

CONFIDENTIAL

THIS DOCUMENT IS THE PROPERTY OF HER BRITANNIC MAJESTY'S GOVERNMENT

(87) 13

COPY NO

78

27 July 1987

CABINET

ECONOMIC PROSPECTS

Memorandum by the Chancellor of the Exchequer

The economy has been steadily growing at a satisfactory rate for the past six years. With industry competing successfully both at home and abroad the prospect this year is for faster Gross Domestic Product (GDP) growth than in recent years, and more than I forecast at the time of the Budget. Unemployment has continued to fall while inflation has remained close to the expected path. So far this year, the current account of the balance of payments has been in modest surplus. We are also seeing, especially in the rapid growth of manufacturing productivity, some benefits from the measures taken over the past seven years to improve supply performance.

2. All this provides an encouraging picture. But we clearly cannot count on the growth rate being sustained at this year's level over the Public Expenditure Survey period. And there are also evident dangers. Abroad, the world economy could be more depressed than now envisaged. At home, pay settlements badly need to fall, not least in the public sector. It is essential that the Government demonstrates its firm commitment to the financial policies that have brought our present success and which alone can deliver declining inflation and the continuation of steady growth in the years ahead.

3. Our prudent monetary and fiscal policies have stabilised financial conditions, enabled us to avoid lurches of policy, and increased confidence in the United Kingdom as a base for investment. The reduction of public expenditure as a share of GDP over the past four years has been especially important. It has enabled us to reduce the Public Sector Borrowing Requirement despite having to adjust to the sharp loss of North Sea revenues. But we have failed to make much progress in reducing the burden of non-North Sea taxation as a share of GDP. Not only is this still well above the figure we inherited, but since 1985 it has actually been rising.

WORLD ECONOMY

4. The most obvious threat to continued steady United Kingdom growth comes from a weakening of demand and output in other major developed countries. Since the fall in oil prices at the beginning of 1986, output growth in the G7 economies has been disappointing. Last year weak world demand originated in the developing countries who, as a group, cut back

CONFIDENTIAL

CONFIDENTIAL

their imports. More recently many of the strains seem to reflect slowness in adjusting to the sharp realignment of exchange rates. Domestic demand in the United States is understandably weakening; while in Germany and Japan it is not rising fast enough to offset the adverse effects of currency appreciation on their exports. Their loss of export markets has been made more acute by the increasing shares taken by the newly industrialised countries, notably in South-East Asia who, with the recent exception of Taiwan, have held their currencies steady against the dollar.

5. Inflation rates in the major economies have been reduced, much as expected. And there are now signs of some progress in correcting the large current account imbalances in the United States, Japan and Germany. The risk of further turmoil in foreign exchange markets has been reduced - although not eliminated - by successful co-operation between the G7 countries. Following the agreement at the Louvre in February, the G7 countries have succeeded in stabilising their currencies by a combination of intervention and a greater willingness to adapt their monetary policies. And there have been some further steps in Germany and even more in Japan to support domestic demand and open markets. It is vital that these measures are sustained and strengthened. Further reductions in the United States budget deficit are also needed.

THE BRITISH ECONOMY

6. A summary of the most recent Treasury assessment is shown in the attached Annex.

7. At home we have seen a continuation of what has by now become a familiar pattern of strong and steady growth coupled with low inflation.

8. A year ago there was concern in some quarters at the mild pause in growth between mid-1985 and mid-1986. In the event, despite disappointing growth abroad, performance at home has exceeded expectations. In the first quarter of this year GDP was just over 4 per cent higher than a year earlier.

9. The prospect is for continuing strong growth in 1987, with the outcome in the year as a whole likely to be closer to 4 per cent than the 3 per cent predicted at Budget time. Domestic demand growth is balanced, with fixed investment rising in line with the growth of consumers' expenditure. With growth in 1987 above the trend of recent years, it would not be surprising if the growth rate fell back a little next year.

10. The recent strong performance of output has contributed to a further rise in employment and in turn to the fastest recorded fall in unemployment since the War. This welcome fall in unemployment to below the three million mark has occurred at the same time as productivity growth in manufacturing has been exceptionally high by historical standards. Indeed increased industrial efficiency has been an essential factor in the greatly improved unemployment prospect. If overall growth

CONFIDENTIAL

CONFIDENTIAL

continues at a steady and sustainable rate, even if somewhat lower than this year, there is every likelihood that the fall in unemployment will also continue.

11. We have always known that the United Kingdom, as a major oil producer, would not benefit as much from the fall in oil prices as the other major economies. The necessary fall in sterling during 1986 largely offset the beneficial impact on inflation of the lower oil prices. However, we are still on course to achieve the Budget forecast of 4 per cent inflation in the fourth quarter of this year, and the outcome could well be a little lower. Nonetheless, this remains uncomfortably above the average rate in most other major economies. It is essential that inflation is kept firmly on a downward path over the medium term.

12. So far, lower inflation has not been adequately reflected in lower pay settlements. The deceleration of private sector pay settlements in 1986 appears to have ended: indeed if anything they may have begun to edge up. Some public sector settlements - notably by local authorities - could also set an unfortunate precedent for the private sector and will make it more difficult to control public finances. Pay increases need to be lower if the hard-won fall in unemployment is to continue.

13. The prospects for the current account of the balance of payments now look a little better than they did at the time of the Budget, and the estimate of last year's deficit has been revised down almost to zero. Over the past year British companies have competed successfully in the home and international markets. In spite of subdued prospects for world trade and buoyant activity at home it now looks as if the current account this year will show a smaller deficit than the Budget forecast of £2½ billion, or half of one per cent of GDP.

14. Since the Louvre agreement towards the end of February, sterling has generally been very steady. Indeed, during April and May there was a pronounced tendency for the pound to strengthen. This was contained by reducing interest rates and intervening in the foreign exchange markets on an unprecedented scale. As a result, the exchange rate has stayed within a very narrow range over the past 4-5 months. This in turn has strengthened confidence within industry.

15. Nevertheless, financial markets are closely watching the behaviour of the economy, and in particular the outlook for inflation. They will also be on the look-out for any signs of a loosening of the rigorous financial policies that have brought our current success. It is vital that we maintain the firm control of public expenditure the Chief Secretary, Treasury proposes.

N L

Treasury Chambers

21 July 1987

CONFIDENTIAL

MAJOR ECONOMIC INDICATORS

	UK				G7 excl UK
	1984	1985	1986	1987	1987
A. <u>Demand & Activity</u>					
GDP	3	3½	3	4	2½
Domestic demand	2½	3	3½	3½	2½
of which					
- consumers' expenditure	2	3½	5	3½	2½
- fixed investment	9	2	1	4	3
Exports of Goods & Services	7	6	3	4	2½***
Imports of goods & Services	9	3	6	3	4***
B. <u>Inflation (Q4 on year earlier)</u>					
RPI	4	5½	3½	3¾	3
Average earnings	6½	7	8	7½	3½†
C. <u>Other items</u> (levels)					
Current balance (£bn)	1½	3½	0	-½	-12
Unemployment (per cent, narrow definition)	11	11½	11½	10½	7½
3 month interest rate	10	12	11	9.1*	6.3*
Sterling index (1980=100)	79	78	73	73.1*	-
Oil price (Brent, \$barrel)	29	27	14	20.6**	-

* close Friday 17 July

** delivery in August 87, as of 17 July

*** goods only

† manufacturing earnings