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CABINET

THE ECONOMIC PROSPECT

Memorandum by the Chancellor of the Exchequer

1. Our strategy for the medium term was set out in the Budget. There have been detailed criticisms of the realism of particular elements in that strategy, for example the size of the assumed turn-round in the finances of the nationalised industries, but its essence has not been seriously challenged. No-one has produced an alternative that would offer a better prospect for the difficult period that faces us. Indeed, all the suggested alternatives would carry high risks of greater inflation and greater loss of output and employment in the longer term. This is a good opportunity on which to take stock of the economy, and in particular to see how far its current course differs from our earlier expectations.

RECENT DEVELOPMENTS

2. The forecasts made before the Budget saw the economy moving into recession in 1980, with gross domestic product falling by about $2\frac{1}{2}$ per cent, and inflation peaking about the middle of the year and then gradually declining. Activity in fact remained rather stronger in the early months of the year than had been expected. But there are now clear signs that output is falling. Though the figures for recent months are distorted by the effects of the steel strike they do not suggest that that fall is faster than had been expected. Similarly, the 240,000 rise in unemployment in the past six months is in line with the Budget-time forecast. Rising labour costs and squeezed profit margins have been a major factor behind the $3\frac{1}{2}$ per cent fall in employment in manufacturing over the past year. Since output has been little changed over most of this period this suggests some improvement in productivity, in contrast with the experience in 1975 when the recession was accompanied by flat or falling productivity.

3. In two important respects, however, recent experience has been worse than expected. First, pay increases have been significantly bigger than we had hoped. Second, though, following the action we took last November, the growth of money supply has been reduced, it is proving more difficult than expected to hold it within the guidelines. This is partly because industry's

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demands for credit have remained very high but also because public spending in cash terms has been rising more rapidly in recent months than we had expected. The Public Sector Borrowing Requirement (PSBR) in 1979-80 came out significantly higher than estimated at Budget time, because of increased local authority borrowing. The central Government's borrowing requirement in the first two months of the current financial year has been increased by higher than expected spending on cash-limited supply expenditure.

INFLATION

4. The economic prospect is dominated by the problem of inflation. Over the past two years the rate of inflation in the Organisation for Economic Co-operation and Development (OECD) area as a whole has almost doubled, from about 8 per cent to 14 per cent. The doubling of the world oil price has played a significant part in this. In Britain, following the rapid monetary expansion between mid-1977 and mid-1979, the inflation rate has also doubled. Part of this acceleration was due to special, once-for-all factors, such as the backlash effect from the Labour Government's attempts to hold down pay, the switch from income tax to Value Added Tax and the necessary adjustment of nationalised industry prices and local authority rents, but pay increases have been disappointingly high.

WORLD ENVIRONMENT

5. Though industrial activity in most of the main economies had been stronger than had been expected at the beginning of the year, the tempo now shows signs of slackening. Led by America, OECD output is likely to fall over the next 12 months. The general expectation is that the world recession will be as severe as that of 1974-75. Most countries seem to have adjusted more smoothly to the oil price rise on this occasion. They appear to have learnt the lesson that the right response is not fiscal expansion. Stock levels have been kept under tighter control and wage-earners in OECD as a whole - though not Britain - appear to have accepted that the higher oil price entails a reduction in real earnings.

6. But while there is good reason to expect that the world recession will be shallower than in 1974-75, there are also grounds for thinking that the recovery from it will be weaker than in 1976. The international environment in which Britain's economy has to earn its living is therefore likely over the next few years to be one of relatively slow growth and rising unemployment. The unemployment rate in the United States and Canada is now nearly 8 per cent. Unemployment, on a comparable basis of measurement, is also above that in Britain in some other countries, including Italy and probably France.

THE PROSPECT FOR THE UNITED KINGDOM ECONOMY

7. In Britain, since the recession started rather later than expected, the fall in output this year could be slightly smaller than the $2\frac{1}{2}$ per cent forecast at Budget time; but by the same token output in 1981 now looks like falling by more than the 1 per cent forecast earlier.

8. While there is general agreement among forecasters that the economy is moving into recession there are differences of view about its likely depth and duration. These stem in particular from a divergence of view about Britain's trading performance, and especially about the consequences of the serious loss of cost competitiveness suffered over the past three years as a result of rapidly rising pay, poor productivity and an appreciating exchange rate. The Treasury's latest forecast assumes that part of our poor trading performance in 1979 was attributable to a relatively high pressure of demand at home: it is therefore thought that in the coming year the effects of the loss of competitiveness may be considerably offset by the fall in domestic spending. If we were to attach more weight to weaker competitiveness there would be a serious loss of export business and continued rapid import penetration in coming years. It is not easy to reach a conclusion as between these two views, and their implications for the United Kingdom economy over the next few years could be markedly different.

9. The recent forecast gives a prospect broadly similar in its general features to that presented in the Budget, but as the recession started rather later than expected more of the decline in investment, stocks and output is carried into 1981. With the completion of the run-down in capital spending and stocks, output growth should resume in 1982, and rise further in 1983, as inflation comes down and the world economy recovers. The levels of gross domestic product in those later years are not significantly different from those assumed in the medium-term financial strategy (MTFS) projections. However, because less of the recession occurs in 1980 and more in 1981 the growth rate over the three years 1981, 1982 and 1983 taken as a whole may fall short of the 1 per cent average assumed in the MTFS projections. Real earnings, which have increased at a totally unsustainable rate in the past two years, could fall if earnings decelerate ahead of prices. This would ease slightly the severe squeeze on profits. Even so, the company sector may remain in substantial financial deficit through this period. Unemployment is expected to rise steeply, and to exceed the level of 1.8 million assumed in the public expenditure survey by autumn 1981. Inflation is forecast to decelerate through the period from its present high level, but not as quickly as we had hoped.

10. The MTFS projections of public finances are affected not only by the worsened outlook for output and inflation in 1981 but also by particular changes to public expenditure and revenue. The most important of these are the smaller contributions to the European Community budget and the lower forecasts of North Sea oil output - amounting to a reduction of over 5 million tonnes, or more than 5 per cent, in some years. Though the effects on North

Sea tax receipts of these lower oil volumes is to some extent offset by the higher oil price, there is still a significant loss of revenue. The net effect of all these changes is to worsen the budgetary prospect for 1981-82 but to leave the prospects for the public finances in the later years close to the projections presented at Budget time. Thus after a tight budgetary position in 1981-82 there should be in the later years some scope for tax reductions consistent with the overriding objective of bringing down the growth of money supply and inflation.

11. The latest view of the medium-term prospects is thus broadly similar to the one I presented in the Budget, but recent developments - particularly the high level of pay settlements - have substantially increased the risks of a more adverse outcome. If the loss of competitiveness hits our external trade more severely than the forecasts assume the recession could be deeper and more protracted and the financial difficulties of the company sector more acute.

CONCLUSION

12. The course of the economy in recent months has not been substantially different from earlier expectations; if anything, inflationary pressures so far this year have remained rather stronger than expected, but there have been increasing signs of contrary pressures from the developing recession. It will be far from easy to contain the PSBR and reduce monetary growth in 1981-82, but in the present delicately poised situation it is more than ever imperative to hold to our strategy. The next two years are bound to be painful and difficult ones. But it is only by bringing about the needed adjustments in the economy in that period that we can create the conditions for sound and sustainable growth in the medium term.

G H

Treasury Chambers

30 June 1980