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SHORT TERM ECONOMIC PROSPECTS

1. The forecasters have now completed their autumn assessment and I attach the report. The main conclusions are:

i) Output is expected to fall by 2½-3% in 1980 and perhaps by slightly less in 1981. The quarterly profile suggests that output could stop falling in the autumn of 1981 but recovery may be slow.

ii) After a sharp fall to 14% in the early months of 1981 the annual inflation rate will not decline much during 1981 and decline only modestly in 1982.

iii) The PSBR forecast now centres on £10¾ billion in 1980-81 and £11¼ billion in 1981-82.

iv) Bringing the growth of money supply back within the MTFS will be difficult and probably necessitate continuing high interest rates.

I am in broad agreement with the picture emerging from the forecast although I expect the inflation rate to decline faster in the early part of 1981 (the current momentum to lower inflation seems very strong), and expect to see an earlier and more pronounced upturn during next year than in the main forecast. But a further difficult year for output seems certain; it will be difficult to meet the monetary profile in the MTFS for 1981-2 as there will be continuing pressure for monetary expansion; and there is considerable scope for setbacks in the movement to lower inflation.

The current state of the economy

2. As is often the case, much of the forecasting exercise has been concerned with an interpretation of the current state of the economy in the light of recent events; particularly the problem of reconciling the recent combination of apparently rapid monetary growth to rising real interest rates, an increasing fiscal deficit, a high exchange rate and a severe drop in output.

The world economy

3. We are clearly in a period of recession for the industrialised countries. Under the impact of the large oil price increase in 1979 and the early part of 1980 world inflation accelerated and output began to decline from the first quarter of 1980. This decline is likely to continue until the end of this year and 1981 could be a year of relatively slow recovery. World industrial output may fall by around 1% this year and 1981 could show scarcely any increase if we take the year as a whole. The fall in world output has brought some weakening of oil prices and commodity prices in general. Inflation has begun to be reduced but only limited further reductions seem in prospect for 1981.

Demand and output in the UK

4. We expect UK output to fall both in 1980 and 1981; the forecast is for a fall in GDP of 2¼% in 1980 (close to the FSBR forecast) and 2½% in 1981. The quarterly profile suggests that output will fall until the autumn of 1981 after which there could be some modest recovery. This could result in the level of unemployment (narrow definition) being 2.5m by the end of 1981. I expect to see an earlier and more pronounced upturn during next year but do not dissent from the view that output in 1981 will be markedly down on the 1980 level. Recent monetary, fiscal and inflation developments suggest that, apart from the exchange rate and interest rates, the stance of policy has moved

from being very restrictive during last Winter to being much less restrictive since Spring; money supply growth has been well in excess of the rate of inflation and the PSBR has been running at an annual rate of maybe £15b. This could suggest some temporary recovery or stabilisation of domestic demand over the coming months but if money supply is to be brought back to the MTFS the real money supply must contract again. A major uncertainty for output continues to be the effect of the major loss of cost competitiveness due to the rising exchange rate and relatively rapid growth in labour costs. So far this year export volumes have held up well but we now face a major contraction. The effect of the loss of competitiveness is expected to have major effects in 1981 and 1982 which will reduce the extent to which the UK is likely to share in the benefits of any upturn in world output. Hence the profile of only a shallow recovery from mid-1981 after the previous sharp fall in output. The forecast shows the level of output in 1982 to be about the same as in 1981. In recent months considerable effort has been devoted in the Treasury to investigating the effects of competitiveness changes and the results of this work are implicit in the forecast. But, even if the competitive effects are smaller than implicit in the forecast, the world outlook suggests there will still be a significant fall in output in 1981 - say 1½ to 2% - and it is very likely that output in 1982 will still be lower than in 1980. The fall in manufacturing output will be more severe; this is the normal pattern in recession and manufacturers are particularly affected by the loss of competitiveness.

Reactions of the company sector to severe financial pressure

5. The decline in output so far this year has been the result of a major reduction in stocks; some important components of demand - consumer spending, public authorities' current spending and exports - have been running at a higher level than last year. This represents some change of emphasis from the FSBR forecast where deteriorating net trade was

expected to contribute to the fall in output. The major inventory liquidation is clearly associated with the liquidity problems faced by the company sector. Earlier this year total income of the economy was rising at about 20% per annum. At the same time policy was aimed at reducing monetary growth to 7-11% with the intention of reducing the growth of total nominal income - and in turn inflation - towards this figure. Although monetary growth has exceeded the target some progress has been made in reducing the underlying growth of total incomes - albeit for the moment largely at the expense of output. The exchange rate and the pressure of demand have been crucial in this process. However, the reduced growth of incomes has been at the expense of the non-oil company sector; and particularly the trading sector. Personal disposable income has continued to rise at 20% per annum while company disposable income has probably been falling in current prices. In an effort to reduce borrowing the company sector has cut its stock levels and laid off many employees. The signs are that more is to come; company income continues to be under pressure and the stock/output ratio for manufacturing industry is above normal. Moreover expectations of future demand are weak, judging from recent CBI surveys.

6. Some of the reduction in company income has been due to the correction of anomalies of one kind or another or special events. The collapse of incomes policy and associated Clegg awards have raised local authority rates; the return to economic pricing in nationalised industries has also raised company overheads; the switch of taxes between direct and indirect, probably (irrationally) increased wage demands and settlements. High interest rates have been a further burden. At the same time the high exchange rate, partly due to higher oil prices, has prevented many of these costs being passed on, while at the same time increasing the purchasing power of the personal sector.

<u>The balance between the personal and company sectors</u>

7. The outlook for 1981 and beyond partly depends upon redressing some of this imbalance. It is particularly

important that some restoration of company disposable income takes place and in the absence of a sharp fall in the exchange rate or fiscal assistance this requires a reduction in real gross earnings. The forecast is based upon an average growth of earnings over the next pay round of 11½%; manufacturing earnings growth is expected to be restrained by market pressures to around 10% and public services pay (on the assumption given to the forecasters) by cash limits to around 9%. But given the pressure upon prices from low domestic demand and a high exchange rate this outcome would not be sufficient to provide much improvement in real company income. Under present circumstances it will be difficult to obtain a significantly better outcome on pay; and there is a real risk of doing less well. The present forecast implies a significant reduction in real pay over the next wage round and a steep deceleration from this year's level of settlements. But this will leave the company sector facing continuing pressure upon margins; it will imply no real improvement in cost competitiveness unless sterling falls, because average earnings in other industrial countries are likely to rise more slowly than in the UK.

Inflation

8. In recent months inflation has been much lower than might be expected on the basis of historic costs; by the end of the year it looks as though retail prices may be up to 3% less than suggested by the usual relationship. The forecasters put this down to the competitive pressures on prices from the efforts of producers to cut stocks and to try and match the prices of importers. The main forecast assumes that firms will continue to be unable to pass on into prices the full increases in costs but after a sharp fall in the inflation rate in the early months of 1981 to 14% little progress is expected for the rest of the year with the rate down to a little over 13% by the fourth quarter. Recent money supply figures provide no reason to expect any further fall; average growth of money supply over the past three years has been 15½%.

The view of some PCC members (including myself) is that in the short run we will do better than this; in recent months the underlying inflation rate has been below this (even allowing for the tendency for price increases to be lower in the second half of the year than the first half) and the indications are that this momentum will be carried forward into next year. The high exchange rate could mean that in the immediate future inflation continues to be below the rate we might expect looking at costs or money supply alone. In turn this could result in lower pay settlements. But the pressure upon profit margins may not continue and in the absence of a major deceleration in costs and monetary growth it will be difficult to sustain the improvement in inflation unless the exchange rate continues to rise to even more difficult levels.

The exchange rate

9. In the forecast the exchange rate is expected to be broadly stable for the rest of this year and only decline moderately in 1981. We need to show even greater modesty than usual in this respect as the exchange rate continues to confound all the forecasters. We can identify some of the major factors that have been contributing to sterling's strength; the oil price rise, increased OPEC funds, high interest rates. But this is clearly not exhaustive and the knowledge of these factors probably would not have led us to predict the current rate. Some of the pressure may subside as the real oil price stabilises and the flow of OPEC funds is reduced as they import more. But the continuing need to keep interest rates high and the determination to keep to the MTFS will exert pressure in the opposite direction. As already mentioned the effect upon competitiveness is substantial; our measure of relative unit labour costs is now 50% higher than it was in 1978. The extent and speed by which the real exchange rate has risen (that is the nominal exchange rate corrected for relative inflation rates) is without precedent. The size of the rise in the exchange rate was neither expected nor intended; it is certainly not a necessary part of Government strategy

that the rate should rise so far, though it has undoubtedly contributed to the reduction in the inflation rate this year. It would ease the process of adjustment considerably if the exchange rate was 10% lower. But it is also clear that there is little that can be done to achieve this without damaging the monetary strategy. It is therefore important to use whatever pressure is available to bring pay and prices in line with the exchange rate and attempt to reduce the real exchange rate by this route. This will inevitably be very difficult as pay and prices are adjusting only slowly to the high exchange rate. The Government has (rightly) been exhorting industry and unions to bear in mind the exchange rate when determining pay and prices; industry can legitimately exhort the Government to do likewise. The major nationalised industry prices and local authority rates are among the items showing least response to the high level of sterling, in part because the public sector is little involved in international trade.

The PSBR

10. The forecast PSBR for 1980-81 is now put at £10¾b although a realistic margin of error is still £2 billion; of this around £8.0b has occurred in the first half of the financial year. This represents an upward adjustment of over £2b compared to the FSBR forecast; the major overruns are for local authorities and public corporations and there is a shortfall of expenditure taxes. The counterparts in the other sectors are a £13b private sector surplus (a £16b personal sector surplus offset by a £3b company sector deficit).

11. For 1981-82 the forecast is a PSBR of £11b; the forecasters stress the very large standard error involved. The assumptions behind the forecast are important; full inflation adjustment of taxes in the Budget; public sector pay limits of 9%; the maintenance of the volume plans in the recent White Paper modified by savings in EC contributions and additional Civil Service manpower cuts. The PCC discussion pointed out that this would not be easy to achieve and the PSBR could be

significantly higher. The 9% earnings assumption for public services' pay could be regarded as optimistic in relation to about 12% forecast for other sectors' earnings; the assumption that the Chief Secretary's July proposals will be achieved in full now look optimistic; nationalised industries' borrowing could be higher as the forecast heavily discounts recent estimates of the bids for external financing (in the light of experience). The counterpart is a £12b private sector surplus (a £14b personal sector surplus offset by a £2b company sector deficit).

The monetary targets

12. Against this background the monetary target will continue to present difficulties. Recent performance has been particularly disappointing. It is not enough to argue that the target was too tight in relation to the underlying inflation rate: the outcome for monetary growth in the first half of the year has been clearly in excess of the inflation rate. The high PSBR in the first half of the year has almost certainly contributed a great deal. It is also likely that the large corporate sector borrowing requirement has involved heavy bank lending. The forecast has been prepared on the assumption that the underlying growth for £M3 will be 12% between February 1980 and April 1981 plus or minus 2%. This might provide an adequate base to re-affirm the monetary strategy and would imply a substantial correction of recent excesses. But this is likely to involve the maintenance of existing interest rates, substantial sales of National Savings and some slowing down in bank lending. A potentially serious problem is the strain on the balance sheets of banks if private sector lending continues to grow faster than the money supply. This may lead banks to bid public sector debt away from the private sector - thus increasing the money supply. This can only be offset by keeping short rates at much the present level.

Conclusion

13. The underlying situation therefore remains extremely difficult.

i) An attempt to get within the upper limit of the monetary target and back to the MTFS on the present PSBR forecast will imply a continuation of high short-term interest rates. Some correction to the PSBR in 1981-82 may be necessary to deliver the monetary target in the MTFS.

ii) Attempts to keep to the monetary policy may mean a continuation of a high exchange rate although the range of error is enormous.

iii) The level of output in the economy is likely to continue to decline into next year. A substantial part of this problem is the high exchange rate and the major disequilibrium between the personal and company sectors.

iv) The inflation rate and earnings outlook are much improved but the cost and monetary background give little confidence that a major reduction of inflation below the centra forecast can be sustained next year.

v) The private sector is making considerable (if belated) efforts to adjust to the high exchange rate. The public sector continues to be substantially out of step.

vi) If a successful shift to a 6-10% monetary target in 1981-82 is to be achieved and maintained this means focusing as many items of income and expenditure as possible towards the target. The present range where public current spending is rising at 20-25% and company income is falling is severely damaging to efforts to impose a strict monetary policy.

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T BURNS
9 October 1980

TABLE 1 SUMMARY OF FORECASTS

		Central forecast
PSBR £bn	1979-80	10
	1980-81	$10\frac{3}{4}$
	1981-82	$11\frac{1}{4}$
	1982-83	$9\frac{1}{2}$
Interest rate (a)	1979 Q4	$15\frac{3}{4}$
	1980 "	$15\frac{3}{4}$
	1981 "	$15\frac{1}{2}$
	1982 "	$14\frac{1}{2}$
Exchange rate (b)	1979 Q4	$68\frac{3}{4}$
	1980 "	$75\frac{1}{2}$
	1981 "	$74\frac{1}{2}$
	1982 "	$71\frac{1}{2}$
Inflation % changes in the RPI	1979 Q4	$17\frac{1}{4}$
	1980 "	$16\frac{1}{4}$
	1981 "	$13\frac{1}{4}$
	1982 "	$11\frac{1}{4}$
GDP growth % by volume	1979	$1\frac{3}{4}$
	1980	$-2\frac{3}{4}$
	1981	$-2\frac{1}{2}$
	1982	-
Company financial balance, £bn (c)	1979	$-3\frac{1}{2}$
	1980	$-2\frac{1}{2}$
	1981	$-2\frac{1}{2}$
	1982	-1
Unemployment rate % (d)	1979 Q4	$5\frac{1}{4}$
	1980 "	$7\frac{3}{4}$
	1981 "	$10\frac{1}{4}$
	1982 "	$11\frac{1}{2}$

Notes: (a) The interest rate is the 3 month interbank rate.

(b) Exchange rate is the effective rate based on 1971 Q4 = 100.

(c) Company financial balance refers to the financial surplus of Industrial and Commercial companies.

(d) Unemployment is given excluding school-leavers seasonally adjusted as a percent of the labour force.