorities could do a lot to help themselves by moderating pay and improving efficiency.

19. Green Paper on Domestic Rating System: Government response?

Government is considering carefully all representations received. We wish to produce proposals for a scheme that will remedy shortcomings of present system while commanding wide support.

F CIVIL SERVICE STAFFING AND PAY

1. Civil Service too big/does too much/is over staffed?

Since Government came to office, Civil Service has been reduced by 9 per cent to 666,400. This is smallest since 1966. Results from reduction in functions, privatisation and improvements in efficiency. On course to achieve aim of having Civil Service of 630,000 by April 1984. This is 102,000 fewer staff in post than in April 1979, and will mean smallest Civil Service since end of Second World war.

2. Civil service pay: non-industrial civil servants

Civil Service Arbitration Tribunal awarded pay increases ranging from 4.75 per cent to 6.25 per cent - worth 5.9 per cent overall - and increases in annual leave. Government accepted award which is being implemented. Increases (announced 12 May) for higher civil service (under-secretary and above) were larger; they were decided in light of recommendations of Top Salaries Review Body. Cash limits and manpower targets not being adjusted. (See also Section K).

3. Megaw Inquiry

Report of Megaw Inquiry into arrangements for deciding civil service pay in future has now been published (Cmnd 8590). Report contains number of important recommendations which are now being considered. (See also E12-13 and K7-8.)

4. Civil Service pay: industrials

[Settlement date 1 July 1982]

On 23 July Government made offer to industrial civil servants estimated to cost about 6 per cent in pay year from 1 July 1982. Cost would be met from within existing cash provision.

5. Scott Report/Public sector pensions?

See K 16.

G SOCIAL SECURITY

1. Restore abatement of Unemployment Benefit?

[Uprating in November 1980 was abated by 5 per cent; this foreshadowed in Budget Speech announcing plans to bring UB into tax.]

Abatement of unemployment benefit has been extensively discussed in House of Commons. We undertook to review when the benefit was brought into tax. We did not, however, commit ourselves to restoration of the abatement. We have undertaken the promised review, and have decided that we cannot afford to restore the abatement.

2. But abatement was a proxy for tax?

Always made clear when decision to abate was announced that it was not solely a proxy for tax but also part of a public expenditure savings package, and a measure likely to improve work incentives.

3. Cost of restoration substantially less than tax revenue?

[Cost of restoration £20 million first year, £60 million full year. Revenue from taxation now estimated at £650 million.]

Wrong in principle to hypothecate money from taxing benefits. But if MPs want to make such a comparison I would draw attention to cost of restoring shortfall in November 1981 uprating - £525 million in full year - this and other increases in social security expenditure more than accounts for the additional revenue.

4. Abatement hits at poorest section of the community?

Only one quarter of the unemployed are solely dependent on UB and hence affected by the abatement. All those affected will have been unemployed for no more than a year and are primarily single people or childless married couples.

5. Increase in PSBR from deficit on National Insurance Fund?

[Government Actuary's Report on Benefit upratings, published 29 June, showed substantially increased deficits on NI Fund for 1981-82 (up from £153 million to £1,045 million) and 1982-83 (up from £94 million to £350 million). These figures distorted by CS strike; underlying deficits nearer £600 million in 1981-82 and £800 million in 1982-83.]

For 1981-82, the published outturn already takes this into account. For 1982-83, revised deficit is one of a number of factors which will affect PSBR but is not, in itself, a sufficient reason to change our overall assessment of PSBR prospects.

6. Increase in National Insurance contributions because of NI Fund deficit?

The higher deficits for earlier years do not make inevitable an increase in contribution rates for 1983-84. A decision on the level of these rates will not be made until late Autumn and will take account of forecasts made at that time of Fund income and expenditure for 1983-84.

7. Burden of State pension scheme too high?

[Government Actuary's Department Quinquennial Review of National Insurance Fund, published Wednesday 21 July, analyses possible future (up to forty years) cost of contributory benefits and levels of contributions needed to pay for them. Most important factor is increasing expenditure on earnings-related pension. Conclusions depend on assumptions about growth in earnings, prices, unemployment etc over period, but on certain assumptions contributions could change from present relationship to earnings - 16.5 per cent combined employees' and employers' contributions - to 15.4 per cent by 1985-86, but rise to 16.7 per cent by 2005-6 and 21.9 per cent by 2025-6.]

Government Actuary's conclusions not firm predictions but illustrations of possible future burden on certain assumptions. We shall be considering report carefully before reaching any conclusion. In meantime DHSS will be consulting widely with interested organisations and would welcome comments by end of this year.

8. Merger of income tax and national insurance planned?

Government's written evidence to TCSC did not suggest such a merger. Committee asked about feasibility of merging the two systems, and the evidence gave an illustration of what a joint system would look like.

9. Death grant - increase to realistic level?

[Consultative document about death grant published 3 March, comments asked for by 30 July.]

Social Services Secretary would still welcome comments on consultative document on death grant published in Spring. As that made clear, aim is to redistribute in more sensible fashion resources now devoted to death grant - cannot afford to add to those resources.

H FISCAL POLICY AND THE PSBR

1. Progress on Fiscal Policy?

[Aim is to achieve reduction in PSBR as percentage of GDP over run of years, so as to achieve lower inflation and interest rates.]

Have made progress; Government has succeeded in reducing PSBR as percentage of GDP, and further reduction is projected. Inflation is now lower than, and interest rates are as low as have been, at any time in last three years.

[IF PRESSED: Real interest rates still uncomfortably high here and overseas; serves to emphasise need to reduce borrowing over medium term.]

2. How does UK fiscal stance compare with other countries?

Many countries reducing borrowing; UK budget deficit now well below average of OECD countries. US experience shows that failure to bring fiscal and monetary policy into line can put excessive pressure on interest rates.

3. How much was PSBR undershoot in 1981-82 and why?

[PSBR for last year turned out £1.8 billion lower than estimate of £10½ billion given in 1982-83 FSBR.]

Information is still incomplete, but higher debt interest receipts, better receipts from Inland Revenue and lower 'supply' issues contributed to the undershoot. Some factors went the other way - deficit on National Insurance Fund for instance turned out higher than expected. The civil service dispute added considerably to uncertainties at time of Budget, and was main factor in most of the errors.

4. 1981-82 undershoot shows fiscal policy too tight?

Last year's undershoot probably does mean fiscal policy somewhat tighter than planned, but must examine strategy as a whole. Firm control of Government borrowing one factor responsible for fall in interest rates (four percentage points) since autumn.

5. Why treat PSBR as crucial statistic when prone to very substantial forecasting error?

[Margins of error are wide: plus or minus £4 billion.]

Although forecasting PSBR is hazardous, this in no way diminishes importance of achieving better balance between Government spending and income. Recognised by all Governments, whatever the difficulties of forecasting.

6. Isn't 1982-83 PSBR likely to undershoot too?

[Budget forecast for 1982-83 was £9.5 billion. PSBR for June quarter £2.8 billion (£1.6 billion seasonally adjusted) - broadly consistent with forecast for 1982-83 as a whole.]

Rash to jump to conclusions about this year's PSBR. PSBR turned out higher than expected in 1979-80 and 1980-81. Last year, many people expeected this to be repeated in 1981-82. PSBR figures for April-June quarter consistent with Budget forecast.

[IF PRESSED: Some of reasons for undershoot last year may imply lower PSBR this year (eg higher tax receipts). But other factors (pressure on Contingency Reserve from Falkland spending, changes in estimated NI contributions) could go other way. Unwise therefore to conclude £9½ billion forecast for this year's PSBR particularly high. Risks in both directions.]

7. Implications of PSBR outturn in April-June for PSBR in 1982-83?

[PSBR for April-June inclusive (published 22 July) was £2.8 billion; April-June 1981 was £7.8 billion.]

Last year's figures severely distorted by Civil Service dispute so comparisons can be seriously misleading. PSBR in June quarter consistent with Budget forecast, so far as can be judged at this stage.

8. Seasonally adjusted, PSBR in April-June too low?

[PSBR, seasonally adjusted, for April-June inclusive was £1.6 billion. Do not fall into trap of multiplying this figure by 4 to get PSBR for 1982-83].

No. Quite wrong to multiply figure by 4 to get 'revised PSBR' estimate for 1982-83. Seasonal adjustment only removes effect of factors occurring at same time each year. Many irregular influences remain e.g tax receipts collected in June quarter delayed from effects of last year's civil service dispute.

9. If PSBR higher in 1982-83 than in 1981-82 won't interest rates have to rise?

As percentage of GDP, outturn for 1981-82 is more or less equal to the forecast for 1982-83 i.e around 3½ per cent. The 1982-83 forecast is still a low figure both by comparison with deficits abroad and in relation to size of deficits over past decade.

10. Implications of lower than planned public expenditure in 1981-82 for 1982-83?

Detailed public expenditure outturn information for 1981-82 will not be available until later this month. Until then, implications for 1982-83 uncertain. [IF PRESSED: It is estimated, on very incomplete information, that the planning total will fall from £105.2 billion in the FSBR to below £105 billion and that ratio of public expenditure to GDP will fall from 45 per cent to 44½ per cent].

11. Unadjusted PSBR misleading guide to fiscal action?

Cyclically-adjusted PSBR may have some merit as indicator but poor guide to fiscal policy. It is actual Government expenditure and revenue that determines the level of interest rates to be financed and influences level of aggregate demand.

12. Inflation-adjusted or 'real' PSBR in surplus - isn't fiscal policy too tight?

['Real' PSBR subtracts from actual PSBR erosion by inflation of real value of Government debt. Calculations by Bank of England and others produce a surplus 'real' PSBR in most years since the 60's].

Policy of this Government is to fight inflation, not to accommodate it. If 'inflation-adjusted PSBR' is in surplus, this calls for cut in inflation, not expansion of actual PSBR.

13. Parliamentary control over borrowing?

[EST at Select Committee on Procedure 29 June].

Welcome interest shown in Procedure Committee. Will continue to provide information to help Parliament reach view on what is happening. Open mind to consider any suggestions from Committee about form of information. [IF PRESSED: Propositions for some form of control a different matter: could complicate policy decisions on spending and revenue].

J MONETARY AND FINANCIAL POLICY

[N.B 26 July announcement about hire purchase requirements].

1. Monetary growth in 1981-82

[Figures for banking June (fourth month of target period) indicated that £M3, M1 and PSL2 grew by 2.0, 0.8 and 0.6 per cent respectively (seasonally adjusted). These changes bring annual rates of growth in 1982-83 target period to 9½, 6¼ and 9 per cent respectively, compared with target range of 8-12 per cent.]

Too early to judge outturn over target period as a whole, but recent figures are again encouraging. Figures point to continuing steady downward pressure on inflation.

2. Monetary conditions too tight?

Exchange rate, money GDP and monetary aggregates suggest financial conditions have been moderately restrictive whilst allowing falls in interest rates. Growth of bank lending is still strong, however; we do not believe that monetary conditions have been too restrictive.

3. Bank lending

Banking June figure is again lower indicating that growth may be slowing. But although part at least of recent growth is in substitution for building society lending and other forms of consumer credit, to the extent that it is additional it may add to inflationary pressures; so must continue to proceed cautiously on interest rates.

4. Interest rates still too high?

[CBI call for Government 'action']

Interest rates have come down significantly over past 6 months, and bank base rates have now fallen four percentage points since their peak last autumn. Of course we would like to see rates lower still; but we must proceed cautiously if we are not to jeopardise progress made to date in reducing inflation. Lower inflation offers best prospect for sustainable lower levels of interest rates.

5. Bank of England and Treasury in conflict, one wanting hold up exchange rate, the other to get interest rates down?

Bank's operations in the money market represent an agreed course of action.

6. Will high and unstable US rates affect UK rates?

US rates not sole determinant of UK rates, but high US rates certainly an adverse development and in September were a key factor in driving our rates up. Recently, however, sterling has remained reasonably firm, probably helped by improved prospects for wage round, and good trade figures. UK interest rates have eased this year against US trend; but we cannot insulate ourselves from difficult international background. (See also T10.)

7. Outlook for mortgage rates?

Recent developments encouraging but canot anticipate decisions of Building Societies Association

8. Monetary targets discredited?

Monetary targets have important role in defining medium term direction of policy. But short term movements in monetary aggregates not always reliable guide to monetary conditions. Policy decisions based on assessment of all available evidence.

9. Why have you been 'over-funding' and providing large-scale money market assistance?

[Latest Bank of England Quarterly Bulletin carried small feature explaining process.]

The rapid growth of bank lending (much of which relates to structural changes) creates problems for conduct of monetary policy. By selling long-term Government debt on larger scale outside banking system it has been possible to contain growth of money which the lending would otherwise have produced. If we had not intervened to relieve resulting shortages in money markets, the banks would have been forced to bid for deposits, raising short-term interest rates to levels which, according to other indicators of monetary conditions, were not justified.

25 JUNE MONETARY PACKAGE

10. Will tax change on zeros and deep discounts reopen corporate bond market? Surely the tax treatment remains unfavourable?

Too soon to say how companies will respond. The tax treatment clearly is not as favourable as some would want - but to allow companies to offset discount against tax and investors to be taxed as on capital gains, would introduce unacceptable asymmetry. Announcement represents important step forward - and we have said we are looking at an accruals based system on US model. Best hope for revival of corporate bond market of course remains lower inflation and lower interest rates. We are on course for both.

11. Doesn't the amendment to the National Loans Act remove the only constraint on the Bank's purchases of bills? Will it mean even huger purchases in the future?

National Loans Act amendment is designed to remove essentially fortuitous constraint on Government's ability to borrow. Existing law could have prevented Government funding its borrowing requirement. Does not necessarily mean large increases in bill purchases. Scale of money market assistance will depend on future course of bank lending etc. Other measures designed to ensure it does not grow so rapidly - encouragement of corporate bond market and variable rate lending to local authorities.

12. Doesn't high Government funding and money market assistance merely mean higher long rates and lower short rates? Isn't it this that prevents companies borrowing long?

Level of interest rates depends essentially on scale of Government borrowing rather than its form. We have succeeded in reducing PSBR and Government's call on financial markets; which has paved way for lower interest rates. Lower funding and higher short term finance would mean higher money supply, which would cause expectations of higher inflation and raise interest rates.

13. Government simply acquiescing in and accommodating rapid growth of bank lending?

Growth in bank lending is response to high inflation and structural changes following ending of direct controls - which were proven to have little effect. Tax and borrowing measures announced 25 June will have some impact on rate of growth but if impact of bank lending on money supply minimised no cause for alarm about inflationary prospects.

K PRICES AND EARNINGS

PRICES

1. Inflation lower than under previous Government?

[Average year-on-year rate of inflation between February 1974 and May 1979 was 15.4 per cent; average level of inflation since May 1979 has been 14.0 per cent.]

Year-on-year rate of inflation was 10.3 per cent and rising when previous Government left office in May 1979. Now (June 1982) 9.2 per cent and falling. On present forecasts, we will be first Government for quarter of a century to successfully reduce the average rate of inflation during its term of office.

2. How low inflation by end 1982?

[Budget time forecast Q4 1981 to Q4 1982 9 per cent and Q2 1982 to Q2 1983 7½ per cent.]

No new forecast to offer at this stage, but the year-on-year rate of inflation was already 9.2 per cent in June. In the coming months, moderation in unit labour costs and competitive pressures on firms to limit price rises suggest Budget-time forecast of 9 per cent by this November could well be bettered.

3. Inflation still not as low as competitors?

[UK inflation 9.5 per cent in May, compared with 6.7 per cent in US, 5.3 per cent in West Germany, and 2.8 per cent in Japan.]

UK inflation now lower than Western European (OECD Europe) average, and well below many countries - such as France and Italy. Still some way to go to match US, West Germany and Japan, but good progress being made in right direction.

4. Long term inflation objective?

[Chancellor's speech in Cambridge 3 July]

Recent developments encouraging. But inflation rate still higher than some competitors e.g Germany. Must not let up. Have always made it clear that price stability not unattainable.

5. Movement in tax and prices index?

[Increase in TPI over 12 months to June 9.4 per cent, compared with RPI increase of 9.2 per cent].

Fact that TPI has been increasing faster than RPI reflects measures taken to restrain Government borrowing, which is essential if inflation is to be controlled. But following recent Budget, difference is now small.

6. Nationalised industry prices

[Increase over 12 months to June 14.0 per cent, compared with RPI increase of 9.2 per cent].

Gap between nationalised industry price increases and RPI due in large measure to cumulative effect of years of artificial price restraint. World oil price rises of 1979 and 1980 have also played important part. Increases regrettable, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so, but sustained improvement only possible if industries succeed in holding down current costs, particularly pay. (See also R7.).

PAY

7. Zero pay norm in next round?

[Chancellor's Speech 6 July.]

This Government is not in the business of setting pay norms. Individual pay bargains need to take realistic account of the particular circumstances, and of the fact that the greater the restraint, the better prospect for jobs. No right to automatic pay increases every year.

8. Will there be a new pay factor for public expenditure?

Not yet been decided whether plans for next financial year will be calculated on basis of an explicit 'pay factor'. However, Government finances large proportion of country's pay bill; will have to ensure its own actions are compatible with overall needs of economy.

9. What pay settlements does Government now want?

Low enough to be consistent with improved job prospects in the industry concerned. Certainly lower than in the past year.

10. What has been average over past year/pay round?

Average has been in single figures, and moving downwards, in each of past two years. We need a substantial further reduction, with really low settlements, and thus a better outlook for jobs, in the year ahead.

11. Government exhortations on pay imply aiming to cut living standards?

[Latest RPDI figures published 1 July show Q1 level much same as in Qs 2 and 3 1981 (Q4 discounted as 'erratically low'), and lower than Q1 1981.]

Lower pay settlements have not in fact cut real earnings in either of the past two years; prices have also come down. This fact casts doubt on the wilder claims about the effect of pay moderation on living standards.

12. Incomes Policy

Proposals for incomes policies, including recent refinements, do not avoid many of the familiar problems of norms, administrative costs, and interference with market forces. Experience gives no encouragement to the idea that incomes policy can be made to work on a permanent basis. They always succumb to the distortions they create.

13. NHS pay

Social Services Secretary announced 23 June that a further £90 million should be made available for increased pay offer in Health Service. This would allow increase in average pay for nurses of 7½ per cent, ambulance men and hospital pharmacists 6½ per cent, and other staff 6 per cent. Government believes this provides sound basis for settlement.

14. Top Salaries Review Board increases too large?

[Government announced on 12 May increases of 14.3 per cent for senior civil servants and senior members of the Armed Forces, and 18.6 per cent for the judiciary.]

Government believes these increases are fully justified. Essential to ensure adequate supply of candidates of sufficient calibre for the Bench, and to provide adequate career structure and differentials in higher levels of Civil Service and Armed Forces. TSRB are only group whose present salaries are below those recommended for April 1980.

15. Average earnings index

[Year on year growth 10.3 per cent in May compared with 10.2 per cent in April. However, underlying unpublished increase slightly lower than in April at around 10 per cent.]

Encouraging that underlying rate of growth continues to fall. But must remember change over the 12 months to May straddles two pay rounds - not entirely indicative of recent trends. Also, earnings index inflated recently by some increase in hours worked.

16. Index-linked pensions and Scott report?

The Government is considering whole question in light of Scott Report. Our aim is to ensure that public servants' pensions are fair to taxpayers, as well as to current employees and pensioners and their dependants.

L BALANCE OF PAYMENTS

1. May trade figures?

[Figures published 9 July show May visible trade deficit of £15 million, estimated overall current account surplus of around £35 million. Cumulative current account surplus £0.9 billion so far this year. Exports fell by some £105 million, mainly due to a fall in oil exports and erratics. Imports rose by £205 million in May, due to higher imports of manufactured goods. Invisible surplus projected at £150 million a month].

Current account fell substantially during May, due to large fall in oil exports from April's high levels and £200 million increase in deficit on non-oil trade. Cumulative surplus this year approaching £1 billion.

2. Exports

Export volumes of manufactured goods now back at high level of 1981 Q4, and holding up well. Export volumes (excluding oil and erratics) in three months to May were 7 per cent higher than a year earlier.

3. Geographical analysis of exports?

Exports to OPEC and other developing countries have risen 10 per cent (3 months on 3 months). Exports to North America have been adversely affected by the US recession and have fallen 1 per cent (on same basis).

4. Imports

Imports of finished manufactures rose by £125 million, principally concentrated in capital and intermediate goods, reflecting a strengthening of investment activity. Imports of oil rose by some £35 million, accounting for some of the fall in the visible balance, while imports of basics, which also fell, remain 8 per cent higher than in 1981 Q1.

5. Worrying trend of import penetration?

Recent figures do suggest some underlying increase in import volumes. But in May, imports of cars fell slightly, and the imports increase was principally concentrated in capital and intermediate goods - suggesting a strengthening of investment activity in UK.

M EXCHANGE RATE AND THE RESERVES

1. Policy towards the exchange rate/falling £?

[Since last autumn sterling has remained broadly stable. The average £ effective rate in Q1 1982 was over 10 per cent lower than in Q1 1981. Previous lows were $1.7470 on 6 April, DM 4.098 on 21 May. Highs were $1.97 on 30 November, DM 4.407 on 9 February. Rates at noon on 23 July were $1.7624, DM 4.2284 and an effective of 91.04. Reserves at end June stood at $17.7 billion, compared with $17.8 billion at end May.]

Government has no target for exchange rate. The rate is taken into account in interpreting domestic monetary conditions and taking decisions on policy. Despite recent sharp fluctuations in value of some currencies caused by strength of dollar, sterling's effective exchange rate has remained relatively stable.

2. Bank of England intervening to support the rate?

Policy is unchanged. Bank do intervene to smooth excessive fluctuations and preserve orderly markets particularly when conditions unsettled. But, as Chancellor has already stated, we have no target - undisclosed, secret or otherwise - for the exchange rate. Most recent reserves figures confirm that policy is unchanged.

3. Concerted intervention to reduce value of dollar?

All experience in recent years that exchange rates for major currencies cannot be manipulated by intervention alone. Intervention can help to steady markets, but not counter major exchange rate trends. That takes changes in real policies, affecting interest rates, monetary conditions and fiscal policies. Lower US inflation is in everyone's interest: matter for real concern is US fiscal/interest rate mix, a problem all countries are familiar with.

4. Improve UK competitiveness by devaluing exchange rate?

Experience shows that exchange rate cannot be manipulated by Government against underlying market trends. Any attempt to lower it by intervention or by relaxing monetary control leads to higher inflation. For example the effective exchange rate depreciated by over a quarter between 1972 and 1976 without leading to any improvement in UK competitiveness.

5. Debt repayments

We have made excellent progress with our plans to reduce the burden of external debt substantially during this Parliament. We aimed to reduce official external debt to $14 billion by end of 1981. This has been more than achieved - external debt is now around $13 billion, compared with over $22 billion when the Government took office.

7 Policy for CAP reform

Key measures are price restraint, curbs on surplus production and strict control of the growth of guarantee expenditure..

8. Costs of CAP to UK consumers

The Minister of Agriculture has dealt with a number of questions on this. Costs to consumers of the CAP as such depend on nature of alternative support system that is envisaged. Arrangements leading to a reduction in the cost of food to the consumer could well involve increased costs to taxpayers.

EUROPEAN MONETARY SYSTEM

9. What is the current attitude of the UK Government?

We fully support the EMS, and acknowledge the contribution which it has made to stability in the exchange markets. However, we do not yet feel able to join the exchange rate mechanism. We must wait until conditions are right for the system and for ourselves.

10. Join the EMS for exchange rate stability?

There is no reason to suppose that by the simple act of joining the EMS exchange rate mechanism we would guarantee exchange rate stability. This has not been the experience of the current participants. Genuine stability requires a return to low inflation rates throughout the Community.

EXPORT CREDITS 'CONSENSUS'

11. Progress on Export Credit Consensus negotiations

In October 1981 participants of OECD-sponsored 'Consensus' reached an interim agreement on the new terms to be applicable for export credits. These terms were to be effective until 15 May 1982. The chairman of the Consensus's second set of compromise proposals were discussed at an EC Council of Ministers on 30 June. Proposals included reclassification of some countries and increase in interest rates charged to 'rich' and 'intermediate' country borrowers. These proposals have now been agreed subject to one outstanding issue concerning the country classifications of Greece and Ireland.

P INDUSTRY

1. Prospects for industry-recovery?

[Recent figures of new company registrations up; but bankruptcies at record high levels]

See A5 and B1.

2. Companies' financial position?

[Industrial and commercial companies (ICC's) - excluding North Sea - gross trading profits (net of stock appreciation) rose 40 per cent to Q1 1982. But rise was from very low base - ICC's real rate of return just 2½ per cent in 1981. ICC's finances showed some weakening in Q4, reflecting slowdown in destocking, and unwinding of civil service dispute, but finances better in 1981 as a whole -

£bn

	1979	1980	1981 Year	H1	H2	1982 Q1
Net borrowing requirement (+)/repayments (-)	+6.1	+5.7	+4.4	-1.2	+5.6	+3.5
Financial surplus (+)/deficit (-)	-2.7	- 1½	+1.2	+1.5	-0.3	-0.5

Some apparent deterioration in financial position during 1981 reflects slowdown in rate of destocking, and effects of unwinding of civil service dispute (which delayed companies' tax payments), but companies' finances much healthier in 1981 than in two previous years.

3. Rate of return still too low?

[Real pre-tax rate of return of ICCs was 2½ per cent in 1981 - half the previous lowest figure in 1975.]

Yes, but Government can only help in limited ways. Fundamental improvement in ICC's profits and real rates of return depend on improved performance by companies, both management and employees. Much encouraged by recent productivity gains and trend towards moderate pay settlements.

4. CBI call for action and meeting with Chancellor

See A 2.

5. High interest rates damaging for industry and investment?

[CBI estimate that each 1 per cent reduction in interest rates reduces industry's borrowing by around £250 million.]

Budget measures have eased pressure on interest rates, and the recent ½ per cent fall in the banks' base rates is encouraging. But Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking. Continuing relatively high level of interest rates must be seen in context of priority attached to reducing inflation and need to control growth in money supply underlying the MTFS.

6. Lower rates for industry?

[Part of CBI current campaign].

De-rating one of a number of possible ways of assisting industry and business, but in last Budget preference given to other forms of relief, notably reductions in NIS. De-rating would be expensive, though less so if applied to industry alone - even that would cost approximately £140 million per annum. Legislation would be required.

7. Government help for small firms

Budget provided further help for small businesses, increasing the number of measures taken so far to over ninety. Enterprise package included further reduction in weight of corporation tax; further increases in VAT registration limits; increase in global amount available for loans under Loan Guarantee Scheme (see below); and doubling of investment limit under Business Start-Up Scheme to £20,000 a year. New measures will encourage start-ups and existing firms.

8. Response to Loan Guarantee Scheme?

[Nearly 5,000 guarantees already issued - about half to new businesses. Total lending under scheme just under £167 million. Budget provided for lending ceiling in first year (to May 1982) to be raised from £100 million to £150 million and for further £150 million to be available in second year (to May 1983). Thirty financial institutions now participating.]

Scheme operating successfully. Too early to assess overall cost . After first year, of nearly 5000 guarantees issued, only 50 have been 'called'. Cost has been more than covered by the premium income received over the period. Scheme is kept under continuous review. (Report on sample survey of borrowers placed in Library of House by Parliamentary Under Secretary of State for Industry (Mr MacGregor) on 12 July).

9. Enterprise zones: response from private sector?

All/first eleven zones now in operation. Response has been very encouraging. Many new firms are setting up in the zones, existing firms are expanding their activities and vacant land has been brought into use. Too early to assess success of zones.

Chancellor announced Tuesday 27 July ten new Enterprise Zones to be created : 7 in England , one each in Scotland, Wales and Northern Ireland.

R NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83 and future years?

Nationalised industries' total external finance increased by £1.3 billion in 1982-83 (£1.2 billion after allowing for NIS cut and other changes). Increase in 1982-83 was roughly half what the industries bid for. Government has given full recognition to problems faced by the industries in a period of recession. EFL's for 1983-84 will be announced later this year, as usual.

INVESTMENT

2. Investment plans unlikely to be attained?

No Government can unconditionally guarantee a level of investment by the nationalised industries. Approved levels set out in last White Paper (Cmnd 8494) are consistent with the industries' agreed external financing requirements, on the basis of their internal resource forecasts. But perfectly possible that plans might need to be revised, for example if the industries fail to restrain their current costs, including pay.

3. Take nationalised industry investment out of PSBR?

Real problem of pressure on resources cannot be solved by changing statistical definitions. Since nationalised industries are part of public sector, their borrowing - for whatever purpose - must by definition form part of public sector borrowing requirement.

4. Is PM satisfied with the rate of return on capital in the nationalised industries?

[Pre-tax rate of return on nationalised industries' capital (including subsidies) has recently been announced as being minus 1 per cent (about the same as in 1979). This compares with 3 per cent for industrial and commercial companies.]

No. That is why we are continuing to press for greater efficiency within nationalised industries, and are setting realistic financial targets to ensure that the taxpayer and consumer get proper value for money.

5. Finance more nationalised industry investment by cutting current spending?

Yes. As in private sector, moderate pay settlements and control of other costs are essential. Ability to finance new investment in nationalised industries bound to diminish if excessive pay settlements agreed. Each 1 per cent off wages saves about £140 million this year; and each 1 per cent off total costs saves £330 million this year.

6. Private finance for NI investment?

In discussions in NEDC and elsewhere, we have indicated our willingness to consider new financing proposals, provided they can be structured so as to induce improvements in efficiency at least sufficient to offset the extra cost, and provided the finance is raised in fair competition with the private sector.

NATIONALISED INDUSTRY PAY AND PRICES

7. Nationalised Industries' prices

[Having risen approximately in line with retail prices for several months, the latest figures show bigger 12 months increase in nationalised industry, water and London Transport than all items RPI (13.8 per cent in June compared 9.2 per cent). This differential reflects March increase in LT fares and ending of electricity industry's rebates to consumers. Removal of these temporary distortions confirms that nationalised industry prices are still increasing somewhat faster than RPI, largely because of increases in energy sector.]

Gap between nationalised industry price increases and RPI has been due in large measure to cumulative effect of years of artifical price restraint. World oil price rises of 1979 and 1980 have also played an important part. We greatly regret the need for these increases, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so. The differential between RPI and NI prices water charges and London Transport fares is now 4½ per cent compared with 14 per cent in January 1982. But sustained improvement will only be possible if the industries succeed in holding down their current costs, particularly pay.

8. What is Government doing to improve Nationalised Industries' efficiency?

We continue to press for greater efficiency within NIs. We are setting realistic financial targets and performance aims. A rolling programme of Monopolies and Mergers Commission investigations has been set up. The introduction of market zones provides greatest incentive to efficiency.

PRIVATISATION

9. What further sales expected?

Special sales of assets in 1982-83 forecast at around £700 million and around £600 million in each of the later years. These figures well above those in last White Paper. This reflects primarily very large sales of energy assets - Britoil and the British Gas Corporation's major offshore oil assets - to be made possible by Oil and Gas (Enterprise) Act (which received Royal Assent in June). Industry Secretary announced 19 July plans to sell 51 per cent of British Telecom - but not before next Election.

10. Special asset sales in 1981-82

Gross sales in 1981-82 totalled £481 million, so target published in 1981 Public Expenditure White Paper of £500 million nearly met. Pleasing result - included two large sales - Cable and Wireless (£182 million) and Amersham International (£64 million). True that delivery of BNOC oil in 1981-82 paid for in 1980-81 and taken into account in special disposals figure for that year reduced 1981-82 receipts by £573 million to total of -£92 million. But it is gross figure which is true measure of success of Government's privatisation programme. As Chancellor said in Cambridge 3 July, 'Public utilities and the so-called "natural monopolies" cannot be allowed permanently and without challenge to remain within State ownership'.

11. Government has sold assets too cheap?

[Heavy oversubscription for British Aerospace, Cable and Wireless, Amersham International, followed by large increases in prices when shares first traded.]

Not in Government's interest to see shares underpriced, given the loss to the PSBR, but also risks in pitching price too high. Getting balance right not easy - especially when company's shares have not previously been traded. Government will continue to consider alternative forms of sale eg tender, but critics should note that sale by tender could make it harder for ~~small~~ investor to buy shares.

12. Contribution to giving people satisfaction of property ownership?

Exercise of returning enterprises from State ownership to ownership by the public has included measures to promote employee share ownership in the enterprise they work for; for example free offers of shares (British Aerospace, Cable and Wireless, Amersham); preference in allocation of shares (B Ae, C & W, Amersham, BP); provision for matching shares - one for each share subscribed for - (B Ae, Amersham, BP). Most radical initiative taken by consortium of managers and employees who bought National Freight Company.

S NORTH SEA AND UK ECONOMY

1. Onerous tax system damaging future field developments?

[Shell/ESSO announcement plans for Tern shelved partly because of tax system; Press reports that Phillips are postponing T-block complex and BP their Andrew field].

Other adverse factors - falling oil prices earlier this year; high development costs - much more important. Detailed study showed that under new tax structure, levels of profitability should still be sufficient to make exploration and development attractive. Hope that new structure will provide more secure and stable tax regime.

2. Chancellor's oil taxation package announced 9 June

[Summary: No field to pay APRT for more than 5 years; APRT repaid after 5 years if not set off against PRT; APRT allowed as a deduction in computing payback; further proposals to smooth PRT payments in second half of 1983; cost £55 million 1982-84]

Following Budget proposals, industry expressed concern on a number of specific matters; we have decided that some mitigation of burden for less profitable, more marginal fields is appropriate to meet particular problems. Tax system introduced in Budget, plus these changes, should enable nation to get its fair share from profits of this national asset, while leaving plenty of incentive to continue developing it.

3. Taxation of petrochemical feedstocks

[Government has announced that new rules on valuation of ethane for petrochemical use in interaffiliate transfers (Finance Bill Clause 129) should be extended to mixed streams of gas with a large ethane component. ICI complain that the extension and the rules themselves give unfair advantage to their integrated oil company competitors and have taken out writ against the Government.]

Government convinced that new formula will give fair valuation. New valuation will not have effect of providing subsidy to ICI's competitors. Have done best to reassure ICI. Will resist ICI's legal action.

4. Government should do more to promote UK Continental Shelf oil production in 1990's?

[Select Committee on Energy's Report on depletion policy published 18 May: recommends reserve powers to impose production cuts but main emphasis on promoting development of fields to come into production in 1990s - increase pace of licensing rounds and overhaul fiscal regime].

Government's considered reply will be given in due course. Accept need to prolong high levels of UKCS production until end of century at least. Energy Secretary announced 17 May Government's plans for Eighth Round of licensing. Do not accept that fiscal regime makes North Sea development unattractive. On Committee's general proposal for overhaul of regime, would point out that industry does not want a structural upheaval: it would create serious uncertainty and major transitional problems.

5. Benefits of North Sea should be used to strengthen economy?

[FSBR projections (in money of the day) of Government revenues from North Sea: £6.4 billion in 1981-82, £6.2 billion in 1982-83, £6.1 billion in 1983-84, and £8.0 billion in 1984-85. Lower than last year's projections, principally because of downward revision to oil price expectations. Projections incorporate March fall to $31 a barrel for Forties oil. Contribution of North Sea to GNP estimated at 4 per cent of GNP in 1981. Not projected to rise before 1985.]

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve lower level of interest rates to benefit of industry and economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Less than 6 per cent of total General Government receipts in 1981-82.

6. North Sea revenues should be channelled into special fund?

North Sea revenues are already committed. Setting up special Fund would make no difference. More money would not magically become available. So money for this Fund would have to come from somewhere else. This would mean higher taxes or lower public expenditure, if public sector borrowing is not to rise. If borrowing did rise, then so would interest rates. Not obvious that net effect would be good for investment.

7. Is Government underestimating North Sea revenues?

No. Other estimates of Government revenues based on assumptions that seem over-optimistic eg on future production.

8. Future North Sea oil prices?

A matter for commercial negotiation between oil companies and BNOC.

9. Are we really any better off for our North Sea oil?

We are better off with oil - at current oil prices - than we would have been without it. We have been spared fall in real national income that other industrial countries have suffered following oil price rises. But North Sea oil costly to produce, so we are not necessarily any better off than we would have been had oil prices not risen. No need therefore for possession of oil to require a contraction in our industrial base.

T WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Why don't major industrial countries together lead revival of Western economy?

OECD's Economic Outlook explains clearly why. Western Governments are convinced 'a significant part of any stimulus to demand would increase public sector deficits, and dissipate itself rather quickly as an increase in inflation'. Furthermore, there is 'the possibility of re-igniting inflationary expectations, which became firmly established over a decade or more...' Remarkable unity on this at recent Finance Ministers' meetings and at Versailles Summit.

2. Western Governments' policies will increase unemployment to 32 million?

[OECD Economic Outlook published 7 July forecast unemployment 'approaching 32 million' in first half 1983 or 9 per cent of OECD Labour force (10½ per cent of Europe's.) Also notes that unemployment is concentrated on the young, and that, in Europe, about one third of jobless have been unemployed 6 months and more.]

True that OECD forecasts rising unemployment - largely as result of increase in number of people looking for work. But OECD also forecasts employment to rise by over 2 million people in OECD area next year.

3. OECD says global recovery won't last?

[Economic Outlook warned investment so far shows little sign of pick-up needed for recovery to be self-sustaining. But same paragraph ends by emphasising importance of improving business outlook.]

Lower inflation should help reduce interest rates and coupling of these two with recovery in output will generate right climate for recovery in investment during 1983.

4. French government 'seen the light' over reflationary policies?

[French government announced package of austerity measures including 4 month prices and wages freeze (to reduce inflation to single figures), increases in social security and unemployment contributions and limit to budget deficit of 3 per cent of GNP in 1982]

Strength and stability of Western economies as a whole will benefit if France - and Italy - can control inflation. So we welcome French government's recognition that inflation is as serious a threat as unemployment and that reining in public sector borrowing is essential part of counter-inflation strategy.

5. Comparison of French Socialist Government 1981-82 with Labour Government in 1974-76?

Many similarities. After oil price shock both governments gave fight against inflation low priority and sought immediate economic growth. In both cases unemployment rose strongly - in UK's case it doubled - inflation and rates of increase in earnings rose, current accounts ran substantial deficits and currencies were depreciated. Important differences, though: French economy fundamentally more healthy, French labour force less unionised, France committed to EMS, but no prospective North Sea oil to help out current account.

6. French unemployment risen despite Socialist growth policy?

[French unemployment 10.8 per cent of labour force in June 82; risen by 1.6 per cent of labour force since May 81 - same as the rise in the average rate for all 7 major industrial countries over same period. (N.B UK's rate has risen more)].

Yes. Unemployment has risen strongly in all industrial countries save Japan. France no exception. But rate of increase in unemployment has not yet slowed down - unlike UK.

7. Anti-inflation policies are working

[Inflation down from a year ago in 5 of major 7 economies - significantly down in US (from 10 to 7 per cent), Japan (5 to 2½), Italy (20 to 15) and UK (11 to 9). Small reductions in Canada (to 11¾), Germany flat, but increase in France (from 13 to 14).]

Yes. Firm fiscal and monetary responses to 1979-80 vindicated by events. UK still some way to go to match US, Germany or Japan in bringing down inflation, but moving in right direction and ahead of some other European countries. Realism in wage settlements is growing; US, Germany and Japan all have wage settlements in single figures. Other policies also working: oil savings have helped cut OECD oil demand. All point towards basis for sustainable recovery.

8. Prospects for UK economy worse than for other countries?

No. OECD's forecast for UK is close to most recent domestic forecasts and predicts average growth of about 1¼ per cent in 1982, rising to annual rate of 2 per cent in second half of 1982. That is very closely in line with OECD forecast for whole of Europe. Unemployment is expected to rise in all major countries except Japan. UK inflation still forecast to exceed OECD average in 1982 because of recent falls in inflation rates of USA, Germany and Japan, but UK should average OECD rate next year. Could do it this year if more responsibility in wage settlements.

9. Better prospects for US economy?

[Q2 GNP figure showed growth of 1.7 per cent at annual rate. But estimates of severity of decline in Q4 and Q1 increased and industrial production still falling in June (10 per cent below July 81). Seasonally adjusted unemployment is 9½ per cent (10½ million), and bankruptcies at post-war high. Inflation and manufacturing earnings both rising at 6½-7 per cent. Tax cuts, effective 1 July, expected to boost consumers' expenditure in Q3].

Yes. Welcome possible indications worst of US recession may be over. Federal Reserve Chairman Volcker noted in testimony to Congress recently that most important trend in US economy was long-term downward shift in nominal wage settlements, which, in manufacturing, are now around 6½ per cent. If combined with productivity improvements this could lead to very low inflation rates in US.

10. US Budget?

[Congress agreed on budget deficit of $104 billion, deficits greater than $116 billion. Congress's decision legally binding; outline agreement has now to be translated into detailed budget by Congressional committees.]

Hope Congress will soon reach agreement on details of budget for FY 83, as uncertainty about budget is probably an important factor adding to pressure on US interest rates.

11. US interest rate developments

[Prime rates dropped ½ per cent in mid-July to 16 per cent; other interest rates fell. Chairman Volcker told Congress that Fed would allow some M1 growth above top of target range and would not act to reduce temporary bulges.]

US interest rates fell recently. Volcker testimony to Congress should reassure markets of broad counter-inflationary thrust of Federal monetary policy. Agreement on details of budget would improve prospects for lower interest rates.

12. Prospects for international interest rates?

Always difficult to forecast interest rates with certainty, but firm and balanced policies should over a period bring lasting reduction in both inflation and interest rates.

U FALKLANDS CRISIS EFFECTS/COSTS

1. UK economy affected by Falklands crisis?

Possible economic consequences cannot of course be ignored. But UK is basically in a strong financial position: inflation is coming down; interest rates on downward trend; balance of payments remains healthy; output is higher than a year ago. Disturbance due to Falklands dispute small in relation to overall macro-economic picture. No question of requiring any change in basic economic strategy.

2. Will dispute with Argentina affect UK trade figures?

Volume of UK-Argentine trade negligible (£20 million a month on either side).

3. Effect of financial restrictions on Argentina?

The crisis restrictions reduced Argentina's capacity to raise loans on the international markets, and will continue to do so while the freeze on assets remains.

4. Future of restrictions?

European Community (and certain other countries) ended their measures on 20 June. USA and New Zealand ended theirs when we accepted de facto end of hostilities (12 July). But arms embargoes remain. UK's measures remain in place for the time being.

5. Argentina's debts

[NOT FOR USE: Argentine foreign debt at end 1981 estimated at $34 billion - about half size of Mexico's or Brazil's.]

Argentina may be seeking debt relief in talks with certain creditors about debt rescheduling. Not with British banks while freeze on assets continues. Proper rescheduling agreement would need to involve all creditors. [IF PRESSED on debt default possibility: banks have taken fairly relaxed attitude because ultimately overseas debt must be repaid by exports; Argentina's export sector is agriculture, which, according to most experts, is fundamentally healthy.]

6. Falklands defence costs?

[Specific figures for replacement of equipment, requisitioning merchant ships etc on BBC programme 8 July were speculative.]

Preliminary assessment of broad order of defence costs (excluding garrison costs) is about £550 million in 1982-83, and £200 million in each of the following two years. Non-defence costs (compensation, rehabilitation) are expected to be minor in comparison. Totals should represent only a very small proportion of total public expenditure.

7. What will be costs of repairing damage and reconstructing the Islands' economy?

Too soon to say what these costs will be. Work has begun on restoration of essential services and on implementing Civil Commissioner's recommendations for priority action (accommodation, inter-Islands air service, education). Necessary financial provision is being made available. Not yet clear how existing FCO and ODA funds will be adequate and how far additional sums will be needed.

8. Is Government paying compensation for war damage?

Government has made it clear that compensation will be generous. [PM's reply at Question Time 15 June Hansard col 739.] Officials working on practical details. No estimate of the cost can yet be made.

9. How will the various costs be met?

Intention is to try to absorb 1982-83 costs within the Contingency Reserve - and to some extent within existing budgets. Remains to be seen how far feasible. How future years' expenditure is to be funded will depend on decisions in forthcoming Public Expenditure Survey. Extra costs to defence budget (costs of the operation eg fuel ship chartering, and equipment replacement) will be met out of monies additional to the 3 per cent annual rate of real growth already reflected in sums currently provided for defence. Decisions have yet to be taken on other programmes. In any case, the costs will be met in a way consistent with the Government's economic strategy.

AIDE MEMOIRE ON THE UK ECONOMY 26 July 1982

RECENT DEVELOPMENTS AND INDICATORS

(i) Activity. GDP fell by 6 per cent between 1979 H2 (last cyclical peak) and 1981 Q2 (trough of current recession), rose about 1 per cent between 1981 Q2 and 1981 4Q then declined by ¾ per cent in 1982 Q1. Weakening at turn of year in part reflects impact of severe weather and strikes.

Underlying level of output broadly flat in 6 months to March 1982, but industrial and manufacturing production rose some 1 and 1½ per cent respectively between April and May. Excluding North Sea industrial production in 3 months to May no higher than last autumn, but about 3 per cent higher than spring of last year. Most independent forecasts, business opinion surveys, and CSO's cyclical indicators expect resumed and continued recovery; May production figures could be first tentative signs of this.

Volume of new engineering and construction orders in 1981 up 14 and 12 per cent on 2H 1980. Whilst home orders in some areas have continued to improve in early 1982 export orders tended to weaken around the turn of the year. Private housing starts up over one third between 2H 1980 and 1981. Total housing starts in 5 months to May 1982 up 37 per cent on 1981 average.

Recovery in 1981 largely reflected sharp fall in rate of destocking. Consumers' expenditure and Government consumption broadly flat. Fixed investment broadly flat in 1981, up 4 per cent between 1981 Q4 and 1982 Q1; DOI investment intentions survey suggests rise of 2 per cent in MDS fixed investment in 1982.

(ii) Lack of complete trade figures for 1981 and changed documentation procedures make recent figures difficult to interpret. Exports have held up better than many had feared. In 9 months to May non-oil exports slightly (about 1 per cent) higher than in 1980. Non oil imports have risen - up 13 per cent in same period - in part reflecting reduced rate of destocking and further rise in import penetration ratio. Current account estimated to be in surplus of £1 billion in first five months of 1982 following £7 billion surplus in 1981.

(iii) Employment and unemployment. UK employment fell 2.1 million (9 per cent) between 2Q 1979 and 4Q 1981 (about two-thirds concentrated in manufacturing), though rate of decline has slowed down. UK adult unemployment risen by 1.6 million since 2Q 1979 (less than fall in employment) and stood at 2.93 million (12.3 per cent) in July. Total unemployment (including school leavers) was 3.19 million (13.4 per cent). Underlying rate of increase in unemployment was 105,000 per month in 4Q 1980, cf 22,000 per month in first seven months of 1982. Other labour market indicators improved during 1981; eg short-time working down by ¾ during 1981, overtime up by over 10 per cent during 1981, and vacancies - despite slight weakening since February - up by 1/5 in 2Q 1982 on 2Q 1981, and

1/2

with more rapid turnover. Little or no further improvement in unemployment or other labour market indicators since turn of year.

(iv) Wages and prices. Increase in earnings in 1980-81 pay round 11 per cent (settlements averaged about 9 per cent), half that of previous pay round. Settlements well inside single figures are now widespread (CBI average for manufacturing 7 per cent) suggesting further moderation in current pay round. 12-monthly increase in RPI 9.2 per cent in June; well inside single figures. Recent progress suggests outturn to November this year could well be within Budget time forecast of 9 per cent. Manufacturers' input prices up just 5½ per cent in 12 months to June. Corresponding rise in manufacturers' output prices 8¼ per cent.

(v) Productivity and Competitiveness (manufacturing). Output per man risen 12 per cent since end-1980. Output per man and output per man hour 5 and 8 per cent respectively higher than previous cyclical peak (1H 1979). Together with pay moderation, resulted in little increase in unit wage and salary costs during 1981 - rise of less than 3 per cent in year to 1Q 1982 - a rate below average of our competitors and comparable to Germany and Japan. Competitiveness (relative normalised unit labour costs) improved by 10-15 per cent during 1981, but remains about 1/3 worse than in 1975.

(vi) Company finances. Gross trading profits of ICCs (net of stock appreciation excluding North Sea) rose about 40 per cent in year to 1Q 1982. But real pre tax rate of return just 2½ per cent in 1981. Despite rise in company borrowing and deterioration in liquidity in 4Q 1982 (largely reflecting reduced sale of destocking and unwinding of civil service dispute which delayed companies' tax payments), company finances healthier in 1981 as a whole than in 1979 and 1980. Company liquidity improved in 1Q 1982.

(vii) Monetary aggregates. £M3 grew at an annual rate of 13 per cent in 1981-82 target period (from mid-February 1981 to mid-April 1982) compared with target range of 6-10 per cent. At least part of excess reflected increased market share of banks in mortgage lending. Over the same period, M1 and PSL2 grew at rates of 7 and 12 per cent per annum respectively. In recent months monetary aggregates have grown more slowly; in first 4 months of 1982-83 target period M1, £M3 and PSL2 grew by 6¼, 9¾ and 9¼per cent at annualised rates respectively of target range of 8-12 per cent.

(viii) Interest rate/exchange rates. Interest rates have fallen since turn of year; process temporarily interrupted by Falklands crisis, but now resumed. 3 month inter-bank rate has fallen from 16 per cent in December to about 12 per cent. After falling over 10 per cent during spring and summer 1981, effective exchange rate broadly constant at around 90 since last August.

(ix) Government borrowing. PSBR £8.8 billion in 1981-82 (3½ per cent of GDP, compared with 5 3/4 per cent in 1980-81) about £1¾ billion lower than estimated at Budget time. In first quarter of 1982-83 PSBR was £1.6 billion.

pm wm 4/10

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

22 July 1982

Michael Scholar Esq
No.10 Downing Street

Dear Michael

You asked for notes for the Prime Minister's Question Time today on the four main proposals now being put forward by the CBI to revise the economy. These were reported in today's Financial Times as being "substantially lower interest rates, lower national insurance surcharges, lower rates for industry and a £1bn package of capital spending by 1984".

The note on an NIS reduction is more detailed than the others to meet your earlier request for a note for use with the 1922 Committee this evening.

Yours ever
Peter

P S JENKINS

NATIONAL INSURANCE SURCHARGE

CBI PROPOSAL

CBI propose "lower National Insurance Surcharge".

Facts

National Insurance Surcharge introduced by Labour Government (Mr Healey). Time of last Budget stood at $3\frac{1}{2}$ per cent (levied on earnings liable to employers National Insurance Contributions).

2. Chancellor in Budget announced effective reduction over the whole year of 1 per cent, to $2\frac{1}{2}$ per cent. This to be brought about by reducing the rate itself to $2\frac{1}{2}$ per cent with effect from 2 August 1982 (earliest practicable date) plus a further temporary reduction of $\frac{1}{2}$ per cent between August 1982 and April 1983. This gives a rate of approximately $2\frac{1}{2}$ per cent over the whole year, as promised.

3. Applies to private sector employers only. Cost in 1982-83 put at £640 million.

4. Because of way reduction effected, running rate of NIS, which will be 2 per cent from 2 August, will go back to $2\frac{1}{2}$ per cent in April 1983 if nothing is done. Decision time for enabling the running 2 per cent rate to continue through 1983-84 comes in November (though to do nothing in November does not mean that the 1983-84 overall rate could not be reduced, because this year's device could be repeated).

5. Employers see NIS as "tax on jobs". Reduction directly reduces costs in employing labour. Matter of debate how far it leaks into wages claims - CBI assert that this does not happen. Of the total cost of the reduction this year about half went to benefit manufacturing and construction; the rest to other sectors (financial, distributory, etc).

6. NIS payable on top of employers NIC (current rate 10.2 per cent). Employers have been shielded from increases in employers NIC rates for two successive years, probably worth about 1 percentage point in full.

Line to take

7. Acknowledge desirability if possible of reducing this tax on jobs invented and imposed by previous Labour Government. Note 1 percentage point effective reduction given in the last Budget, starting to come through in 10 days time, costing £640 million in 1982-83. Note also way employers have been shielded from increases in National Insurance Contribution rates for two successive years. Aware that going rate of NIS will go back to $2\frac{1}{2}$ per cent next April if further action is not taken. Right time to consider this in the autumn. But likely to be many other claims on available resources if borrowing is to be kept in check and interest rates (another CBI priority) restrained. However desirable, NIS reduction is expensive. A better and more direct way for industry to cut its labour costs is to restrain pay increases.

Lower interest rates?

Interest rates have been falling - down 4 points since last autumn. Since the clearing banks reduced their base rates to 12 per cent on 13 July., short-term rates have come down further. Cannot ignore developments in other countries, particularly US. But some success in uncoupling our interest rates from US rates; at beginning of year our rates some 2 points higher than in the US, now some 1-2 points lower. Progress made in reducing interest rates reflects satisfactory developments on main monetary indicators and government borrowing under control. How would CBI proposals be able to sustain lower interest rates when there are reports that they would add £1.8 billion to PSBR in first year.

Lower rates for industry?

[A 10 per cent derating for all non-domestic ratepayers would cost approximately £600 million per annum; if applied to industry alone about £140 million.]

Derating, whether for all non-domestic ratepayers or for industry alone, would require legislation. It would also be expensive, though less so if it were to apply to industry alone (10 per cent derating for industry approximately £140 million per annum). One of a number of possible ways of assisting industry and business, but in last Budget preference was given to other forms of relief, notably reduction in NIS.

£1 billion Capital Spending Package by 1984?

[Capital expenditure has fallen from about 17 per cent of total public expenditure in 1976-77 to about 11 per cent in 1981-82. Cmnd 8494 plans show a further fall to just over 10 per cent in 1982-83.]

Why has fixed investment fallen?

- sales of council houses score as negative capital expenditure
- also a fall in council house new construction
- finally (much smaller) fall in roads programme

Government has therefore not been cutting "productive investment".

What is really happening to cause fall

- "needs" have declined since 1970s
- increasing proportion of nationalised industries investment financed out of own resources
- defence procurement counts as current expenditure and increasing defence capital expenditure worsens apparent capital/current balance.

How much is capital expenditure planned to increase, does it meet "needs"

[Plans for 1982/83 provide for cash spending in new construction to increase by 14 per cent to £10.3 billion; for nationalised industry investment to rise by 26 per cent to over £7½ billion.]

No reason to assume future standards and public amenities and services will be jeopardised.

Line to take

Government prepared to give priority to worthwhile capital projects whenever possible within overall spending totals. Public expenditure plans have not cut "productive investment" and there is no reason to assume present plans will jeopardise future standards and public amenities and services. Nationalised industries' investment in 1982/83 planned to be about a quarter higher than previous year. The real answer is to continue with policies to lower interest rates, increase incentives and provide for the prospect of a higher rate of return on investment in the private sector.

PPS/CHANCELLOR

file no TEB/CA/01

copied to:

Mr Salveson (for transmission to No.10)
PS/CST
PS/FST
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PS/MST(R)
PS/Home Secretary
PS/Lord Chancellor
PS/Foreign Secretary
PS/Secretary of State for Education and Science
PS/Lord President of the Council
PS/Secretary of State for Northern Ireland
PS/Secretary of State for Defence
PS/Minister of Agriculture, Fisheries and Food
PS/Secretary of State for Environment
PS/Secretary of State for Scotland
PS/Secretary of State for Wales
PS/Lord Privy Seal
PS/Secretary of State for Industry
PS/Secretary of State for Social Services
PS/Secretary of State for Trade
PS/Secretary of State for Energy
PS/Secretary of State for Transport
PS/Chancellor of the Duchy of Lancaster
PS/Secretary of State for Employment
PS/Paymaster General
and officials in HMT, Revenue Departments and other Departments in Whitehall

TREASURY WEEKLY BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 12 July, are sidelined.

M M Deyes

M M DEYES

RA

R I G ALLEN

19 July 1982

EB Division
H M Treasury
01-233-3364

ECONOMIC BRIEF: CONTENTS

A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

[Longer term economic policy objectives discussed by Chancellor in CPC lecture 3 July, and interview published FT 5 July.]

Main objectives are to achieve, over a period, a sustained improvement in the economy through reduction of inflation and promotion of enterprise and initiative. Reduction of inflation requires maintaining steady but not excessive downward pressure on monetary variables, and complementary fiscal policies. Improvement of supply side depends on restoration of flexible and competitive market economy and better incentives.

2. Outcome of 15 July Cabinet discussions on economic policy?

Well known that Cabinet normally meets on Thursday morning. Well known also that this is time of year when public expenditure plans are reviewed. Cannot say more than that.

3. Fiscal boost desirable?

[Sam Brittan FT 8 July argued money GDP growth in 1982-83 may undershoot MTFS figure of 9½ per cent; hence fiscal boost could be accommodated 'in the context of a reaffirmation of the MTFS'. Reports in some of weekend papers of impending 'mini Budget'; discounted by others.]

Last year's PSBR undershoot probably meant that fiscal policy was somewhat tighter than expected. But it helped create the conditions for the fall in rates - now down four points from last autumn's peak. There is no reason at this stage to depart from Budget forecast of PSBR for this year. [IF PRESSED on possible GDP 'undershoot' for year: We do not have a money GDP target (though MTFS includes projections of money GDP). Nor is it sensible to 'fine tune' money GDP in way Mr Brittan suggests. Fiscal policy is set in relation to money growth and PSBR. No reason to depart from Budget judgment at this stage on either count (See also Sections H and J).]

4. Economy still in recession?

Recession can be defined in different ways. What is quite clear is that a turning point was reached in first half of last year, and that a modest recovery has begun - and is projected to continue. Most encouraging pointer to sustained recovery is progress against inflation (12-monthly RPI increase down to 9.2 per cent in June.)

5. Government policies caused recession by deflating demand?

[Industrial production down 11 per cent; GDP (output) down 5 per cent; total final expenditure down 1 per cent since first half 1979.]

No. Output had fallen much more strongly than demand during the current recession. At same time import penetration has continued on rising trend. Essential problems of economy lie on 'supply side' - lack of competitiveness etc. Government policies aimed at helping industry to redress these problems by : deregulating, restoring incentives and implementing a financial strategy under which inflation and interest rates can fall over the medium term.

6. Economic recovery in doubt?

[GDP figures for Q1 1982, published 22 June, show little change on Q4 1981. May industrial production figures published 13 July show production in March-May 3 per cent higher than underlying spring 1981 level.]

May industrial production figures the most encouraging for some time - though too much weight should not be put on single month's information. Prospect is for continuing though gradual recovery: increase in May index could be first tentative sign of this. (See also Section B).

7. What factors caused recent flattening out in recovery?

Recovery is slow and fragile.Number of factors - temporary rise in interest rates last summer/autumn; temporary pause in progress on reducing inflation; slower, and later than expected, world recovery - could all have weakened confidence and activity. But prospect is for continuing through gradual recovery.

8. Tighter than expected fiscal policy to blame?

[Latest published estimate of 1981-82 PSBR £8.8 billion compared with Budget time estimate of £10.6 billion.]

Relationship between PSBR and output extremely complicated (especially since precise reasons for undershoot not well understood). Essential to consider influence of fiscal and monetary policies together. Firm control of Government borrowing essential to maintain downward pressure on interest rates; latter have fallen four percentage points since last autumn and this can only improve prospects for recovery. (See also Section H).

9. Recovery depends entirely on developments in the US?

Clearly cannot isolate ourselves from international developments. Lower world interest rates (particularly in US) would undoubtedly benefit the world economy and the UK. But UK policy certainly not determined in Washington, or Wall Street. At turn of year, UK short term interest rates were two points above those in US, currently 2-2½ points below.

10. Recent interest rate/monetary developments?

Some success in uncoupling UK interest rates from US rates. Steady reduction in former made possible by satisfactory developments in main monetary indicators - monetary aggregates, exchange rate, and progress on inflation. Government borrowing also under control. Latest bank lending figures in May more encouraging but not yet sufficient to confirm improved trend.

11. Unemployment accelerating again?

[June figures published 22 June show rise in UK (not seasonally adjusted) level to 3.06 million; seasonally adjusted figure shows 39,000 increase on previous month, compared with average 22,000 monthly rise between January and May. NB: July figures to be published 20 July.]

See Section C.

12. TUC-Labour Party Liaison Committee document 'Economic Planning and Industrial Democracy: the Framework for Full Employment'

[Document published 14 July reinterates objective of reducing unemployment to 1 million within a Parliament and spells out ideas for machinery of planning envisaged in 'Labour's Programme 1982' published last month. Envisages a new national economic plan, NEDC transformed into tripartite National Planning Council with new Department of Economic and Industrial Planning (taking over Treasury medium-term functions, including PESC), and further tier of planning bodies for regions. Planning agreements to be concluded at company level fostered by Government incentives and sanctions, statutory rights of worker participation, and a National Economic Assessment of the distribution of resources and share of national income going to different groups (back-door incomes policy).]

Government is deeply concerned about unemployment. But do not believe it will be cured by further dose of interventionism and bureaucracy inhibiting free operation of markets and exercise of managerial judgement. Our policies are directed to creating the conditions for recovery in output and jobs, not to stifling enterprise. No reason to suppose that latest proposals will be any more successful than National Plan of 1964-70. 'National Economic Assessment' has a poor historical pedigree. Under the 'social contract', RPI inflation reached 26.9 per cent (August and September 1974) and wage inflation over 30 per cent (during H1 1975). Subsequent reduction followed by winter of discontent.

13. Report on Budgetary Reform by the TCSC ("Armstrong" Report)

[Report published 17 June.]

Government will want to consider its recommendations. We did draw attention in our evidence to the various practical and other constraints and also to the progress already made in the Armstrong direction under this Government (eg MTFS). Will be thinking carefully about recommendations to publish Green Book/PEWP in January etc. But cannot anticipate reply to the report.

BULL POINTS As at 19.7.82

(i) Activity. Recovery has begun: industrial and manufacturing output 2-3 per cent higher than spring 1981. [But NB, underlying level of output broadly flat for last 6 months.] Business opinion surveys, most recent major independent forecasts, and CSO's cyclical indicators see prospect of continuing, but gradual recovery.

(ii) Investment. Total fixed investment rose 4 per cent between 4Q 1981 and 1Q 1982. DOI investment intentions survey suggests 2 per cent rise in and services' investment in 1982. Suggests fall in investment all but over. Private sector investment, particularly in plant and machinery holding up well. Investment in plant and machinery in 1981 only slightly (1½ per cent) lower than 1980, 8 per cent higher than in 1H 1979.

(iii) Total housing starts up 37 per cent in five months to May 1982 on 1981 average.

(iv) Interest rates. Short-term rates have fallen 4 points since turn of year (now about 12½ per cent). Process temporarily interrupted by Falklands dispute, now resumed. Recent falls reflect several factors:- single figure inflation, M1, £M3 and PSL2 developing favourably in relation to target, Government borrowing under control, exchange rate firm.

(v) Inflation. 12-monthly increase in RPI now in single figures - 9.2 per cent in June - more than halved since spring 1980 peak (21.9 per cent). Inflation in June lowest since December 1978, but trend now firmly downwards, not upwards as then. Manufacturers' output prices up just 8¼ per cent in year to June.

(vi) Costs.

- Increase in average earnings halved in 1980-81 pay round. Public sector pay in line. Further moderation in average level of settlements in current round. CBI pay databank for manufacturing settlements suggests average now around 7 per cent compared with 9 per cent in previous round.
- Little increase in manufacturers' unit wage and salary costs over last year - only 3 per cent up in year to 1Q 1982, below average of our major competitors and comparable to that of Germany and Japan.
- Manufacturers' input prices up just 5½ per cent in year to June.
- CBI April survey shows lowest degree of unit cost pressures for 15 years.

(vii) Manufacturing productivity. Output per head rose 12 per cent since end 1980. Output per head and output per hour 5 and 8 per cent higher than previous peak in 1H 1979.

(viii) Competitiveness. Cost competitiveness improved by 10-15 per cent during 1981 reflecting pay moderation, higher productivity and exchange rate fall, but remains 1/3 worse than in 1975.

(ix) Profits: Industrial and commercial companies gross trading profits (net of stock appreciation excluding North Sea) risen since 1Q 1981. In 1Q 1982 40 per cent higher than a year earlier. Recovery in profits from very low base: ICC's pre tax real rate of return just 2½ per cent in 1981.

(x) Exports have held up better than many feared following 50 per cent loss of competitiveness between 1975 and 1Q 1981. In 9 months to May 1982 non-oil exports (excluding erratics) slightly (about 1 per cent) higher than in 1980.

(xi) Special employment measures. Total provision for special employment schemes planned to reach £1½ billion in 1982-83, and to be £4 billion over current and next two financial years. 280,000 unemployed school-leavers last year found places on YOP by Christmas.

(xii) Overseas investment in UK: US direct investment in Britain amounted to stock of over $14 billion in 1980. Nearly 60 per cent of all US outward non-oil direct investment now takes place in EC - over half of that in UK. Half of all Japanese investment in the EC also comes to Britain.

(xiii) Overseas debt repayments. Official external debt reduced from over $22 billion in May 1979 to around $13.7 billion at end-May 1982.

Economic Briefing Division, HM Treasury, 01-233 3819/5809

B ECONOMIC ACTIVITY AND PROSPECTS

1. Recent output figures

[Underlying level of output broadly unchanged in six months to March. In part reflects impact of very severe weather and industrial disputes at turn of year. Latest figures show industrial (excluding North Sea) and manufacturing production rose some 1 and 1½ per cent respectively between April and May. But in latest three months underlying level of industrial production little changed from last autumn; 3 per cent higher than in spring of last year.]

Whilst recent output figures have been disappointing, prospect remains of continuing but gradual recovery. This view shared by CSO (index of leading indicators) and most outside forecasts (see 5-6 below). Whilst not too much should be made of one month's figures, May index of industrial production could be first tentative sign of this. Best help for sustained recovery is lower inflation and interest rates.

2. Other evidence of improvement in economy?

See Bull Points (following Section A).

3. Government's forecasts?

[FSBR forecast (9 March) assesses recovery to have begun. Main points are:

per cent increase on year earlier

	1982	1983 H1
GDP	1½	2
Manufacturing output	3	2
Consumers expenditure	½	½
Investment (private sector and public corporation)	4¼	5
Exports	3½	3

Forecast expects some stockbuilding in 1982, Government expenditure flat.]

FSBR forecast sees prospect of some recovery continuing into 1983. (Last two Government assessments of economy were broadly correct). Healthy rise in private sector investment and exports. Inflation well into single figures (7½ per cent) by mid 1983. Further progress depends on continued moderation in domestic costs and restoration of competitiveness.

4. FSBR forecast now looks too optimistic?

[Recent press reports (eg FT 29 June) suggest latest internal Bank and Treasury forecasts put growth in 1982 less than FSBR forecast of 1½ per cent; inflation lower than FSBR forecast of 9 per cent. Several independent forecasts have recently revised down their forecasts of growth in 1982 marginally (from around 1½ per cent to about 1-1¼ per cent), largely reflecting the recent disappointing output figures. Despite this most groups have not altered their assessment of the strength of the recovery during the course of 1982 and in

1983 (NB but several groups forecast 2-2½ per cent growth in 1983 on the basis of some fiscal stimulus - a further cut in NIS or reductions in the standard rate of tax - in the 1983 Budget).]

Recent output figures are disappointing (though May more encouraging), but we have been doing rather better than expected on inflation. Clearly there are uncertainties and dangers, not least of which will be the international environment - though there are some recent more favourable indications of the beginning of recovery in the US. At present there is no reason to doubt the broad shape of gradual recovery as forecast at Budget time. Certainly the majority of outside forecasters do not doubt it.

5. Outside forecasts

[GDP profile in recent major assessments:

	NIESR	LBS	St James	Phillips &Drew	CEPG	CBI	OECD	FSBR
	(May)	(June)	(Apr)	(July)	(April)	(May)	(July)	(March)
Per cent change 1982 on 1981	+1	+1	+1¼	+1½	-½	+1	+1¼	+1½]

Nearly all ~~see~~ prospect of continued recovery (as always, a range, with Cambridge forecast (CEPG) being the more pessimistic) and see single figure inflation through rest of 1982 - also in line with FSBR. [See also C3 (unemployment)).]

6. Latest CBI assessment?

[CBI Enquiry for June reports little change in order books or stocks since last April, and expectations of broadly flat output over next four months. S. Brittan (FT 5 July) suggests 'preliminary evidence' of more pessimistic July CBI enquiry and lower CBI forecast of growth. Gloomy remarks by Sir T Beckett to conservative back benchers meeting.]

CBI June Enquiry disappointing: confirms recent indications of temporary flattening out in activity since last autumn. But encouraging signs of further moderation in inflationary expectations - necessary condition for improved growth. Latest CBI forecast believes modest recovery will resume in second half of this year, and predicts inflation rate below 8 per cent this autumn.

C LABOUR MARKET

[NB. Unemployment and vacancy figures for July to be released 20 July.]

1. Recent unemployment figures and other labour market indicators?

[In June, unemployment (UK adult seasonally adjusted) rose by 39,000 to 2,911,000 (12.2 per cent). Total unemployment rose by 92,000 to 3,061,000 (12.8 per cent). Vacancies (UK sa) fell for fourth consecutive month to 105,000 compared 113,000 in February. Vacancy flow data for May (latest month available) show inflow and outflow much same as April, slightly down on March, but much improved this year - about 164,000 per month compared about 145,000 per month in 2Q 1981. Recent unemployment/vacancy figures are shown below:

	1980 Q4	1981 Q1	Q2	Q3	Q4	1982 Q1	Q2
Unemployment (UK adult sa)	105	77	62	51	33*	21*	30*
Vacancies level	99	98	89	96	104	112	107

*After allowing for over 60's transferring to supplementary benefit.

Other labour market indicators (overtime, short-time, hours worked in manufacturing) improved during 1981, but have shown little or no further improvement since end of last year.]

Of course figures provide no grounds for satisfaction or complacency. But rise in unemployment this year less than half that in first six months of 1981; vacancies in June one-fifth higher than in Q2 1981.

[IF PRESSED Apparent general weakening of labour market indicators can be interpreted as consistent with hesitation in recovery since last autumn. Cannot draw implications from June figures about future levels of unemployment.]

2. Unemployment higher than in other countries?

[On standardised definitions in Q4 1981 UK unemployment was 12½ per cent compared with 7½ per cent OECD rate; a UK doubling compared with an OECD rise of almost one half since 1979.]

Whole world affected by rising unemployment. In our case we have additional self inflicted wounds of high pay awards and low productivity. Unemployment now rising very fast in some countries eg Germany.

3. Unemployment expected to continue rising rapidly?

[Mr Shore at Treasury First Order Question Time 15 July alleged no single forecasting group was predicting any fall in unemployment over next three years. Most outside forecasters see continued rise in registered unemployment during 1982 reaching about 3 million (UK adults) in Q4. Opinion divided for 1983: some (CEPG, Cambridge Econometrics, ITEM, NIESR) see rise continuing but at a slower rate; some broadly flat (LBS, St James); others (P&D, S & Coates) expect slight (roughly 50-100,000) but temporary fall in 1983: Liverpool foresee fall of 400,000. MSC annual review claims 'almost 40 per cent of unemployed people will be without a job for year or more throughout 1980s.']

Unemployment forecasts uncertain; independent forecasters encompass differing views for 1983 - several projecting stabilisation, some [a slight] decline. Rise in unemployment so far this year less than half that of a year ago. Employment situation will benefit from some further recovery in activity this year (see B1).

4. What is Government's own forecast of unemployment?

Government does not publish such a forecast. However it was assumed for expenditure planning purposes in Cmnd 8494 that unemployment (GB, excluding school leavers) would average 2.9 million in 1982-83, and for rest of survey period. Current (June) figure is 2.91 million and, though this is still rising, it is not inconsistent with PEWP figure.

5. Employment continuing to fall?

[Total employment declined 2.1 million (9 per cent) between mid 1979 and end 1981.]

Decline in H2 1981 about two-thirds that in H1. Best help for permanent jobs is sustainable recovery.

6. Recent productivity gains inimical to higher employment/lower unemployment?

[Output per head in manufacturing up 12 per cent since end-1980.]

This may be true in the short run. But in the longer term, as experience in UK and many other countries clearly demonstrates, higher productivity essential for growth and employment opportunities.

7. What is Government doing to provide more jobs?

Government pursuing sensible fiscal and monetary policies to curb inflation and creating conditions for enterprise - only measures that will ensure sustainable increase in employment. Nevertheless Government expanding schemes to meet special difficulties and improve training - eg plan to spend £1½ billion in cash on 1982-83 (40 per cent more than in 1981-82) on special employment and training measures; new Youth Training Scheme costing £1 billion a year from 1983-84; and MSC working on proposed new community work scheme announced in Budget Speech.

8. MSC Task Group proposals on youth training?

Government has accepted Task Group's scheme as immense step towards setting standards and systems of training for young people as good as those anywhere overseas.

D TAXATION

1. Burden of taxation

[Total taxation (i.e including for example income tax, indirect taxes, corporation tax, rates and NIC) in 1978-79 was 34½ per cent of GDP (at market prices), 36 per cent in 1979-80, 37½ per cent 1980-81. It is forecast to be 40½ per cent in 1981-82 and 39½ per cent in 1982-83. Corresponding figures excluding NICs are: 1978-79 28½ per cent, 1979-80 31½ per cent 1981-82 34 per cent, 198283 33 per cent.]

This has inevitably increased during a time when the recession has been adding to public spending. Changes proposed in Budget will reduce total burden in 1982-83 compared with 1981-82. [NB: Not true of burden on persons.]

2. Burden of tax has risen for most households/real weekly net income fallen since 1979?

[Parliamentary Written Answer 7 July col 111-2 showed that real weekly net income has fallen for manual workers.

Slow growth of output and difficulty of restraining public expenditure have inevitably meant higher tax burden. But aggregate real personal income after direct taxes still higher than under last Government [although not true of all sections of population]. And more honest to raise taxes to finance necessary higher expenditure than to increase borrowing, with the increased interest rates and inflation that would bring.

3. Burden has fallen for the rich?

Abolition of absurdly high marginal rates and raising of thresholds in 1979 essential to remove disincentives. Reimposition of an 83 per cent top rate of income tax would finance a reduction of less than one quarter of 1p in the basic rate.

4. Burden has risen most for the poor?

Proportion of income paid in income tax and NICs will fall in 1982-83 for lowest paid taxpayers. And low paid with children entitled to benefits such as FIS.

5. Personal tax burden increased by last Budget - when NICs taken into account?

The real increase in personal allowances and tax thresholds will reduce income tax as a percentage of income at all levels of incomes. Those over pension age who are taxpayers will benefit from income tax changes and will be unaffected by NIC rise, and, of course, State pensions are being uprated from November. [IF PRESSED: In immediate cash terms, increases in personal allowances etc will compensate for NIC increase for majority of taxpayers. Taking into account increased earnings in 1982-83 (for example using the

Government Actuary's 7½ per cent assumption) percentage of income paid in income tax plus NIC will rise for most people, but will fall for the lowest paid, ie below about ½ average earnings (married) and below about 1/3 average earnings (single).]

6. No improvement in incentives?

There will be 1.2 million fewer taxpayers than if allowances had remained at 1981-82 levels, and ½ million fewer higher rate taxpayers. For the substantial number taken out of tax or with reduced marginal rates, incentives will improve.

7. Poverty trap/unemployment trap getting worse?

The poverty and unemployment traps are a matter for concern. Must be remembered that result from attempts to relieve poverty over a period of years when the economy has shown little growth. The answer is to get sustained growth going again - this is the objective of our economic policies.

8. Family Forum call for Green Paper on effects of taxation and benefits on the family

Issued raised are among those covered by TCSC sub-committee's inquiry. Chief Secretary will be giving evidence on 21 July. Await report with interest.

9. Budget reduction in NIS not enough for industry?

Cut welcomed by CBI and industry generally. Provides substantial help on business costs. 1 per cent reduction maximum possible without risks for PSBR: outright abolition too costly. And other measures to help business directly - energy, construction, innovation and enterprise packages plus helpful - and welcomed - improvements in capital tax regime (see also Section P).

10. Excise duties increases inflationary/harmful to industries

Increases in excise duties as a whole slightly less than broadly compensate for past year's inflation. Variations between duties take account of industrial considerations e.g supplementary increase last July on tobacco/Scotch whisky industry/help for industry by smaller increases on e.g derv - mainly used by industry.

11. How has Government used fiscal incentives to encourage wider share-ownership?

Total of over 460 profit-sharing and share option schemes now approved by Inland Revenue. Compares with less than 30 in May 1979. Reflects liberalisation and extension of arrangements to promote profit-sharing and share-option schemes contained in 1980 Finance Act. Further fiscal encouragement on way from 1982 Finance Bill.

E PUBLIC EXPENDITURE AND FINANCE

[Public Expenditure White Paper (Cmnd 8494) published 9 March. Gives planning totals of £115.2 billion in 1982-83, £121.1 in 1983-84 and £128.4 in 1984-85. About £5 billion higher than last White Paper in 1982-83 and £7 billion in 1983-84. Net effect of changes announced in Budget is to reduce totals to £114.9 billion, £120.4 billion and £127.6 billion].

1. <u>Public expenditure too high</u>?

Spending in 1982-83 planned to be about £5 billion (4½ per cent) lower than intended by last Government even if higher than planned when this Government first took office. Decisions to increase spending represent flexible but prudent response to changed circumstances e.g additional spending to help young unemployed. Drive to improve management in public sector and reduce administration expenses continues.

2. <u>Ratio of public spending to GDP is getting back to peak levels of mid 1970's</u>?

Ratios in 1980-81 (43 per cent) and 1981-82 (44½ per cent forecast) remain below level of 1974-75 and 1975-76 (46 per cent in both years). Rise in ratio in 1981-82 mainly reflects higher expenditure on social security at a time when real GDP falling. Ratio expected to fall in next few years: assumptions in MTFS would mean figures of 44½ per cent in 1982-83, 42½ per cent in 1983-84 and 41 per cent in 1984-85. Reflects assumed GDP growth and curbing of public expenditure.

3. <u>Ratio to GDP must grow unless big improvement in economic performance</u>?

[David Blake article <u>The Times</u> 30 June on official study of long-term public expenditure.]

An official study prepared on long-term public expenditure as part of normal, and continuing, process of controlling public expenditure and monitoring longer term effects. Has yet to be considered by Government. But report may point too pessimistic picture of level of public expenditure in long term. Government's policies are designed to secure real and lasting improvement in our economic performance; evidence that they are succeeding. Inflation is already coming down faster than expected at budget time.

4. <u>Study on longer term public expenditure concludes that unemployment could stay at 3 million for rest of decade</u>?

This is not a conclusion of the study. Report does not make <u>any</u> forecast of future unemployment - it uses a purely hypothetical assumption, intended to show what might happen to public expenditure if the worst is assumed about unemployment.

5. <u>Increase spending in recession</u>?

No good trying to spend way out of recession. Any benefits would be short-term. If increased spending not financed responsibly, would soon lead to more inflation. If financed prudently, would lead to higher interest rates and/or higher taxes. We are responding, within limits of prudence, to needs of current circumstances.

6. Spending Ministers seeking extra £5,000 million public expenditure in 1983-84?/Treasury once again seeking cuts in public expenditure?

Bids for additional expenditure have been put forward in usual way as part of annual public expenditure survey. Ministers collectively will have to decide which are to be allowed and, depending on size of any increase, to what extent the increase should be met by savings elsewhere.

7. Not enough capital expenditure?

Government prepared to give priority to worthwhile capital projects wherever this can be done within overall spending totals. Plans do allow for changes between 1981-82 and 1982-83. Planned capital expenditure also reflects decline in needs since early mid-1970s (e.g roads, schools). Planned spending should not jeopardise future standards and availability of public amenities and services.

8. Cash planning means concentration on first year, not enough on services in later years?

Government recognise case for medium-term planning. But planning must be related to availability of finance as well as prospective real resources. Cannot accept unconditional commitment to forward plans for services. Volume plans formerly had to be cut when conflicted with financial constraints - e.g after IMF intervention in 1976.

9. End-year flexibility?

Possibility of end year flexibility is being looked at again. There could be some managerial advantages in such a scheme. But we also have to consider question of cost.

10. Cut public sector pay bill/administrative costs of central government?

Only one third of current expenditure is on wages and salaries and much of that is for nurses, teachers, members of armed forces, police and so on. Provision for public service pay increases 1982-83 limited to 4 per cent. Administrative costs are not far short of 10 per cent of total public expenditure. We are determined to reduce that proportion, and to maintain drive for more efficient management throughout public sector.

11. What allowance will Government make for pay increase in public services next year?

Government attaches great important to realistic wage settlements next year, in both public and private sectors. Provision for public service pay will be made from within cash plans for 1983-84. (See also K12.)

12. Will Government's operation of cash limits for civil service [and NHS] pay change as result of Megaw Inquiry Report?

Government is committed to policy of using cash limits to control public expenditure. We will consider and discuss the implications of Megaw report in due course. (See also K12.)

LOCAL GOVERNMENT

13. Overspending in 1982-83? Government response?

Local authorities are budgeting to spend some £1½ billion above Government's plans (£1¼ billion in England, £200 million in Scotland, £60 million in Wales). Government cannot ignore this large planned overspend. In ENGLAND, Environment Secretary intends to implement scheme for grant abatement announced last year and is considering further across-the-board grant cut. Secretary of State for SCOTLAND is seeking to reduce grants of Lothian Regional Council (by £45 million) and Stirling District Council (by £1½ million). Secretary of State for WALES has announced his intention to withhold grant. He also asked Welsh local authorities to submit revised budgets. Amount of grant to be withheld will be determined in light of these.

Local authorities have only themselves to blame for these grant penalties.

14. Large rate increases this year are Government's fault?

Not at all. If local authorities had sought to spend in line with Government's plans, rate increases should be very low. Where they are high, it is because local authorities have chosen to overspend.

15. Government's plans imply enormous job losses?

Not necessarily. Government's plans for local authority expenditure are realistic and achievable. Local authorities could do a lot to help themselves by moderating pay and improving efficiency.

16. Green Paper on Domestic Rating System: Government response?

Government is considering carefully all representations received. We wish to produce proposals for a scheme that will remedy shortcomings of present system while commanding wide support.

F CIVIL SERVICE STAFFING AND PAY

1. Civil Service too big/does too much/is over staffed?

Since Government came to office, Civil Service has been reduced by 9 per cent to 666,400. This is smallest since 1966. Results from reduction in functions, privatisation and improvements in efficiency. On course to achieve aim of having Civil Service of 630,000 by April 1984. This is 102,000 fewer staff in post than in April 1979, and will mean smallest Civil Service since end of Second World war.

2. Civil service pay: non-industrial civil servants

Civil Service Arbitration Tribunal awarded pay increases ranging from 4.75 per cent to 6.25 per cent - worth 5.9 per cent overall - and increases in annual leave. Government accepted award which is being implemented. Increases (announced 12 May) for higher civil service (under-secretary and above) were larger; they were decided in light of recommendations of Top Salaries Review Body. Cash limits and manpower targets not being adjusted. (See also Section K).

3. Megaw Inquiry

Report of Megaw Inquiry into arrangements for deciding civil service pay in future has now been published (Cmnd 8590). Report contains number of important recommendations which are now being considered. (See also E11-12 and K11-12.)

4. Civil Service pay: industrials

[Settlement date 1 July 1982]

Claim for increase in pay in line with inflation, shorter working week and longer holidays, is under discussion with the unions.

5. Scott Report/Public sector pensions?

See K 14.

G SOCIAL SECURITY

1. Restore abatement of Unemployment Benefit?

[Uprating in November 1980 was abated by 5 per cent; this foreshadowed in Budget Speech announcing plans to bring UB into tax.]

Abatement of unemployment benefit has been extensively discussed in House of Commons. We undertook to review when the benefit was brought into tax. We did not, however, commit ourselves to restoration of the abatement. We have undertaken the promised review, and have decided that we cannot afford to restore the abatement.

2. But abatement was a proxy for tax?

Always made clear when decision to abate was announced that it was not solely a proxy for tax but also part of a public expenditure savings package, and a measure likely to improve work incentives.

3. Cost of restoration substantially less than tax revenue?

[Cost of restoration £20 million first year, £60 million full year. Revenue from taxation now estimated at £650 million.]

Wrong in principle to hypothecate money from taxing benefits. But if MPs want to make such a comparison I would draw attention to cost of restoring shortfall in November 1981 uprating - £525 million in full year - this and other increases in social security expenditure more than accounts for the additional revenue.

4. Abatement hits at poorest section of the community?

Only one quarter of the unemployed are solely dependent on UB and hence affected by the abatement. All those affected will have been unemployed for no more than a year and are primarily single people or childless married couples.

5. Increase in PSBR from deficit on National Insurance Fund?

[Government Actuary's Report, published 29 June, shows substantially increased deficits on NI Fund for 1981-82 (up from £153 million to £1,045 million) and 1982-83 (up from £94 million to £350 million). These figures distorted by CS strike; underlying deficits nearer £600 million in 1981-82 and £800 million in 1982-83.]

For 1981-82, the published outturn already takes this into account. For 1982-83, revised deficit is one of a number of factors which will affect PSBR but is not, in itself, a sufficient reason to change our overall assessment of PSBR prospects.

6. Increase in National Insurance contributions because of NI Fund deficit?

The higher deficits for earlier years do not make inevitable an increase in contribution rates for 1983-84. A decision on the level of these rates will not be made until late Autumn and will take account of forecasts made at that time of Fund income and expenditure for 1983-84.

7. Merger of income tax and national insurance planned?

Government's written evidence to TCSC did not suggest such a merger. Committee asked about feasibility of merging the two systems, and the evidence gave an illustration of what a joint system would look like.

8. Death grant - increase to realistic level?

[Consultative document about death grant published 3 March, comments asked for by 30 July.]

Social Services Secretary would welcome comments on recently published consultative document on death grant. As have made clear, aim is to redistribute in more sensible fashion resources now devoted to death grant - cannot afford to add to those resources.

H FISCAL POLICY AND THE PSBR

[NB PSBR for June quarter to be released 22 July.]

1. Progress on Fiscal Policy?

[Aim is to achieve reduction in PSBR as percentage of GDP over run of years, so as to achieve lower inflation and interest rates.]

Have made progress; Government has succeeded in reducing PSBR as percentage of GDP, and further reduction is projected. Inflation is now lower than and interest rates are as low as have been at any time in last three years.

[IF PRESSED: Real interest rates still uncomfortably high here and overseas; serves to emphasise need to reduce borrowing over medium term.]

2. How does UK fiscal stance compare with other countries?

Most countries reducing borrowing; UK budget deficit now well below average of OECD countries. US experience shows that failure to bring fiscal and monetary policy into line can put excessive pressure on interest rates.

3. How much was PSBR undershoot in 1981-82 and why?

[PSBR for last year turned out £1.8 billion lower than estimate of £10½ billion given in 1982-83 FSBR.]

Information is still incomplete, but higher debt interest receipts, better receipts from Inland Revenue and lower 'supply' expenditure issues contributed to the undershoot. Some factors went the other way - deficit on National Insurance Fund for instance turned out higher than expected.

4. 1981-82 undershoot shows fiscal policy too tight?

Last year's undershoot probably does mean fiscal policy somewhat tighter than planned, but must examine strategy as a whole. Firm control of Government borrowing one factor responsible for fall in interest rates (four percentage points) since autumn.

5. Why treat PSBR as crucial statistic when prone to very substantial forecasting error?

[Margins of error are wide: plus or minus £4 billion.]

Although forecasting PSBR is hazardous, this in no way diminishes importance of achieving better balance between Government spending and income. Recognised by all Governments, whatever the difficulties of forecasting.

6. Isn't 1982-83 PSBR likely to undershoot too?

[Budget forecast for 1982-83 was £9.5 billion. NOT FOR USE before 22 July. PSBR figures for June quarter to be released 22 July £2.9 billion - broadly consistent with forecast for 1982-83 as a whole.]

Rash to jump to conclusions about this year's PSBR. PSBR turned out higher than expected in 1979-80 and 1980-81. Last year, many people expeected this to be repeated in 1981-82. CGBR figures for April-June quarter consistent with Budget forecast.

[IF PRESSED: Some of reasons for undershoot last year may imply lower PSBR this year (lower 'supply' issues, higher tax receipts). But other factors (pressure on Contingency Reserves from Falkland spending, changes in estimated NI contributions) could go other way. Unwise therefore to conclude that £9½ billion forecast for this year's PSBR particularly high. There are risks in both directions.]

7. Implications of CGBR outturn in April-June for PSBR in 1982-83?

[CGBR for April-June inclusive (published 9 July) was £3.1 billion; April-June 1981 was £7.4 billion.]

Last year's figures severely distorted by Civil Service dispute, so comparisons can be seriously misleading. Though appearing high, seasonal pattern of CGBR means that April-June figures consistent with Budget forecast for PSBR in 1982-83.

8. If PSBR higher in 1982-83 than in 1981-82 won't interest rates have to rise?

As percentage of GDP, outturn for 1981-82 is more or less equal to the forecast for 1982-83 i.e around 3½ per cent. The 1982-83 forecast is still a low figure both by comparison with deficits abroad and in relation to size of deficits over past decade.

9. Implications of lower than planned for public expenditure in 1981-82 for 1982-83?

Detailed public expenditure outturn information for 1981-82 will not be available until later this month. Until then, implications for 1982-83 uncertain. [IF PRESSED: It is estimated, on very incomplete information, that the planning total will fall from £105.2 billion in the FSBR to below £105 billion and that ratio of public expenditure to GDP will fall from 45 per cent to 44½ per cent].

10. Unadjusted PSBR misleading guide to fiscal action?

Inflation/cyclically-adjusted PSBR may have some merits as indicators but poor guide to fiscal policy. It is actual Government expenditure and revenue that determines the level of interest rates to be financed and influences level of aggregate demand.

11. Parliamentary control over borrowing?

[EST at Select Committee on Procedure 29 June].

Welcome interest shown in Procedure Committee. Will continue to provide information to help Parliament reach view on what is happening. Open mind to consider any suggestions from Committee about form of information. [IF PRESSED: Propositions for some form of control a different matter: could complicate policy decisions on spending and revenue].

J MONETARY AND FINANCIAL POLICY

1. Monetary growth in 1981-82

[Figures for banking June (fourth month of target period) indicated that £M3, M1 and PSL2 grew by 2.0, 0.8 and 0.6 per cent respectively (seasonally adjusted). These changes bring annual rates of growth in 1982-83 target period to 9½, 6¼ and 9 per cent respectively, compared with target range of 8-12 per cent.]

Too early to judge outturn over target period as a whole, but recent figures are again encouraging. Figures point to continuing steady downward pressure on inflation.

2. Monetary conditions too tight?

Exchange rate, money GDP and monetary aggregates suggest financial conditions have been moderately restrictive whilst allowing falls in interest rates. Growth of bank lending is still strong, however; we do not believe that monetary conditions have been too restrictive.

3. Bank lending

Banking June figure is again lower indicating that growth may be slowing. But although part at least of recent growth is in substitution for building society lending and other forms of consumer credit, to the extent that it is additional it may add to inflationary pressures; so must continue to proceed cautiously on interest rates.

4. Interest rates still too high?

Interest rates have come down significantly over past 6 months, and bank base rates have now fallen four percentage points since their peak last autumn. Of course we would like to see rates lower still; but we must proceed cautiously if we are not to jeopardise progress made to date in reducing inflation. Lower inflation offers best prospect for sustainable lower levels of interest rates.

5. Bank of England and Treasury in conflict, one wanting hold up exchange rate, the other to get interest rates down?

Bank's operations in the money market represent an agreed course of action.

6. Will high and unstable US rates affect UK rates?

US rates not sole determinant of UK rates, but high US rates certainly an adverse development and in September were a key factor in driving our rates up. Recently, however, sterling has remained reasonably firm, probably helped by improved prospects for wage round, and good trade figures. UK interest rates have eased this year against US trend; but we cannot insulate ourselves from difficult international background. (See also T10.)

7. Monetary targets discredited?

Monetary targets have important role in defining medium term direction of policy. But short term movements in monetary aggregates not always reliable guide to monetary conditions. Policy decisions based on assessment of all available evidence.

8. Why have you been 'over-funding' and providing large-scale money market assistance?

[Latest Bank of England Quarterly Bulletin carried small feature explaining process.]

The rapid growth of bank lending (much of which relates to structural changes) creates problems for conduct of monetary policy. By selling long-term Government debt on larger scale outside banking system it has been possible to contain growth of money which the lending would otherwise have produced. If we had not intervened to relieve resulting shortages in money markets, the banks would have been forced to bid for deposits, raising short-term interest rates to levels which, according to other indicators of monetary conditions, were not justified.

25 JUNE MONETARY PACKAGE

9. Will tax change on zeros and deep discounts reopen corporate bond market? Surely the tax treatment remains unfavourable?

Too soon to say how companies will respond. The tax treatment clearly is not as favourable as some would want - but to allow companies to offset discount against tax and investors to be taxed as on capital gains, would introduce unacceptable asymmetry. Announcement represents important step forward - and we have said we are looking at an accruals based system on US model. Best hope for revival of corporate bond market of course remains lower inflation and lower interest rates. We are on course for both.

10. Doesn't the amendment to the National Loans Act remove the only constraint on the Bank's purchases of bills? Will it mean even huger purchases in the future?

National Loans Act amendment is designed to remove essentially fortuitous constraint on Government's ability to borrow. Existing law could have prevented Government funding its borrowing requirement. Does not necessarily mean large increases in bill purchases. Scale of money market assistance will depend on future course of bank lending etc. Other measures designed to ensure it does not grow so rapidly - encouragement of corporate bond market and variable rate lending to local authorities.

11. Doesn't high Government funding and money market assistance merely mean higher long rates and lower short rates? Isn't it this that prevents companies borrowing long?

Level of interest rates depends essentially on scale of Government borrowing rather than its form. We have succeeded in reducing PSBR and Government's call on financial markets; which has paved way for lower interest rates. Lower funding and higher short term finance would mean higher money supply, which would cause expectations of higher inflation and raise interest rates.

12. Government simply acquiescing in and accommodating rapid growth of bank lending?

Growth in bank lending is response to high inflation and structural changes following ending of direct controls - which were proven to have little effect. Tax and borrowing measures announced 25 June will have some impact on rate of growth but if impact of bank lending on money supply minimised no cause for alarm about inflationary prospects.

K PRICES AND EARNINGS

PRICES

1. Inflation lower than under previous Government?

[Average year-on-year rate of inflation between February 1974 and May 1979 was 15.4 per cent; average level of inflation since May 1979 has been 14.0 per cent.]

Year-on-year rate of inflation was 10.3 per cent and rising when previous Government left office. Now (June) 9.2 per cent and falling. On present forecasts, we will be first Government for quarter of a century to successfully reduce the average rate of inflation during its term of office.

2. How low inflation by end 1982?

[Budget time forecast Q4 1981 to Q4 1982 9 per cent and Q2 1982 to Q2 1983 7½ per cent.]

No new forecast to offer at this stage, but the year-on-year rate of inflation was already 9.2 per cent in June. In the coming months, moderation in unit labour costs and competitive pressures on firms to limit price rises suggest Budget-time forecast of 9 per cent by this November could well be bettered.

3. Inflation still not as low as competitors?

[UK inflation 9.5 per cent in May, compared with 6.7 per cent in US, 5.3 per cent in West Germany, and 2.8 per cent in Japan.]

UK inflation now lower than Western European (OECD Europe) average, and well below many countries - such as France and Italy. Still some way to go to match US, West Germany and Japan, but good progress being made in right direction.

4. Long term inflation objective?

We must not rest on our laurels but continue to work towards maximum possible price stability.

5. Movement in tax and prices index?

[Increase in TPI over 12 months to June 9.4 per cent, compared RPI increase of 9.2 per cent].

Fact that TPI has been increasing faster than RPI reflects measures taken to restrain Government borrowing, which is essential if inflation is to be controlled. But following recent Budget, difference is now small.

6. Nationalised industry prices

[Increase over 12 months to May 14.0 per cent, compared increase of 9.5 per cent].

Gap between nationalised industry price increases and RPI due in large measure to cumulative effect of years of artificial price restraint. World oil price rises of 1979 and 1980 have also played important part. Increases regrettable, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so, but sustained improvement only possible if industries succeed in holding down current costs, particularly pay. (See also R7.).

PAY

7. Average earnings index

[Year on year growth 10.3 per cent in May compared with 10.2 per cent in April. However, underlying unpublished increase slightly lower than in April at around 10 per cent.]

Encouraging that underlying rate of growth continues to fall. But must remember change over the 12 months to May straddles two pay rounds - not entirely indicative of recent trends. Also, earnings index inflated recently by some increase in hours worked.

8. Current level of pay settlements

Recent decisions on public service pay announced by government confirm downward trend of settlements since the last pay round, when they generally averaged 8-9 per cent. Settlements are also well below rate of inflation for second year running.

9. Government has 6 per cent 'norm'?

There is no norm - nor has there been. Four per cent factor (allowed in 1982-83 public spending calculations) remains basis on which provision for public service pay has been set. Where extra provision has been needed to help finance proposed higher increases, as with nurses, doctors and dentists, it has been found partly from other savings on programmes concerned, and partly from Contingency Reserve.

10. NHS pay

Social Services Secretary announced 23 June that a further £90 million should be made available for increased pay offer in Health Service. This would allow increase in average pay for nurses of 7½ per cent, ambulance men and hospital pharmacists 6½ per cent, and other staff 6 per cent. Government believes this provides sound basis for settlement.

11. Top Salaries Review Board increases too large?

[Government announced on 12 May increases of 14.3 per cent for senior civil servants and senior members of the Armed Forces, and 18.6 per cent for the judiciary.]

Government believes these increases are fully justified. Essential to ensure adequate supply of candidates of sufficient calibre for the Bench, and to provide adequate career structure and differentials in higher levels of Civil Service and Armed Forces. TSRB are only group whose present salaries are below those recommended for April 1980.

12. Zero pay norm in next round?

[Chancellor's Speech 6 July.]

This Government is not in the business of setting pay norms (compare K8). It is for individual employers and employees to make bargains they think right in their particular circumstances, bearing in mind that the greater the restraint, the better prospect for jobs for those on the dole. No right to automatic pay increases every year.

13. Will there be a new pay factor for public expenditure?

Not yet been decided whether plans for next financial year will be calculated on basis of an explicit 'pay factor'. However, Government finances large proportion of country's pay bill; will have to ensure its own actions are compatible with overall needs of economy.

14. Government exhortations on pay imply aiming to cut living standards?

[Latest RPDI figures published 1 July show Q1 level much same as in Qs 2 and 3 1981 (Q4 discounted as 'erratically low'), and lower than Q1 1981.]

No. Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

15. Index-linked pensions and Scott report?

The Government is considering whole question in light of Scott Report. Our aim is to ensure that public servants' pensions are fair to taxpayers, as well as to current employees and pensioners and their dependants.

16. Incomes Policy

Proposals for incomes policies, including recent refinements, do not avoid many of the familiar problems of norms, administrative costs, and interference with market forces. Experience gives no encouragement to the idea that incomes policy can be made to work on a permanent basis. They always succumb to the distortions they create.

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L BALANCE OF PAYMENTS

1. May trade figures?

[Figures published 9 July show May trade deficit of £15 million, estimated current account surplus of around £35 million, giving cumulative total of £0.9 billion so far this year. Exports fell by some £105 million, mainly due to a fall in oil exports and erratics. Imports rose by £205 million in May, due to higher imports of manufactured goods. Invisible surplus projected at £150 million a month].

Current account fell substantially during May, due to large fall in oil exports from April's high levels and £200 million increase in deficit on non-oil trade. Cumulative surplus this year approaching £1 billion.

2. Exports

Export volumes of manufactured goods now back at high level of 1981 Q4, and holding up well. Export volumes (excluding oil and erratics) in three months to May were 7 per cent higher than a year earlier.

3. Imports

Imports of finished manufactures rose by £125 million, principally concentrated in capital and intermediate goods, reflecting a strengthening of investment activity. Imports of oil rose by some £35 million, accounting for some of the fall in the visible balance, while imports of basics, which also fell, remain 8 per cent higher than in 1981 Q1.

4. Geographical analysis of exports?

Exports to OPEC and other developing countries have risen 10 per cent (3 months on 3 months). Exports to North America have been adversely affected by the US recession and have fallen 1 per cent (on same basis).

M EXCHANGE RATE AND THE RESERVES

1. Policy towards the exchange rate/falling £?

[Since last autumn sterling has remained broadly stable. The average £ effective rate in Q1 1982 was over 10 per cent lower than in Q1 1981. Previous lows were $1.7470 on 6 April, DM 4.098 on 21 May. Highs were $1.97 on 30 November, DM 4.407 on 9 February. Rates at noon on 16 July were $1.7165, DM 4.281 and an effective of 90.86. Reserves at end June stood at $17.7 billion, compared with $17.8 billion at end May.]

Government has no target for exchange rate. The rate is taken into account in interpreting domestic monetary conditions and taking decisions on policy. Despite recent sharp fluctuations in value of some currencies caused by strength of dollar, sterling's effective exchange rate has remained relatively stable.

2. Bank of England intervening to support the rate?

Policy is unchanged. Bank do intervene to smooth excessive fluctuations and preserve orderly markets particularly when conditions unsettled. But, as Chancellor has already stated, we have no target - undisclosed, secret or otherwise - for the exchange rate. Most recent reserves figures confirm that policy is unchanged.

3. Concerted intervention to reduce value of dollar?

All experience in recent years that exchange rates for major currencies cannot be manipulated by intervention alone. Intervention can help to steady markets, but not counter major exchange rate trends. That takes changes in real policies, affecting interest rates, monetary conditions and fiscal policies. Lower US inflation is in everyone's interest: matter for real concern is US fiscal/interest rate mix, a problem all countries are familiar with.

4. Improve UK competitiveness by devaluing exchange rate?

Experience shows that exchange rate cannot be manipulated by Government against underlying market trends. Any attempt to lower it by intervention or by relaxing monetary control leads to higher inflation. For example the effective exchange rate depreciated by over a quarter between 1972 and 1976 without leading to any improvement in UK competitiveness.

5. Debt repayments

We have made excellent progress with our plans to reduce the burden of external debt substantially during this Parliament. We aimed to reduce official external debt to $14 billion by end of 1981. This has been more than achieved - external debt is now around $13 billion, compared with over $22 billion when the Government took office.

N EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. 1982 Budget - Parliament/Commission dispute

An agreement between the Parliament and the Council was signed on 30 June. If it is ratified by the European Parliament, it will provide the basis for settling the 1982 budget dispute, and also contribute to avoiding such disputes in future.

2. UK budget settlement

Foreign Ministers agreed on 25 May to a settlement for the UK budget contribution for 1982. The settlement provides for a basic refund of £490 million ecus in respect of 1982, with provision for changes to this figure if our unadjusted net contribution varies from the Commission estimate of £880 million. It was also agreed that the problem for the longer term would be settled by the end of November.

3. UK objectives for longer-term negotiations?

Government has made it clear that, in spite of our relative economic position, UK is prepared to remain a net contributor - but only on a very modest scale.

4. Implementation of budget settlement

Being considered by Foreign Ministers on 19-20 July. The 25 May agreement envisaged partial rebates to Germany, Italy, Greece and Ireland for their share in financing UK refunds, making France bear a larger burden - but France will remain a substantial net recipient from the budget.

5. CAP prices 1982-83 and the Luxembourg Compromise

We made clear in Foreign Affairs Council on 20 June that we wished to have clarity about the EC's decision-making procedures. Four other member states shared our wish to re-establish the principle of unanimity when vital national interests are invoked. This is an improvement on 1966, though it is still an agreement to disagree.

6. Commission's ideas for changes to 'own resources' system

['EEC considers new source to boost budget: FT 5 July.]

Understand that Commission are considering measures to diversify Community's revenue sources. If they put forward proposals we will consider them. Our opposition to any increase in the 1 per cent VAT ceiling is well known.

7. Policy for CAP reform

Key measures are price restraint, curbs on surplus production and strict control of the growth of guarantee expenditure.

8. Costs of CAP to UK consumers

The Minister of Agriculture has dealt with a number of questions on this. Costs to consumers of the CAP as such depend on nature of alternative support system that is envisaged. Arrangements leading to a reduction in the cost of food to the consumer could well involve increased costs to taxpayers.

EUROPEAN MONETARY SYSTEM

9. What is the current attitude of the UK Government?

We fully support the EMS, and acknowledge the contribution which it has made to stability in the exchange markets. However, we do not yet feel able to join the exchange rate mechanism. We must wait until conditions are right for the system and for ourselves.

10. Join the EMS for exchange rate stability?

There is no reason to suppose that by the simple act of joining the EMS exchange rate mechanism we would guarantee exchange rate stability. This has not been the experience of the current participants. Genuine stability requires a return to low inflation rates throughout the Community.

EXPORT CREDITS 'CONSENSUS'

11. Progress on Export Credit Consensus negotiations

In October 1981 participants of OECD-sponsored 'Consensus' reached an interim agreement on the new terms to be applicable for export credits. These terms were to be effective until 15 May 1982. The chairman of the Consensus's second set of compromise proposals were discussed at an EC Council of Ministers on 30 June. Proposals included reclassification of some countries and increase in interest rates charged to 'rich' and 'intermediate' country borrowers. These proposals have now been agreed subject to one outstanding issue concerning the country classifications of Greece and Ireland.

P INDUSTRY

1. Prospects for industry-recovery?

See A 6 and B1.

2. Companies' financial position?

[Industrial and commercial companies (ICC's) - excluding North Sea - gross trading profits (net of stock appreciation) rose 40 per cent to Q1 1982. But rise was from very low base - ICC's real rate of return just 2½ per cent in 1981. ICC's finances showed some weakening in Q4, reflecting slowdown in destocking, and unwinding of civil service dispute, but finances better in 1981 as a whole -

£bn

	1979	1980	1981 Year	H1	H2	1982 Q1
Net borrowing requirement (+)/repayments (-)	+6.1	+5.7	+4.4	-1.2	+5.6	+3.5
Financial surplus (+)/deficit (-)	-2.7	- 1½	+1.2	+1.5	-0.3	-0.5

Some apparent deterioration in financial position during 1981 reflects slowdown in rate of destocking, and effects of unwinding of civil service dispute (which delayed companies' tax payments), but companies' finances much healthier in 1981 than in two previous years.

3. Rate of return still too low?

[Real pre-tax rate of return of ICCs was 2½ per cent in 1981 - half the previous lowest figure in 1975.]

Yes, but Government can only help in limited ways. Fundamental improvement in ICC's profits and real rates of return depend on improved performance by companies, both management and employees. Much encouraged by recent productivity gains and trend towards moderate pay settlements.

4. High interest rates damaging for industry and investment?

[CBI estimate that each 1 per cent reduction in interest rates reduces industry's borrowing by around £250 million.]

Budget measures have eased pressure on interest rates, and the recent ½ per cent fall in the banks' base rates is encouraging. But Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking. Continuing relatively high level of interest rates must be seen in context of priority attached to reducing inflation and need to control growth in money supply underlying the MTFS. (See brief J).

5. Government help for small firms

Budget provided further help for small businesses, increasing the number of measures taken so far to over ninety. Enterprise package included further reduction in weight of corporation tax; further increases in VAT registration limits; increase in global amount available for loans under Loan Guarantee Scheme (see below); and doubling of investment limit under Business Start-Up Scheme to £20,000 a year. New measures will encourage start-ups and existing firms.

6. Response to Loan Guarantee Scheme?

[Nearly 5,000 guarantees already issued - about half to new businesses. Total lending under scheme just under £167 million. Budget provided for lending ceiling in first year (to May 1982) to be raised from £100 million to £150 million and for further £150 million to be available in second year (to May 1983). Thirty financial institutions now participating.]

Scheme operating successfully. Too early to assess overall cost . After first year, of nearly 5000 guarantees issued, only 50 have been 'called'. Cost has been more than covered by the premium income received over the period. Scheme is kept under continuous review.

7. Enterprise zones: response from private sector?

All eleven zones now in operation. Response has been very encouraging. Many new firms are setting up in the zones, existing firms are expanding their activities and vacant land has been brought into use. Too early to assess success of zones.

R NATIONALISED INDUSTRIES

EXTERNAL FINANCING LIMITS

1. EFLs for 1982-83 and future years?

Nationalised industries' total external finance increased by £1.3 billion in 1982-83 (£1.2 billion after allowing for NIS cut and other changes). Increase in 1982-83 was roughly half what the industries bid for. Government has given full recognition to problems faced by the industries in a period of recession. EFL's for 1983-84 will be announced later this year, as usual.

INVESTMENT

2. Investment plans unlikely to be attained?

No Government can unconditionally guarantee a level of investment by the nationalised industries. Approved levels set out in last White Paper (Cmnd 8494) are consistent with the industries' agreed external financing requirements, on the basis of their internal resource forecasts. But perfectly possible that plans might need to be revised, for example if the industries fail to restrain their current costs, including pay.

3. Take nationalised industry investment out of PSBR?

Real problem of pressure on resources cannot be solved by changing statistical definitions. Since nationalised industries are part of public sector, their borrowing - for whatever purpose - must by definition form part of public sector borrowing requirement.

4. Is PM satisfied with the rate of return on capital in the nationalised industries?

[Pre-tax rate of return on nationalised industries' capital (including subsidies) has recently been announced as being minus 1 per cent (about the same as in 1979). This compares with 3 per cent for industrial and commercial companies.]

No. That is why we are continuing to press for greater efficiency within nationalised industries, and are setting realistic financial targets to ensure that the taxpayer and consumer get proper value for money.

5. Finance more nationalised industry investment by cutting current spending?

Yes. As in private sector, moderate pay settlements and control of other costs are essential. Ability to finance new investment in nationalised industries bound to diminish if excessive pay settlements agreed. Each 1 per cent off wages saves about £140 million this year; and each 1 per cent off total costs saves £330 million this year.

6. Private finance for NI investment?

In discussions in NEDC and elsewhere, we have indicated our willingness to consider new financing proposals, provided they can be structured so as to induce improvements in efficiency at least sufficient to offset the extra cost, and provided the finance is raised in fair competition with the private sector.

NATIONALISED INDUSTRY PAY AND PRICES

7. Nationalised industries' prices

[Having risen approximately in line with retail prices for several months, the latest figures show bigger 12 months increase in nationalised industry, water and London Transport than all items RPI (13.8 per cent in June compared 9.2 per cent). This differential reflects March increase in LT fares and ending of electricity industry's rebates to consumers. Removal of these temporary distortions confirms that nationalised industry prices are still increasing somewhat faster than RPI, largely because of increases in energy sector.]

Gap between nationalised industry price increases and RPI has been due in large measure to cumulative effect of years of artifical price restraint. World oil price rises of 1979 and 1980 have also played an important part. We greatly regret the need for these increases, but holding prices down artificially would distort market forces and add to burden on taxpayer. Underlying position has been improving steadily for past year or so. The differential between RPI and NI prices water charges and London Transport fares is now 4½ per cent compared with 14 per cent in January 1982. But sustained improvement will only be possible if the industries succeed in holding down their current costs, particularly pay.

8. What is Government doing to improve Nationalised Industries' efficiency?

We continue to press for greater efficiency within NIs. We are setting realistic financial targets and performance anus. A rolling programme of Monopolies and Mergers Commission; investigation has been set up. The introduction of market zones provides greatest incentive to efficiency.

PRIVATISATION

9. What further sales expected?

Special sales of assets in 1982-83 forecast at around £700 million and around £600 million in each of the later years. These figures well above those in last White Paper. This reflects primarily very large sales of energy assets - Britoil and the British Gas Corporation's major offshore oil assets - to be made possible by Oil and Gas (Enterprise) Act (which received Royal Assent in June). Industry Secretary announced 19 July plans to sell 51 per cent of British Telecom - but not till after next Election.

10. Special asset sales in 1981-82

Gross sales in 1981-82 totalled £481 million, so target published in 1981 Public Expenditure White Paper of £500 million nearly met. Pleasing result - included two large sales - Cable and Wireless (£182 million) and Amersham International (£64 million). True that delivery of BNOC oil in 1981-82 paid for in 1980-81 and taken into account in special disposals figure for that year reduced 1981-82 receipts by £573 million to total of -£92 million. But it is gross figure which is true measure of success of Government's privatisation programme. As Chancellor said in Cambridge 3 July, 'Public utilities and the so-called "natural monopolies" cannot be allowed permanently and without challenge to remain within State ownership'.

11. Government has sold assets too cheap?

[Heavy oversubscription for British Aerospace, Cable and Wireless, Amersham International, followed by large increases in prices when shares first traded.]

Not in Government's interest to see shares underpriced, given the loss to the PSBR, but also risks in pitching price too high. Getting balance right not easy - especially when company's shares have not previously been traded. Government will continue to consider alternative forms of sale eg tender, but critics should note that sale by tender could make it harder for small investor to buy shares.

12. Contribution to giving people satisfaction of property ownership?

Exercise of returning enterprises from State ownership to ownership by the public has included measures to promote employee share ownership in the enterprise they work for; for example free offers of shares (British Aerospace, Cable and Wireless, Amersham); preference in allocation of shares (B Ae, C & W, Amersham, BP); provision for matching shares - one for each share subscribed for - (B Ae, Amersham, BP). Most radical initiative taken by consortium of managers and employees who bought National Freight Company.

S NORTH SEA AND UK ECONOMY

1. Onerous tax system damaging future field developments?

[Shell/ESSO announcement plans for Tern shelved partly because of tax system; reports that Phillips are postponing T-block complex and BP their Andrew field].

Other adverse factors - falling oil prices earlier this year; high development costs - much more important. Detailed study showed that under new tax structure, levels of profitability should still be sufficient to make exploration and development attractive. Hope that new structure will provide more secure and stable tax regime.

2. Chancellor's oil taxation package announced 9 June

[Summary: No field to pay APRT for more than 5 years; APRT repaid after 5 years if not set off against PRT; APRT allowed as a deduction in computing payback; further proposals to smooth PRT payments in second half of 1983; cost £55 million 1982-84]

Following Budget proposals, industry expressed concern on a number of specific matters; we have decided that some mitigation of burden for less profitable, more marginal fields is appropriate to meet particular problems. Tax system introduced in Budget, plus these changes, should enable nation to get its fair share from profits of this national asset, while leaving plenty of incentive to continue developing it.

3. Taxation of petrochemical feedstocks

[Government has announced that new rules on valuation of ethane for petrochemical use in interaffiliate transfers (Finance Bill Clause 119) should be extended to mixed streams of gas with a large ethane component. ICI complain that the extension and the rules themselves give unfair advantage to their integrated oil company competitors and have taken out writ against the Government.]

Government convinced that new formula will give fair valuation. New valuation will not have effect of providing subsidy to ICI's competitors. Have done best to reassure ICI. Will resist ICI's legal action.

4. Government should do more to promote UK Continental Shelf oil production in 1990's?

[Select Committee on Energy's Report on depletion policy published 18 May: recommends reserve powers to impose production cuts but main emphasis on promoting development of fields to come into production in 1990s - increase pace of licensing rounds and overhaul fiscal regime].

Government's considered reply will be given in due course. Accept need to prolong high levels of UKCS production until end of century at least. Energy Secretary announced 17 May Government's plans for Eighth Round of licensing. Do not accept that fiscal regime makes North Sea development unattractive. On Committee's general proposal for overhaul of regime, would point out that industry does not want a structural upheaval: it would create serious uncertainty and major transitional problems.

5. Benefits of North Sea should be used to strengthen economy?

[FSBR projections (in money of the day) of Government revenues from North Sea: £6.4 billion in 1981-82, £6.2 billion in 1982-83, £6.1 billion in 1983-84, and £8.0 billion in 1984-85. Lower than last year's projections, principally because of downward revision to oil price expectations. Projections incorporate March fall to $31 a barrel for Forties oil. Contribution of North Sea to GNP estimated at 4 per cent of GNP in 1981. Not projected to rise before 1985.]

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve lower level of interest rates to benefit of industry and economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Less than 6 per cent of total General Government receipts in 1981-82.

6. North Sea revenues should be channelled into special fund?

North Sea revenues are already committed. Setting up special Fund would make no difference. More money would not magically become available. So money for this Fund would have to come from somewhere else. This would mean higher taxes or lower public expenditure, if public sector borrowing is not to rise. If borrowing did rise, then so would interest rates. Not obvious that net effect would be good for investment.

7. Is Government underestimating North Sea revenues?

No. Other estimates of Government revenues based on assumptions that seem over-optimistic eg on future production.

8. Future North Sea oil prices?

A matter for commercial negotiation between oil companies and BNOC.

9. Are we really any better off for our North Sea oil?

We are better off with oil - at current oil prices - than we would have been without it. We have been spared fall in real national income that other industrial countries have suffered following oil price rises. But North Sea oil costly to produce, so we are not necessarily any better off than we would have been had oil prices not risen. No need therefore for possession of oil to require a contraction in our industrial base.

T WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Why don't major industrial countries together lead revival of Western economy?

OECD's Economic Outlook (published 7 July) explains clearly why Western Governments are convinced 'a significant part of any stimulus to demand would increase public sector deficits, and dissipate itself rather quickly as an increase in inflation'. Furthermore, there is 'the possibility of re-igniting inflationary expectations, which became firmly established over a decade or more...' Remarkable unity on this at recent Finance Ministers' meetings and at Versailles Summit.

2. Western Governments' policies will increase unemployment to 32 million?

[OECD Economic Outlook published 7 July forecast unemployment 'approaching 32 million' in first half 1983 or 9 per cent of OECD Labour force (10½ per cent of Europe's. Also notes that unemployment is concentrated on the young, and that, in Europe, about one third of jobless have been unemployed 6 months and more.]

True that OECD forecasts rising unemployment - largely as result of increase in number of people looking for work. But OECD also forecasts employment to rise by over 2 million people in OECD area next year.

3. OECD says global recovery won't last?

[Economic Outlook warned investment so far shows little sign of pick-up needed for recovery to be self-sustaining. But same paragraph ends by emphasising importance of improving business outlook.]

Lower inflation should help reduce interest rates and coupling of these two with recovery in output will generate right climate for recovery in investment during 1983.

4. French government 'seen the light' over reflationary policies?

[French government announced package of austerity measures including 4 month prices and wages freeze (to reduce inflation to single figures), increases in social security and unemployment contributions and limit to budget deficit of 3 per cent of GNP in 1982]

Strength and stability of Western economies as a whole will benefit if France - and Italy - can control inflation. So we welcome French government's recognition that inflation is as serious a threat as unemployment and that reining in public sector borrowing is essential part of counter-inflation strategy. (See also M6.)

5. Anti-inflation policies are working

[Inflation down from a year ago in 6 of major 7 economies - significantly down in US (from 10 to 6½ per cent), Japan (5 to 2½), Italy (20 to 15) and UK (11 to 9). Small reductions in ~~and~~ Canada (to 11¾), Germany flat but increase in France (from 13 to 14).]

Yes. Firm fiscal and monetary responses to 1979-80 vindicated by events. UK still some way to go to match US, Germany or Japan in bringing down inflation, but moving in right direction and ahead of some other European countries. Realism in wage settlements is growing; US, Germany and Japan all have wage settlements in single figures. Other policies also working: oil savings have helped cut OECD oil demand. All point towards basis for sustainable recovery.

6. Prospects for UK economy worse than for other countries?

No. OECD's forecast for UK is close to most recent domestic forecasts and predicts average growth of about 1¼ per cent in 1982, rising to annual rate of 2 per cent in second half of 1982. That is very closely in line with OECD forecast for whole of Europe. Unemployment is expected to rise in all major countries except Japan. UK inflation still forecast to exceed OECD average in 1982 because of recent falls in inflation rates of USA, Germany and Japan, but UK should average OECD rate next year. Could do it this year if more responsibility in wage settlements.

7. Prospects for US economy?

[Industrial production still falling in June; now 10 per cent below peak in July 1981. But stocks also decreasing - so consumption could be rising - and leading indicators rising for third successive month in May. Seasonally adjusted unemployment is 9½ per cent. Year-on-year rate of consumer price inflation down from 11 per cent in September 1981 to 6.7 per cent in May.]

Welcome signs that US recession may have ended. US has made good progress in reducing inflation. Some signs now of activity recovering, with housing starts and retail sales rising in May.

8. US Budget?

[One day after Congress agreed on budget deficit of $104 billion, Congressional Budget Office revised its economic and technical assumptions and re-estimated Congress's proposed FY deficit at $116½ billion. Congress's decision is not legally binding; outline agreement has now to be translated into detailed budget by Congressional committees.]

Welcome outline agreement on budget by both House of Congress. Hope Congress will soon reach agreement on details of budget for FY 83, as uncertainty about budget is probably an important factor adding to pressure on US interest rates.

9. US interest rate developments

[Prime rates still 16½ per cent, 3-month CD's dropped to 14.2 per cent]

True US interest rates rose recently. But prime rates well below peak of 21½ per cent last summer. Agreement on details of budget would improve prospects for lower interest rates.

10. Prospects for international interest rates?

Always difficult to forecast interest rates with certainty, but firm and balanced policies should over a period bring lasting reduction in both inflation and interest rates.

U FALKLANDS CRISIS EFFECTS/COSTS

1. UK economy affected by Falklands crisis?

Possible economic consequences cannot of course be ignored. But UK is basically in a strong financial position: inflation is coming down; interest rates on downward trend; balance of payments remains healthy; output is higher than a year ago. Disturbance due to Falklands dispute small in relation to overall macro-economic picture. No question of requiring any change in basic economic strategy.

2. Will dispute with Argentina affect UK trade figures?

Volume of UK-Argentine trade negligible (£20 million a month on either side).

3. Will freeze on Argentine assets affect standing of City?

We have not confiscated Argentine's assets, merely frozen them. This action was taken under extraordinary provocation; we believe international financial community will understand this.

4. Effect of restrictions on Argentina?

The crisis and our action will greatly reduce Argentina's capacity to raise loans on the international markets. A number of Argentine public foreign borrowing operations amounting to many hundreds of $million have been suspended since crisis began.

5. Future of restrictions?

European Community (and certain other countries) ended their measures on 20 June. USA and New Zealand ended theirs when we accepted de facto end of hostilities (12 July). But arms embargoes remain. UK's measures remain in place for the time being. Must take into account Argentina's restrictions against us.

6. Argentina's debts

[NOT FOR USE: Argentine foreign debt at end 1981 estimated at $34 billion - about half size of Mexico's or Brazil's.]

Argentina may be seeking debt relief in talks with certain creditors about debt rescheduling. Not with British banks while freeze on assets continues. Proper rescheduling agreement would need to involve all creditors. [IF PRESSED on debt default possibility: banks have taken fairly relaxed attitude because ultimately overseas debt must be repaid by exports; Argentina's export sector is agriculture, which, according to most experts, is fundamentally healthy.]

7. Falklands defence costs?

[Specific figures for replacement of equipment, requisitioning merchant ships etc on BBC programme 8 July were speculative.]

Preliminary assessment of broad order of defence costs (excluding garrison costs) is about £550 million in 1982-83, and £200 million in each of the following two years. Non-defence costs (compensation, rehabilitation) are expected to be minor in comparison. Totals should represent only a very small proportion of total public expenditure.

8. What will be costs of repairing damage and reconstructing the Islands' economy?

Too soon to say what these costs will be. Work has begun on restoration of essential services and on implementing Civil Commissioner's recommendations for priority action (accommodation, inter-Islands air service, education). Necessary financial provision is being made available. Not yet clear how existing FCO and ODA funds will be adequate and how far additional sums will be needed.

9. Is Government paying compensation for war damage?

Government has made it clear that compensation will be generous. [PM's reply at Question Time 15 June col 739.] Officials working on practical details. No estimate of the cost can yet be made.

10. How will the various costs be met?

Intention is to try to absorb 1982-83 costs within the Contingency Reserve - and to some extent within existing budgets. Remains to be seen how far feasible. How future years' expenditure is to be funded will depend on decisions in forthcoming Public Expenditure Survey. Extra costs to defence budget (costs of the operation eg fuel ship chartering, and equipment replacement) will be met out of monies additional to the 3 per cent annual rate of real growth already reflected in sums currently provided for defence. Decisions have yet to be taken on other programmes. In any case, the costs will be met in a way consistent with the Government's economic strategy.

AIDE MEMOIRE ON THE UK ECONOMY 19 July 1982

RECENT DEVELOPMENTS AND INDICATORS

(i) Activity. GDP fell by 6 per cent between 1979 H2 (last cyclical peak) and 1981 Q2 (trough of current recession), rose about 1 per cent between 1981 Q2 and 1981 4Q then declined by ¼ per cent in 1982 Q1. Weakening at turn of year in part reflects impact of severe weather and strikes.

Underlying level of output broadly flat in 6 months to March 1982, but industrial and manufacturing production rose some 1 and 1½ per cent respectively between April and May. Excluding North Sea industrial production in 3 months to May no higher than last autumn, but about 3 per cent higher than spring of last year. Most independent forecasts, business opinion surveys, and CSO's cyclical indicators expect resumed and continued recovery; May production figures could be first tentative signs of this.

Volume of new engineering and construction orders in 1981 up 15 and 11 per cent on 2H 1980. Whilst home orders have continued to improve in early 1982 export orders tended to weaken around the turn of the year. Private housing starts up over one third between 2H 1980 and 1981. Total housing starts in 5 months to May 1982 up 37 per cent on 1981 average.

Recovery in 1981 largely reflected sharp fall in rate of destocking. Consumers' expenditure and Government consumption broadly flat. Fixed investment broadly flat in 1981, up 4 per cent between 1981 Q4 and 1982 Q1; DOI investment intentions survey suggests rise of 2 per cent in MDS fixed investment in 1982.

(ii) Lack of complete trade figures for 1981 and changed documentation procedures make recent figures difficult to interpret. Exports have held up better than many had feared. In 9 months to May non-oil exports slightly (about 1 per cent) higher than in 1980. Non oil imports have risen - up 13 per cent in same period - in part reflecting reduced rate of destocking and further rise in import penetration ratio. Current account estimated to be in surplus of £1 billion in first five months of 1982 following £7 billion surplus in 1981.

(iii) Employment and unemployment. UK employment fell 2.1 million (9 per cent) between 2Q 1979 and 4Q 1981 (about two-thirds concentrated in manufacturing), though rate of decline has slowed down. UK adult unemployment risen by 1.7 million (less than fall in employment) and stood at 2.91 million (12.2 per cent) in June. Total unemployment (including school leavers) was 3.06 million (12.8 per cent). Underlying rate of increase in unemployment slowed sharply during 1981 (105,000 per month in 4Q 1980 cf 25,000 per month in H1 1982). Other labour market indicators improved during 1981; eg short-time working down by ¾ during 1981, overtime up by over 10 per cent during 1981, and vacancies - despite slight weakening since February - up by 1/5 in 2Q 1982 on 2Q 1981, and with more rapid turnover. Little or no further improvement in unemployment or other labour market indicators since turn of year.

(iv) Wages and prices. Increase in earnings in 1980-81 pay round 11 per cent (settlements averaged about 9 per cent), half that of previous pay round. Settlements well inside single figures are now widespread (CBI average for manufacturing 7 per cent) suggesting further moderation in current pay round. 12-monthly increase in RPI 9.2 per cent in June; well inside single figures. Recent progress suggests outturn to November this year could well be within Budget time forecast of 9 per cent. Manufacturers' input prices up just 5½ per cent in 12 months to June. Corresponding rise in manufacturers' output prices 8¼ per cent.

(v) Productivity and Competitiveness (manufacturing). Output per man risen 12 per cent since end-1980. Output per man and output per man hour 5 and 8 per cent respectively higher than previous cyclical peak (1H 1979). Together with pay moderation, resulted in little increase in unit wage and salary costs during 1981 - rise of less than 3 per cent in year to 1Q 1982 - a rate below average of our competitors and comparable to Germany and Japan. Competitiveness (relative normalised unit labour costs) improved by 10-15 per cent during 1981, but remains about 1/3 worse than in 1975.

(vi) Company finances. Gross trading profits of ICCs (net of stock appreciation excluding North Sea) rose about 40 per cent in year to 1Q 1982. But real pre tax rate of return just 2½ per cent in 1981. Despite rise in company borrowing and deterioration in liquidity in 4Q 1982 (largely reflecting reduced sale of destocking and unwinding of civil service dispute which delayed companies' tax payments), company finances healthier in 1981 as a whole than in 1979 and 1980. Company liquidity improved in 1Q 1982.

(vii) Monetary aggregates. £M3 grew at an annual rate of 13 per cent in 1981-82 target period (from mid-February 1981 to mid-April 1982) compared with target range of 6-10 per cent. At least part of excess reflected increased market share of banks in mortgage lending. Over the same period, M1 and PSL2 grew at rates of 7 and 12 per cent per annum respectively. In recent months monetary aggregates have grown more slowly; in first 4 months of 1982-83 target period M1, £M3 and PSL2 grew by 6¼, 9¾ and 9¼per cent at annualised rates respectively of target range of 8-12 per cent.

(viii) Interest rate/exchange rates. Interest rates have fallen since turn of year; process temporarily interrupted by Falklands crisis, but now resumed. 3 month inter-bank rate fell from 16 per cent in December to around 12½ per cent. After falling over 10 per cent during spring and summer 1981, effective exchange rate broadly constant at around 90 since last August.

(ix) Government borrowing. Latest published provisional estimate suggests PSBR £8.8 billion in 1981-82 ($3\frac{1}{2}$ per cent of GDP, compared with 5 3/4 per cent in 1980-81) about £$1\frac{3}{4}$ billion lower than estimated at Budget time. CGBR £3.1 billion in April-June 1982.

PART 17 ends:-

AW to MCS 14/7

PART 18 begins:-

Treasury Monitoring report 19/7

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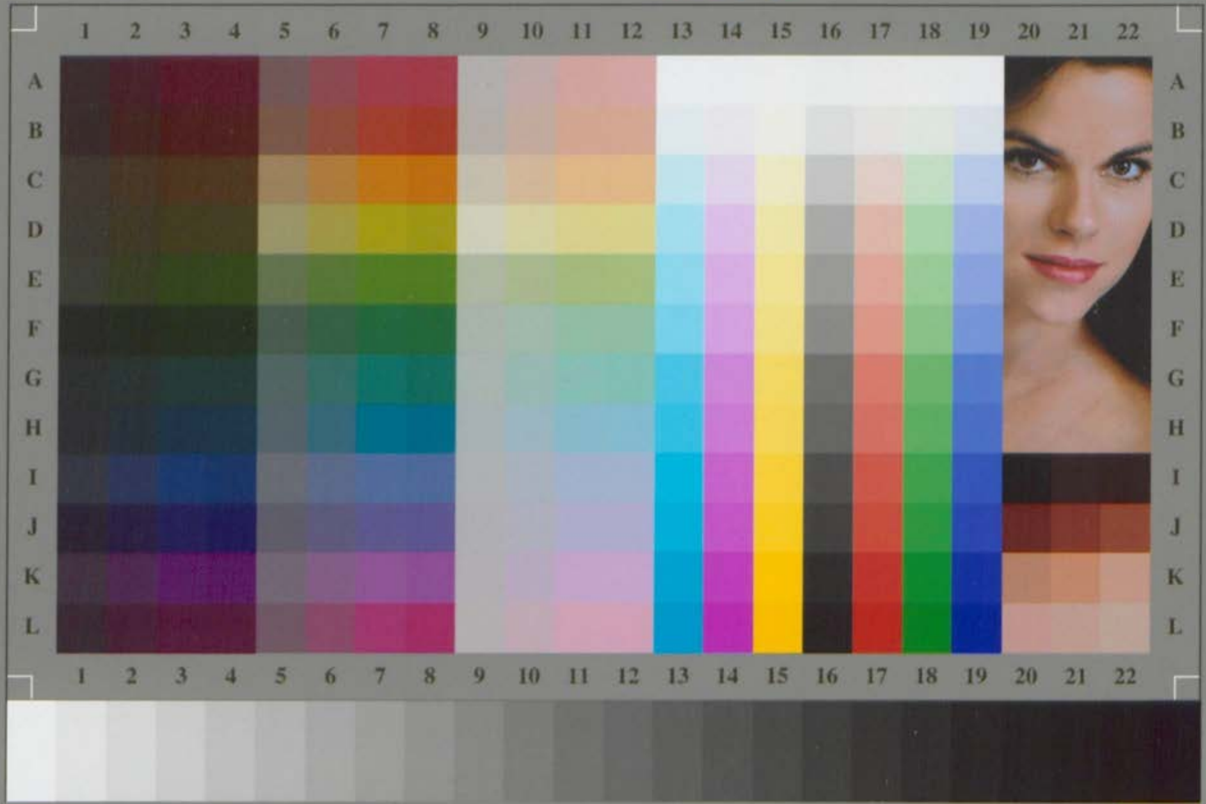

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