cc: Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Mr Burns
Sir K. Couzens
Sir A. Rawlinson
Mr Ryrie

Mr Littler
Mr Middleton
Mr Bridgeman
Mr Cassell
Mr Lavelle
Mr Shepherd
Mr Bottrell
Mr Davies

F(SCT)

Mr Folger
Mr Ridley
Mr Cropper
Mr Cardona
Mr Unwin

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

13 February 1980

Dear Edward

PM. 'economic strategy' TL 3/3

When you wrote to me on 12th December last you enclosed a number of questions to which you indicated that the Treasury and Civil Service Committee would value a written response as background to the enquiries they are planning to undertake in the course of this year.

I thought that the most helpful response I could make would be to set out in this letter the main objectives of the Government's economic strategy and to relate this so far as possible to the particular points raised in the questions with your letter.

The Government's economic strategy

The main objectives of the Government's economic strategy are to reduce inflation and to create conditions in which sustainable economic growth can be achieved. This requires firm monetary and fiscal policies and we have not hesitated to take action on both fiscal policy and interest rates to curb the excessive increase in monetary growth that we inherited. At the time of the Budget last June, when the rate of monetary growth was above the previous Government's target, a target growth rate of 7-11 per cent was set for sterling M3 for the period mid-June 1979 to mid-April 1980, and Minimum Lending Rate was raised to 14 per cent. It was also estimated that the PSBR for the current financial year would be some £8¼ billion (4½ per cent of GDP).

As the Committee will be aware, however, in the period to October 1979 the underlying rate of monetary growth continued significantly above the target rate as a result of higher than expected public borrowing (due in large part to delayed Post Office and VAT payments following industrial action) and persistently high bank lending. The Government, therefore, acted to bring the PSBR back into line with the Budget estimates by advancing Petroleum Revenue Tax payments; Minimum Lending Rate was raised to

/17 per cent;

The Rt. Hon. Edward Du Cann, MP.

17 per cent; and the 7-11 per cent target annual growth rate for the money supply was extended to cover the 16 months to mid-October 1980.

A firm limit on monetary growth also requires a consistent fiscal stance if interest rates are not to rise, and this means tight control of public expenditure if the tax burden is not to increase. In the Budget I announced public spending plans for 1979-80 stabilised at the 1978-79 levels, and the White Paper published in November 1979 (Cmnd 7746) held plans for 1980-81 at the 1979-80 level. Since then, however, we have looked again at the 1980-81 plans to see where further savings are sensible and practicable, and these will be set out in due course, together with the plans for the later years, in the second White Paper. The scope is limited as the start of the financial year approaches but any further savings will mean that less needs to be found by taxes if borrowing is not to be increased.

The ways in which control of the money supply affects the growth of money national income and ultimately prices are complex. Lower monetary growth may be expected to result in a lower growth of money incomes and nominal expenditure, because of its effects on the exchange rate and asset prices and the fiscal changes required to achieve lower monetary growth. Lower growth of money incomes will ultimately lead to lower inflation; and the speed at which this occurs depends crucially on expectations in both domestic and external markets, and in particular on the effects on domestic pay negotiations. As I have made clear on many occasions, the more moderate are pay settlements, the faster will the adjustment of prices and the smaller any transitional effects upon profits, output, investment and employment.

<u>The Exchange Rate and the balance of payments</u>

The Government, through the Bank of England, intervene in the exchange markets to prevent excessive fluctuations in the exchange rate but they do not attempt to establish any particular value for sterling. The exchange rate for sterling is thus primarily set by market forces; and the market's perception of the appropriate rate is of course, likely to vary from time to time as particular factors assume grater or less importance in the market's judgement.

Recently, sterling has been generally firm, as the market has laid particular stress on the UK's favourable position as an oil producer at a time of rising oil prices. The market has also taken a favourable view of the Government's commitment to firm fiscal and monetary policies. The abolition of exchange control has resulted in an outflow from the private sector the direct effect of which is to reduce the money supply; but because of the factors

/referred to

referred to above these flows have been more than offset by inflows from the rest of the world.

The balance of payments on current account was in substantial deficit in 1979 but this deficit was more than offset by capital inflows; and the reserves rose. The poor trend in our trade performance in recent years, which reflects the UK's inadequate industrial performance, is a matter for concern. The way to improve this, however, is not by a depreciation of the exchange rate - since any gains to competitiveness will in time be eroded - but by higher productivity and lower cost increases.

The Government believe, therefore, that overriding priority must be given to reducing inflation, which impairs economic efficiency and discourages investment, and to strengthening the supply side of the economy.

The UK's net contribution to the EEC Budget is expected to rise to about £1.2 billion at outturn prices in 1980, making the UK the largest net contributor. This represents a massive transfer of real income to richer member countries; and adds substantially to public expenditure and the PSBR. It also has an adverse effect on the balance of payments and is contributing to the erosion of the traditional surplus on invisible account. These are the reasons why the Government are determined to achieve a very substantial reduction in the size of the transfer.

<u>The supply side of the economy</u>

Starting with my Budget last June, the Government have taken a number of steps to improve the supply side of the economy both through changes in taxation and through measures to restore the flexible working of the market economy.

So far as taxes are concerned, our primary concern is that both the structure and level should not discourage enterprise and should permit hard work and initiative to be rewarded. My Budget last June accordingly included a substantial switch in taxation away from taxes on incomes to taxes on spending. I believe that the reduction in marginal rates of income tax should be particularly helpful in improving incentives by allowing people to keep a higher proportion of extra earnings; and the increases in personal allowances helped the lower paid. The Government's longer-term aim is to reduce the basic income tax rate to no more than 25 per cent.

The Government are also concerned that in the economy at large market forces should be encouraged to work as

/freely and

freely and flexibly as possible. This is why we have abolished price, dividend and exchange controls, none of which served any useful purpose, but all of which hindered the efficient functioning of the economy.

The abolition of price controls leaves companies free to make pricing decisions in the light of market conditions. Dividend controls were widely acknowledged to be a source of distortion in the capital markets and a disincentive to progressive firms, especially smaller ones, as well as an administrative burden to both public and private sectors. And the abolition of exchange control now leaves capital markets free to direct funds to those investments - whether at home or abroad - which are expected to yield the highest returns. At the same time, the Government's Competition Bill will strengthen the power of the Director General of Fair Trading and of the Monopolies and Mergers Commission to deal with practices which restrict competition.

The Government have also eschewed all the apparatus of formal incomes policies which have failed in the past and led to distortions in the labour market. As my colleagues and I have frequently stated, the Government do not intend to intervene in individual wage negotiations except where they are inevitably involved as direct employers. They are concerned, however, that negotiators should understand and accept as quickly as possible that their own best interests are served by modest pay settlements, and that a de-escalation of pay settlements is crucial if Britain is to be transformed once more into a successful trading nation.

The Government intend to restore a broad balance of power in the framework for collective bargaining. Reforms to be effected by the Employment Bill, such as those removing specific abuses in picketing and the closed shop, have been designed to that end. Other measures in the Bill remove aspects of employment protection which have in practice turned out to discourage employment rather than improve its conditions.

Economic developments since 1976

The enclosure to your letter also sought information on economic policy measures and the development of the main economic indicators over the past three years. This is already largely available from published sources. Major policy measures are, for example, listed in Economic Trends monthly calendar of events. More details have also been provided both by this Government and their predecessor in successive White Papers on public expenditure and in the

/Annual Financial

Annual Financial Statement and Budget Report. And figures for GDP, unemployment and the balance of payments are published regularly in Government statistical publications. However, the Committee may find it helpful to have a summary of major policy measures and economic developments,
..... and these are attached at Annexes A-E.

The effectiveness of monetary policy as a means of reducing inflation

Monetary policy is essentially a medium-term policy. The practice of publishing targets for the monetary aggregates is of relatively recent origin in this country, dating from 1976. The UK's experience, therefore, is limited so that past experience may not be a good guide to developments in the new situation. The Government's commitment to a firm monetary policy has contributed significantly to the strength of sterling; and a high exchange rate has a direct beneficial effect on inflation through the reduction in the cost of imports.

For the future, I believe that the Government's determination to maintain a strict monetary policy will have an important influence on inflationary expectations, whose importance I have already stressed above. And I am confident that a progressive reduction in the rate of monetary growth over a period of years, supported by consistent public expenditure and taxation policies, will both result in a marked reduction in the rate of inflation and will prove the only way of achieving a permanent reduction.

The forecasts

Finally, the enclosures with your letter asked about the Government's forecasts for the future. A copy of the Government's Industry Act forecast published last
..... November is attached and the Committee may find it convenient to have this to hand. A further forecast will, of course, be published with the Budget on 26 March.

Yours ever

Geoffrey

GEOFFREY HOWE

I. MONETARY TARGETS

Monetary targets were first set for the year 1976-77. For that year and 1977-78 the Government's objectives were defined in terms of a limit (agreed with the IMF) on DCE, although ranges for £M3 growth were defined consistent with that limit. For subsequent periods a target range has been set for £M3 growth. The targets, and monetary growth over the target periods, have been as follows:-

Date	Period	Target	Outturn
15 Dec 1976	12 months to mid April 1977	1) DCE (limit): £9.0bn 2) £M3 (consistent range): 9-13%	1) DCE: £4.6bn 2) £M3: 7.4%
29 Mar 1977	12 months to mid April 1978	1) DCE (limit): £7.7bn 2) £M3 (consistent range) 9-13%	1) DCE: £4.2bn 2) £M3: 15.7%
11 April 1978	12 months to mid April 1979	£M3: 8-12%	£M3: 10.7%
19 Nov 1978	12 months to mid October 1979	£M3: 8-12%	£M3: 13.4%
12 June 1979	10 months to mid April 1980 subsequently extended to	£M3: 7-11% (annual rate)	£M3: 11.5% (annual rate after 6 months)
15 Nov 1979	16 months to mid October 1980	£M3: 7-11% (annual rate)	

Note: All figures seasonally adjusted: growth rates calculated as seasonally adjusted increase on seasonally adjusted stock.

II. INTEREST RATES

Details of interest rate movement are available in section 13 of Financial Statistics, in particular table 13.11 for Minimum Lending Rate, table 13.10 for short term rates and table 13.7 for redemption yields on British Government securities of different maturities. Average interest rates for the past three years are summarised in the attached table overleaf.

		Minimum Lending Rate	3-Month Inter-bank rate	20-year Government stocks
1977	1	12.31	11.81	13.89
	2	8.39	8.05	13.00
	3	7.24	6.94	12.57
	4	5.85	5.74	11.15
1978	1	6.53	6.63	11.52
	2	8.57	9.04	12.68
	3	10.00	9.67	12.63
	4	11.39	11.59	13.14
1979	1	13.02	12.67	13.35
	2	12.48	12.22	12.13
	3	14.00	14.08	12.38
	4	15.45	15.69	14.10

III. SUPPLEMENTARY SPECIAL DEPOSITS SCHEME

The SSD scheme (or "corset") was first introduced in December 1973, and has been activated on two other occasions since then. It is currently in force, although the Chancellor said in his statement of 15 November 1979 that he did not envisage it having a permanent role to play in monetary control. Details of the operation of the scheme since it was first introduced are given in the table overleaf.

SSD SCHEME: HISTORY

Date Announced	Base Period	First Penalty Period	Period of Adjustment 1/	Guideline 2/	Suspension Announced	IBELs Growth to First Penalty Period	IBELs Growth Whole Period 3/
1. 17 December 1973 (extension 30 April 1974 and 12 November 1974)	average mid Oct to mid Dec 1973	average mid April to mid June 1974	5 months	8% for first 6 months, then 1½% a month	28 February 1975	2.2%	7.0%
2. 18 November 1976 (extension 12 May 1977)	average mid Aug to mid Oct 1976	average mid Feb to mid April 1977	4 months	3% for first 6 months, then ½% a month	11 August 1977	-2.5%	-1.0%
3. 8 June 1978 (extensions 17 August 1978, 3 April 1979, 12 June 1979, 15 November 1979)	average mid Nov 1977 to mid April 1978	average mid Aug to mid Oct 1978	3 months	4% for first 7½ months, then 1% a month		1.6%	20.6% (to most recent period, average mid Oct - mid Dec 1979)

Notes
1. The period of adjustment is the time between the announcement and the middle of the first penalty period.
2. The first part of the guideline shows allowed growth from the average of the base period to the average of the first penalty period.
3. Growth over whole period is measured from base period to the average of the last (or most recent) three months for which the scheme was in operation.

ANNEX B

PSBR 1976-1977 to 1979-80*

£ billion

	Date	1976-77	1977-78	1978-79	1979-80
1. Chancellor's Statement & letter of Intent to IMF	15.12.76	11.2	8.7	8.6	
2. Budget forecast: FSBR 1977-78	29.3.77	(8.8p)	8.5		
3. October package	26.10.77		7.5	7.0	
4. Letter of intent to IMF	14.12.77			8.6	
5. Budget forecast: FSBR 1978-79	11.4.78		(5.7p)	8.5	
6. Industry Act Forecast	Nov1978			8.0	8.5
7. Budget Forecast: FSBR 1979-80	12.6.79			(9.2p)	8.3
8. Industry Act Forecast	Nov1979				8.3
9. Outturn (Financial statistics Dec.1979)		8.5	5.6	9.3	

p = Provisional or estimated outturns

* This table should be read in conjunction with the fiscal measures contained in annexes C and D.

PUBLIC EXPENDITURE AND CASH LIMIT EVENTS BETWEEN 1 JANUARY 1977 and 31 DECEMBER 1979

January 1977	Publication of Cmnd 6721 Volume I: "The Governments Expenditure Plans".
February 1977	Publication of Cmnd 6721 Volume II: "The Governments Expenditure plans".
29 March 1977	Publication of Cmnd 6767: "Cash Limits 1977/78"
August 1977	Publication of Cmnd 6902: "Cash Limits 1976/77 Provisional Outturn".
26 October 1977	Chancellor's Statement on increase in Public Expenditure of £1bn in 1978/79 (at 1977 survey prices) (OR Cols 1438-9).
January 1978	Publication of Cmnd 7049 Volumes I and II: "The Government's Expenditure Plans 1978/79 to 1981/82".
11 April 1978	Budget Statement involving an increase in expenditure on programmes of approximately £550m (at 1978 survey prices) met by a reduction in the contingency reserve.
April 1978	Publication of Cmnd 7161: "Cash Limits 1978/79".
July 1978	Publication of Cmnd 7295: "Cash Limits 1977/78 Provisional Outturn".
January 1979	Publication of Cmnd 7439: "The Governments Expenditure Plans 1979/80 to 1982/83".
23 February 1979	Statement by Chief Secretary on cash limit policy for 1979/80 (OR WA 334-5).
April 1979	Publication of Cmnd 7515: "Cash Limits 1978/80".
22 May 1979	Chancellors Statement on cash limits policy (OR cols 903-5).
22 May 1979	Minister of State CSD's statement on the government's policy on adjusting the 1979/80 cash limits to meet civil service pay increases and the recruitment ban (OR WA 77).
12 June 1979	Budget measures including £1.75 billion in specific cuts in public expenditure in 1979/80, the expected cash limit squeeze of about £1 billion and the programme of asset disposal (figures at 1979 survey prices).

October 1979	Publication of Cmnd 7681: "Cash Limits 1978/79 Provisional Outturn".
November 1979	Publication of Cmnd 7746: "The Government's Expenditure Plans 1980/81".

MAIN TAX MEASURES: DECEMBER 1976 TO DECEMBER 1979

Budget of 29 March 1977

2. Chancellor proposed reductions in direct taxation of £1.8 billion for 1977-78 (mainly on the income tax allowances with the personal allowances to be raised between 9 and 13 per cent, and the basic rate, which was to be cut by 2 pence). Increases in indirect taxation of £0.8 billion proposed (mainly on the specific duties).

3. During debate, the Finance Bill was amended, the principal changes being:-

(a) income allowances further increased by about 5 per cent;

(b) the proposed increase in the duty on road fuel was not approved; and

(c) the proposed reduction of 2p in the basic rate of income tax was limited to 1p.

Mini-Budget of 26 October 1977

4. Income tax personal allowances raised by about 12 per cent at a cost in the financial year 1977-78 of £0.8 billion. Measures introduced to help small firms.

Budget of 11 April 1978

5. Chancellor proposed £2 billion cut in personal taxation mainly by introducing a lower rate band of 25 per cent on the first £750 of taxable income and raising thresholds, the personal allowances being increased by about 5 per cent. Further measures introduced to help small firms.

6. In debate, the basic rate of income tax was reduced by 1p and the threshold for the higher rates was raised by a further

£1000. The National Insurance Surcharge was increased from 2 to 3½ per cent from 2 October 1978.

PRT measures of 2 August 1978

7. Changes proposed in the Petroleum Revenue Tax, including increasing the rate from 45 to 60 per cent from 1 January 1979. Legislation in 1979 Finance Bill.

Budget of 3 April 1979

8. Caretaker Budget because of impending General Election.

Budget of 12 June 1979

9. Direct tax reductions of £3.5 billion in 1979-80 mainly through increases of 18 per cent in income tax personal allowances and a 3p cut in basic rate. Highest rate of tax on earned income reduced from 83 to 60 per cent. Indirect tax increases of £2.5 billion mainly through unification of the 8 and 12½ per cent VAT rates at 15 per cent. PRT measures, which had been announced in August 1978, to be implemented.

PRT measures of 15 November 1979

10. Changes proposed to speed the flow of PRT revenue by requiring payment on account, effectively advancing the due date for collection by 2 months.

1. Rate of Growth of GDP

		Year on Year % increase, Average estimate
	1976	3.1
	1977	1.9
	1978	2.7
1st 3 qtrs 1979 on same period 1978	(1979)	2.0

2. Balance of payments current account £m

1976	- 1152
1977	- 202
1978	+ 714
1979 (provisional)	- 2418

3. Unemployment

		UK, seasonally adjusted, excluding school-leavers	
		000's	%
1976	Mar	1243.6	5.2
	Jun	1278.6	5.4
	Sep	1297.7	5.4
	Dec	1317.5	5.5
1977	Mar	1336.3	5.5
	Jun	1376.5	5.7
	Sep	1417.5	5.9
	Dec	1421.0	5.9
1978	Mar	1411.4	5.8
	Jun	1378.1	5.7
	Sep	1360.2	5.6
	Dec	1319.6	5.5
1979	Mar	1361.5	5.6
	Jun	1278.7	5.3
	Sep	1263.9	5.2
	Dec	1294.6	5.3

Sources

1,2 Economic Trends and Press Notice

3. D E Gazette

Economic prospects for 1980

The Industry Act (1975) requires the Government to publish economic forecasts twice yearly. This supplement reviews economic developments so far this year and looks at the prospects up to the end of 1980.

Summary

In difficult world conditions and with a recent history of rising inflation, the UK economy is likely to experience some decline in economic activity in 1980. The priority in economic policy is to counteract inflation by adherence to a declining path of monetary growth combined with the necessary fiscal restraint. This long-term policy should begin to bear fruit in 1980, with the annual increase in the retail price index (RPI) declining from about 17 per cent in the fourth quarter of 1979 to some 14 per cent in the fourth quarter of 1980. During the period of adjustment to a lower rate of inflation some adverse effects on international competitiveness, profitability and personal real incomes are almost inevitable. Any quantitative assessment of the economic prospect is subject in present circumstances to very large uncertainties. The figures put forward should not be interpreted as indicating anything more precise than that the rate of inflation next year — though declining — is likely to remain in double figures and that there will probably be some fall in real gross domestic product (GDP).

Recent developments

The higher rate of inflation over the past twelve months has reflected both high pay settlements and rises in oil and other commodity prices. Prices of materials and fuel used by manufacturing industry rose by some 20 per cent in the year to October, indicating the significant non-wage element in rising costs, even though this was greatly mitigated by the strength of sterling, for which the effective rate appreciated by nearly 10 per cent in the same period. The domestic rate of inflation, as measured either by retail prices or the wholesale price of (non-food) manufactures stood at about 17 per cent over the twelve-month period. The tax and price index, which takes account of direct as well as indirect taxation, had risen by a little under 15 per cent. Taken in conjunction with pay increases of some 15 per cent to 16 per cent on an underlying basis the real value of earnings was still increasing, though by less than in 1978 or the early months of 1979 when the trend of commodity prices had been much more favourable. An appreciating exchange rate and a relatively high rate of domestic inflation has led to a sharp loss of international competitiveness in terms of both prices and costs.

The money supply has increased by over 13 per cent over the last 12 months. And, as the Chancellor of the Exchequer explained to the House of Commons on 15 November, it was still outside the Government's 7 per cent to 11 per cent target range by mid-October. This reflected a high public sector borrowing requirement (PSBR) in the first part of the financial year and continued high bank lending. It was expected that measures taken in the Budget which increased the PSBR, such as the reductions in personal taxation, would come through faster than those which reduced it, such as higher value added tax (VAT) and sales of public sector assets. But in the event, public borrowing, especially by the local authorities and public corporations, has been higher than expected — largely as a result of industrial action which has delayed the payment of telephone bills and VAT. The rapid increase in bank lending to some extent reflects an unexpectedly buoyant rate of stockbuilding. On 15 November the Bank of England's minimum lending rate was increased from 14 per cent to 17 per cent and measures were taken to bring the forecast PSBR back to the Budget estimate of £8.3 billion. The monetary target was rolled forward for a further six months; the target range for the growth of sterling M3 is now 7 per cent to 11 per cent at an annual rate from mid-June 1979 to mid-October 1980. At the same time the supplementary special deposits scheme was extended for six months.

The weak recovery from the 1974/75 recession was checked in the autumn of 1978 and followed by a fall in activity in the early months of 1979, largely because production was disrupted by bad weather and industrial disputes. There was a marked rebound in output in the second quarter, followed by a fall in the third quarter partly as a result of the engineering industry dispute, and the trend of activity over the past 12 months has probably been fairly flat. The manufacturing sector has followed a broadly similar pattern to total GDP. Despite the lack of output growth, employment in industry has declined only marginally. Unemployment was on a downward trend until the summer of 1979, though this appears to have been checked in recent months.

Personal consumption has added to demand but there appears to have been little change in public sector demand or in private sector investment. An increasing share of consumption has been met by imports rather than by domestic production.

The growth of personal consumption reflected brisk growth in real personal disposable incomes in the period up to mid-1979. The precise timing of both income and consumption movements are complicated by the short-term effects of Budget changes. Taking the first nine months of 1979 the level of personal consumption rose by some 4½ per cent compared with a year earlier; this was probably a little below the growth in real incomes over the same period. The fall in consumption in the third quarter of 1979 partly reflected the effect of the Budget which had brought forward expenditure into the second quarter. In view of the trend in prices and real incomes the strong upward movement in consumption has probably now ceased.

Private sector investment in distributive and service industries [illegible] a strong upward trend until mid-year, but manufacturing investment appeared to have passed a cyclical peak and private sector housing investment has declined sharply since the end of last year. Stockbuilding has remained at a fairly high level so far this year albeit with erratic quarterly fluctuations. Public sector expenditure on goods and services has remained roughly constant.

The quarterly path of overseas trade has been greatly obscured and damaged by industrial disputes. It may be best to compare the first ten months of 1979 with the equivalent period of 1978. In this period export volumes (excluding fuel) rose only marginally (three-quarters per cent) while import volumes (excluding fuel) rose by 14 per cent, with a substantially larger growth in imports of manufactures. These movements reflected strong consumer demand and worsening competitiveness and, probably, the permanent loss of some exports as a result of industrial disputes. Despite favourable terms of trade (reflecting the strong exchange rate) and continuing improvement in the balance of trade in oil, the visible balance deteriorated and over the first ten months of 1979 was in deficit by some £3 billion; of this £1½ billion was in the first quarter. The invisible surplus, on provisional figures, has also deteriorated. This reflects an estimated worsening of the services balance as well as rising North Sea oil profits accruing to foreign-owned companies and some further increase in UK net contributions to the EEC. Over the first ten months of 1979 the current account is provisionally estimated to have been in deficit by some £2½ billion. It remains highly uncertain to what extent this deficit reflects temporary disturbances.

Prospects for 1980

Policy assumptions

The forecast takes account of the measures announced on 15 November and assumes that monetary growth is held within the new target range. The public expenditure forecasts for 1980-81 are based on the recent White Paper *The Government Expenditure Plans 1980-81* (Cmnd 7746). For the purpose of this forecast tax receipts are projected on the conventional assumption that allowances, thresholds and specific tax rates are uprated in line with the RPI growth during the previous calendar year.

Inflation

Prices in the UK are rising at or a little above 1 per cent per month. In the current quarter, the retail price index is likely to be a little over 17 per cent higher than a year earlier (consistent with the Budget forecast), an increase which includes the once-and-for-all effects of the rise in VAT. The effective exchange rate is assumed to remain close to its present level in 1980, so that future import prices follow movements in world prices: although the expected recession in industrial countries may limit any rise in commodity prices, some of the effects of higher import prices that have occurred so far this year will still be feeding through into domestic prices in the early part of next year. The growth of domestic costs depends, essentially, on the climate of pay negotiations. This forecast allows for a progressive reduction in the level of settlements over the coming year in response to the Government's fiscal and monetary policies. It leads to a forecast reduction in the rate of retail price inflation (over a 12-month period) to 14 per cent in the fourth quarter of 1980. With the share of profits already exceptionally low and adversely affected by the continued rise in labour costs and by the fall in economic activity, a significant fall in the rate of inflation implies a slower growth of costs.

Demand, trade and activity

Taking account of the weakness of activity, a small fall in real personal incomes is likely in 1980, despite the prospect of large pay increases in the public services, largely based on the reports of the Clegg Commission. However, consumer confidence

Table 1: Economic Prospects to end-1980

	percentage changes 1978 to 1979	1979 to 1980
A. Output and expenditure at constant 1975 prices		
Gross domestic product (at factor cost)	1	−2
Consumers' expenditure	4	½
General Government expenditure on goods and services	½	0
Public corporations' fixed investment	−4½	−4½
Private sector investment	−2	−1
Exports of goods and services	1½	0
Stockbuilding (as per cent of GDP)	¼	−2
Imports of goods and services	11½	−2½

B. Balance of payments on current account	1979	1980
	£ billion	
	−2½	−2

C. Retail price index	*percentage changes* 4th quarter 1978 to 4th quarter 1979	4th quarter 1979 to 4th quarter 1980
	17½	14

†This margin applies to General Government consumption.

Table 2. Forecasts of expenditure, imports and gross dome

£million at 1975 prices, seasonally adjusted

	Consumers' expenditure	General Government expenditure on goods and services: Final consumption	Fixed investment	Total	Other fixed investment
1977	63,350	23,250	3,950	27,200	16,200
1978	66,700	23,650	3,350	27,000	17,150
1979	69,300	23,900	3,200	27,100	16,650
1980	69,650	24,150	3,000	27,150	16,400
1978 First half	32,950	11,750	1,750	13,500	8,650
Second half	33,750	11,900	1,600	13,500	8,500
1979 First half	34,900	11,850	1,650	13,500	8,200
Second half	34,400	12,050	1,550	13,600	8,450
1980 First half	34,900	12,100	1,500	13,600	8,300
Second half	34,750	12,050	1,500	13,550	8,100
Percentage changes					
1977 to 1978	5½	1½	−15	−1	6
1978 to 1979	4	1	−4	½	−3
1979 to 1980	½	1	−7	0	−1½

Margins of error in [illegible] per[illegible]
1½
1½
1½†
6½
4
3½
¾
2½
£ billion
2
per cent
4

*The errors relate to the average differences (on either side of the central figure) between forecast and outturn. The method of calculating these errors has been explained in earlier publications on government forecasts, notably in November 1978 (see *Economic Progress Report Supplement* or *Economic Trends* No. 301, November 1978). The errors are after adjustment for the effects of major changes, where excluded from the forecasts, in fiscal policy and hire purchase terms controls. Quarterly forecasts are grouped so as to be comparable with the changes between calendar years as shown. For a forecast made in quarter 0 the errors (both for the constant price magnitudes and for the current account) relate to the forecast changes between the 'base year' (quarters −1 to −4) and the forecast period (quarters 1 to 4). The strict comparison with the present calendar year forecast would, of course, involve a base year comprising quarters 0 to −3. For the retail price index the margin relates to the percentage change between quarter 0 and quarter 4.

Although roughly appropriate in respect of time horizon and period covered these figures are likely to understate the true margins of error for the general reasons indicated in the concluding paragraphs of the text.

roduct

services	Stock-building	Total final expenditure	*less* Imports of goods and services	*less* Adjustment to factor cost	Statistical adjustment	Gross domestic product at factor cost	GDP index 1975 = 100
0	1,250	139,700	30,400	10,850	−200	98,250	105.1
0	1,100	144,300	31,600	11,850	0	100,850	107.9
0	1,450	147,350	35,300	12,300	2,200	101,950	109.1
0	−450	145,600	34,400	12,250	1,100	100,050	107.0
0	600	71,600	15,700	5,900	−50	49,950	106.9
0	500	72,700	15,900	5,950	50	50,900	108.9
0	800	73,350	17,600	6,200	1,400	50,950	108.9
0	650	74,000	17,700	6,100	800	51,000	109.2
0	−50	73,300	17,300	6,150	550	50,400	107.8
0	−400	72,300	17,100	6,100	550	49,650	106.2
		3½	4	9½		2½	
		2	11½	3½		1	
		−1	−2½	0		−2	

should be helped by the projected decline in the rate of price inflation, and the savings ratio is likely to fall. On balance, little change in personal consumption is forecast for next year.

Industrial and commercial companies are likely to meet difficult trading conditions next year, reflecting weak world demand and unfavourable UK competitiveness. The adverse effects on output and profitability, combined with tight monetary conditions, may lead to a downturn in private investment and stockbuilding, both of which appear, in any case, to be close to cyclical peaks. The forecast of private sector investment is strongly influenced by the latest surveys of firms' investment intentions undertaken by the Department of Industry and the Confederation of British Industry (CBI). Private manufacturing investment is expected to show little change this year and then fall by about 7 per cent next year, rather less than in some previous downturns. Little change is forecast for other private investment in 1980. Stockbuilding was unexpectedly high in the first half of 1979. A turning point is forecast around the end of this year as companies react to the falling away in demand and to financial pressure. The forecast is for destocking on a significant scale during 1980, implying a large turnround (some 2 per cent of GDP) between 1979 and 1980.

The forecast is for little change in the volume of General Government expenditure on goods and services in 1980. This is consistent with the White Paper on public expenditure in 1980-81 (Cmnd 7746).

Many governments overseas are tightening policies in order to contain the inflationary impact of higher oil prices, with the result that inflation may be better contained than after the 1973-74 oil price rises. In common with most international economic organisations, we expect a slowdown in world economic activity next year. The US is expected to enter a period of recession and growth in the other industrial countries is expected to slow down, but without coming to a halt altogether. Economic growth in the main industrial countries is forecast to drop from 4 per cent in 1978, to under 3 per cent in 1979 and to around 1 per cent in 1980. The growth in the volume of world trade is expected to be very slow but the growth of UK markets should be less affected and the imports of smaller OECD countries and OPEC — relatively more important to the UK — are expected to grow faster than trade in general. UK-weighted trade in manufactures, estimated to have risen 5 per cent to 6 per cent in 1979, may rise a further 4 per cent in 1980. The implication of the forecast for UK inflation combined with the assumption of a constant effective exchange rate, is that the UK's cost and price competitiveness does not change greatly from its recent level.

After a period of stability, the share of UK exports of manufactures in world trade appears to have fallen in 1979, with the disruptions caused by industrial disputes in the UK, and probably some effects of worsening competitiveness, adding to the longer-term tendency of the UK to lose share in world markets. In 1980, world trade growth is liable to be weaker and the lagged effects of changes in competitiveness more strongly unfavourable, so that there may be little change in the volume of manufacturing exports.

For both import and export volumes this forecast gives some weight to the views of outside forecasters but it is still less optimistic than most on short-term trends in trade volumes. The import propensity has moved upwards in recent years, and fluctuates cyclically though erratically from year to year. With the fall in demand forecast for 1980, the volume of imports should decline. There is particular uncertainty about the forecast for imports of manufactures.

With exports forecast to change little next year and with the prospect of a substantial fall in domestic demand — notably for stocks — the prospect is inevitably for some fall in economic activity. However, largely for cyclical reasons, there may be no further growth next year in the share of demand met from overseas. The forecast, subject of course to a large margin of error, is for a fall in GDP of the order of 2 per cent — of the same order as occurred in 1974. The implication of this forecast is that there is likely to be some rise in unemployment.

The current account

The terms of trade improved between 1977 and 1979 by about 7 per cent. With little change assumed in the exchange rate and with commodity prices rising only slowly, some further improvement in the terms of trade may take place in 1980. On invisibles, the outturn so far this year is, on very provisional figures liable to substantial revision, a good deal less favourable than in 1978, partly as a result of higher government payments, notably to the EEC, higher profits earned by foreign companies operating in the North Sea, and higher interest rates in the UK. While there should be an improving trend in the balance of services, higher North Sea profits will continue to reduce the net balance on interest, profits and dividends. There could be some further deterioration in the total balance on invisibles next year.

In total, the current account of the balance of payments seems likely to be in substantial deficit this year, perhaps by some £2½ billion. The figure has been affected to a considerable but incalculable extent by the effects of major industrial disputes such as those in the road haulage and engineering industries. Continuing poor performance by the motor industry has also been an important factor. Unless there are disputes on a comparable scale next year, the fall in demand for imports will probably be sufficient to bring about some improvement in the current account, though a significant deficit — possibly of the order of £2 billion — is still forecast.

Public sector borrowing

In the first six months of the current financial year the PSBR is provisionally estimated at £6½ billion. This is high in relation to the Budget forecast of £8¼ billion for the year as a whole and reflects, in particular, higher than expected borrowing by local authorities and public corporations; the latter is mainly due to the Post Office. There are, however, strong reasons for expecting a big reduction in the PSBR in the second half of the year: receipts from the higher rate of VAT and from the planned £1 billion of asset sales will be almost entirely in the second half of the year and the loss arising from the delays to telephone bills should be partially recovered, though the forecast assumes that £400 million is still outstanding at the end of the financial year. With great uncertainty still remaining, the estimated outcome was in the region of £9 billion before the acceleration of payments of petroleum revenue tax (PRT) announced on 15 November, which will reduce the PSBR by about £700 million in 1979-80, and by smaller amounts in later years.

Most of the factors which, even now, make it hazardous to forecast the 1979-80 PSBR create comparable uncertainty about the figures for 1980-81, and many other factors make the margins of error for that year even greater. The prospect for 1980-81 is affected both by the large 'Clegg' increases in public service pay and by the poor outlook for economic activity. There are, however, favourable factors too, such as a full year's receipts of VAT at the higher rate, the build-up of revenue from North Sea taxation and the recovery of the remaining backlog of Post Office receipts. On the assumptions adopted for this forecast the prospect — subject of course to a very high margin of error — is for little change from the 1979-80 level in the PSBR as a percentage of GDP. In the absence of a fall in economic activity the prospect — given the same policy assumptions — would, of course, be more favourable. If, for example, stronger private sector activity led to no change in real GDP next year rather than the forecast 2 per cent fall, the PSBR would be likely to fall by at least half per cent of GDP. With rising GDP the PSBR would be reduced still further. It should also be noted that any projection of the PSBR at this stage reflects not only very high margins of error (past experience would suggest an *average* margin of error in either direction of some 2 per cent of market price GDP) but also involves necessarily arbitrary or conventional assumptions about future policy decisions. The objective for the PSBR in 1980-81 will be determined at the time of the Budget in the light of developments in the economy and, above all, of the requirements for meeting the Government's monetary target.

Margins of error

At present any assessment involves unusually large uncertainties. In particular, there is no reliable way of using past experience to assess the pace at which inflation responds to the present emphasis of monetary and fiscal policy. This applies particularly to the effects of policy on expectations, both insofar as they influence pay settlements directly and insofar as they influence financial markets and hence, in turn, the exchange rate, domestic prices and pay settlements. Similarly, because of the loss of trading competitiveness, which has occurred and is assumed not to be corrected, the forecast is particularly sensitive to fallible estimates of cost and price elasticities. Given the strong cyclical downturn the response of investment and stockbuilding to movements in output, profitability and financial conditions is both important and more than usually difficult to predict.

In the circumstances it is not sufficient to use margins of error based on the record of past forecasts and the assessment of uncertainty has to be fairly subjective. Nevertheless, the final column of Table 1 shows the average errors obtained from past forecasts with a time horizon comparable to the present forecast for 1980. In addition to the arguments for believing that margins of error are bigger in present circumstances it should be emphasised that these are *average* errors which, by definition, have frequently been exceeded.

Given these qualifications the forecast should not be interpreted as suggesting much more than that retail price inflation is likely to slow down but to remain in double figures next year and that there will probably be some fall in real GDP.

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