10 DOWNING STREET

Prime Minister

You may like to see this now, in advance of any comments.

Note the scope for tax reductions in the next Budget, assuming the PSBR as in the last MTFS, of £13.6 bn.

DRW
23/10

It will be dangerous either to speak or to plan on this basis at present. The uncertainty has become too great now

CC DNG.

11

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-270 3000
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Sir Peter Middleton KCB
Permanent Secretary

Covering SECRET

Professor Brian Griffiths
10 Downing Street
LONDON
SW1

23 October 1987

Dear Brian

I attach a copy of the autumn forecast. It needs to be treated with particular care because it does not allow for the effects of the last few days. We shall of course be publishing in the Autumn Statement a version which has been adjusted to take some account of this and other points which have arisen in discussion.

As promised, I will arrange a time for you to discuss it with Terry Burns and myself.

Copy to David Norgrove.

Yours sincerely

[signature]

pp P E MIDDLETON

SECRET

Copy No 12

TREASURY ECONOMIC FORECASTING EXERCISE

OCTOBER 1987 REPORT

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TREASURY ECONOMIC FORECASTING EXERCISE

REPORT BY EA AND PSF

(1) SUMMARY

The forecast covers the period to the end of 1989 (1989-90 for public finances). Table 1 summarises the results and compares them with earlier exercises and with the current average of outside forecasts.

(i) Main results

(a) Following the latest CSO upward revisions, in the Blue Book and subsequently, the growth of **money GDP** in 1986-87 is, at 6½ per cent, very close to that envisaged in the 1986 MTFS. With only limited data available on the early quarters of 1987-88 the prospect is for money GDP growth of 9 per cent, over a point above the figure in the 1987 MTFS. This overshoot could be greater if, following past practice, the CSO revises up the GDP data for the early part of the financial year. The forecast is for overshoots of the MTFS growth rates for money GDP that average almost 2 percentage points in 1988-89 and 1989-90. Both higher real growth and higher inflation than assumed in the MTFS contribute to these overshoots.

(b) Both real **GDP** and **domestic demand** appear to be growing at higher rates in the UK than in the rest of the G7. The forecast is for growth of consumers' expenditure of 4¾ per cent in 1987 and 4½ per cent in 1988, lower than the very high rate of 5¾ per cent recorded for 1986. This deceleration of consumers' expenditure is, however, offset by a strong rise in investment. Total domestic demand grows at 4 per cent in 1987 and 1988, before dropping to 3 per cent in 1989. UK domestic demand growth in 1987 and 1988 is on average 1 per cent higher than the average for the rest of the G7.

The latest forecast is for GDP growth of 4 per cent in 1987 - in line with the June forecast, but above the FSBR forecast of 3 per cent. With nearly all indicators suggesting that activity continues to be strong in the second half of 1987, forecast GDP growth in 1988 is 3 per cent (half a percent higher than in the FSBR and the June forecast) and 2½ per cent in 1989. Growth of **manufacturing output** could be over 5 per cent in 1987, though somewhat lower thereafter. **Unemployment** should continue to fall at a rapid rate in the near future, though as output growth moderates the rate of decline is likely to be less.

(c) **RPI** inflation in 1987(4) is likely to be very close to the FSBR forecast of 4 per cent, though above the 1986 Autumn Statement forecast of 3¾ per cent. The forecast is for a pick up to 5¼ per cent by

1988(4). This owes something to the rise in short term interest rates - and therefore the mortgage rate - that is judged necessary to keep the sterling index constant while the UK economy is relatively so buoyant. However, most of the rise in RPI inflation between the fourth quarters of 1987 and 1988 is the result of

the assumed **revalorisation of specific duties** in the 1988 budget after the standstill this year,

a large rise in **LA rates** in 1988-89, given the forecast of their current expenditure and the recent RSG settlement,

and some substantial increases in certain **nationalised industry prices** (plus BGC), following a period in which nominal prices have hardly risen and real prices have fallen substantially.

These factors, together with a gradual increase in unit labour costs, will have an increasing influence on the RPI from the second quarter of 1988.

With the exception of the assumed rise in the mortgage rate nearly all the factors that are forecast to cause a rise in RPI inflation between 1987(4) and 1988(4) will cause the inflation rate of the **GDP deflator** (at market prices) to rise between 1987-88 and 1988-89. The GDP deflator is also likely to be boosted by rising costs and margins in the construction industry, where the recent boom in output seems likely, on the strength of a recent further surge in orders, to continue for some while. The forecast is for construction prices to accelerate a little later than suggested in the June forecast, from early 1988 onwards.

The forecast has the relatively satisfactory recent performance of **unit labour costs in manufacturing** continuing, although growth in the range of 2½-4 per cent throughout the period is slightly above average growth in the UK's principal competitors. Strong productivity growth and the continued fall in employers' pension contributions keep growth of unit labour costs in manufacturing some 5 percentage points below growth in average earnings. Indeed these factors probably reduce the incentive for employers to press for more moderate growth in earnings.

(d) **GNP growth of the major 7** (less the UK) is likely to remain close to the 2¾ per cent recorded for 1986. There has, however, been an upturn in the growth of industrial production and world trade in manufactures which should continue in 1988. Short term interest rates are forecast to rise further in the US - with rates in Japan and Germany remaining unchanged - to moderate the likely fall in the dollar exchange rate.

(e) It is extremely difficult to analyse the recent behaviour of the **current account**, a difficulty compounded by frequent and large revisions to the 'recorded' data for invisibles and doubts about the seasonal adjustment of visible trade. The visible balance was surprisingly favourable in the early months of the year. Since then there has been a sharp deterioration.

Internal forecasts for 1987 made during much of 1986 and the early part of 1987 showed relatively small current account deficits (as a proportion of GDP) on the basis of rather less domestic demand and output in the UK economy than has in the event occurred. At the same time the world economy has been less buoyant than forecast. For given activity at home and abroad the current account has so far been better than expected. As with the June exercise, the present forecast attempts to take account of this record.

In both 1988 and 1989 North Sea production is forecast to fall by about 5 per cent. With a constant (indexed) oil price at $18 this will produce falls in the **balance of trade on oil** of just under £1b. in each year. Over the forecast period UK labour costs rise slightly more than those in competing economies (in domestic currencies), so that, with short term interest rates set to keep the sterling index at 72.5, there is a small deterioration in measured competitiveness over the period. This, together with higher growth of domestic demand and output in the UK than in the rest of the G7, produces a £2½b. deterioration in **the non-oil current account** between 1986 and 1988, producing overall current account deficits of £2½b. and £4½b. in 1987 and 1988 respectively. While the growth of domestic demand falls in 1989 it remains above growth in the rest of the G7, contributing to a further deterioration in the current account.

(f) The emergence of a growing current deficit coupled with continued outward investment flows implies a need for substantial offsetting **capital account** inflows. The forecast is that UK companies and banks are able to attract these at the projected interest rates, and that confidence in sterling is sufficient to keep the sterling index constant. (With the dollar assumed to fall gradually, the assumption of a flat sterling index implies a very small fall in the £/DM rate over the period.) A weakening of sentiment would make it more difficult to finance the projected current deficit, and put upward pressure on interest rates.

TABLE 1 : SUMMARY OF FORECAST

	FSBR 1987	SUMMER 1987	OCTOBER 1987	AVERAGE OUTSIDE FORECAST SEPTEMBER 1987
A THE WORLD ECONOMY				
1. GNP (MAJOR 7 EXCLUDING UK) (per cent change on a year earlier)				
1986	2.6	2.5	**2.7**	
1987	2.6	2.3	**2.5**	
1988	3.0	2.8	**2.6**	
1989	3.0	2.8	**2.4**	
2. DOMESTIC DEMAND (MAJOR 7 EXCLUDING UK) (per cent change on a year earlier)				
1986	3.8	3.7	**3.8**	
1987	3.0	2.6	**2.6**	
1988	3.2	2.8	**2.6**	
1989	3.0	2.8	**2.5**	
3. WORLD TRADE IN MANUFACTURES (weighted by UK market shares: per cent change on a year earlier)				
1986	2.4	2.1	**1.3**	
1987	3.4	2.6	**2.6**	
1988	4.1	3.2	**3.4**	
1989	5.0	4.3	**3.8**	
B UK ACTIVITY AND DEMAND				
4. GDP VOLUME (non-North Sea GDP in brackets) (per cent change on a year earlier)				
1986	2.6(2.7)	2.8(2.9)	**3.1(3.2)**	
1987	3.0(3.1)	3.9(4.1)	**4.1(4.5)**	3.2
1988	2.4(2.9)	2.3(2.8)	**3.0(3.5)**	2.4
1989	2.4(2.8)	1.7(2.1)	**2.4(2.8)**	
5. VOLUME OF DOMESTIC DEMAND (per cent change on a year earlier)				
1986	3.2	3.5	**3.8**	
1987	3.5	3.6	**3.9**	
1988	2.4	3.3	**4.1**	
1989	2.2	2.0	**2.9**	
6. UNEMPLOYMENT (UK S.A. EXCLUDING SCHOOL LEAVERS million)				
1986 Q4	3.14	3.14	**3.14**	
1987 Q4	2.88	2.73	**2.74**	2.84
1988 Q4	3.01	2.58	**2.52**	2.82
1989 Q4	2.94	2.61	**2.54**	
C INFLATION AND MONEY GDP				
7. MONEY GDP (MARKET PRICES) (per cent change on a year earlier)				
1986-87	6.1	6.3	**6.6**	
1987-88	7.5	8.8	**8.9**	
1988-89	6.4	7.9	**8.5**	
1989-90	6.1	7.1	**7.8**	

	FSBR 1987	SUMMER 1987	OCTOBER 1987	AVERAGE OUTSIDE FORECAST SEPTEMBER 1987
8. RPI (excluding mortgage interest payments in brackets) (per cent change on a year earlier)				
1986 Q4	3.4(3.4)	3.4(3.4)	**3.4(3.4)**	
1987 Q4	3.9(3.4)	3.8(3.6)	**3.9(3.7)**	4.0
1988 Q4	3.3(3.0)	5.1(4.4)	**5.3(4.6)**	4.6
1989 Q4	3.3(3.2)	4.2(3.9)	**4.3(3.9)**	
9. GDP market price deflator (per cent change on a year earlier)				
1986-87	3.2	3.0	3.0	
1987-88	4.5	5.0	4.6	
1988-89	4.0	5.7	5.4	
1989-90	3.6	5.1	5.2	

D **PUBLIC FINANCES**

	FSBR 1987	SUMMER 1987	OCTOBER 1987	AVERAGE OUTSIDE FORECAST SEPTEMBER 1987
10. PSBR - £ billion				
1986-87	4.1	3.3	**3.5**	
1987-88	3.9	1.0	**-1.2**	3.4
1988-89	4.4	0.8	**-5.0**	
1989-90	4.9	0.8	**-5.4**	
11. PSBR - % OF GDP				
1986-87	1.1	0.9	**0.9**	
1987-88	1.0	0.2	**-0.3**	
1988-89	1.0	0.2	**-1.1**	
1989-90	1.0	0.2	**-1.1**	
12. ANNUAL FISCAL ADJUSTMENT - £ billion				
1988-89	3.2*	7.4*	**13.6***	
1989-90	1.7*	1.1*	**2.8***	
allocated to				
(a) reducing personal taxes				
1988-89	3.2	3.7	**4.1****	1.8
1989-90	1.7	0.5	**2.0**	
(b) reducing PSBR				
1988-89	0.0	3.7	**9.5**	
1989-90	0.0	0.6	**0.8**	

*Assuming PSBR ratio of 1 per cent as in 1987 MTFS.
**This is one third of the fiscal adjustment remaining after the higher than previouslyassumed level of privatisation receionts has been used to reduce the PSBR.

E **MONETARY CONDITIONS**

	FSBR 1987	SUMMER 1987	OCTOBER 1987	AVERAGE OUTSIDE FORECAST SEPTEMBER 1987
13. SHORT TERM INTEREST RATES (per cent))				
1986 Q4	11.2	11.2	**11.2**	
1987 Q4	10.3	9.5	**10.5**	9.5
1988 Q4	10.1	10.5	**11.0**	8.9
1989 Q4	9.7	10.5	**11.0**	

	FSBR 1987	SUMMER 1987	OCTOBER 1987	AVERAGE OUTSIDE FORECAST SEPTEMBER 1987
14. MO (per cent change on a year earlier)				
1986-87	4.3	4.3	**4.3**	
1987-88	4.0	4.3	**5.1**	
1988-89	3.4	4.0	**4.4**	
1989-90	3.0	3.4	**3.4**	
15. STERLING INDEX (1975=100)				
1986	72.8	72.8	**72.8**	
1987	70.3	71.7	**72.0**	71.8(Q4)
1988	69.3	72.0	**72.5**	70.5(Q4)
1989	67.3	72.0	**72.5**	
16. £/DM EXCHANGE RATE				
1986	3.19	3.19	**3.19**	
1987	2.78	2.93	**2.95**	
1988	2.67	2.86	**2.94**	
1989	2.52	2.77	**2.87**	
17. RELATIVE UNIT LABOUR COSTS (1980=100)				
1986	77.6	77.7	**77.3**	
1987	74.0	75.2	**74.8**	
1988	73.5	77.1	**76.7**	
1989	70.1	78.6	**76.9**	
F TRADE AND CURRENT ACCOUNT				
18. VOLUME OF NON-OIL EXPORTS OF GOODS AND SERVICES (EXCL. ERRATICS) (per cent change on a year earlier)				
1986	1.9	1.9	**2.0**	
1987	5.8	4.4	**6.1**	
1988	4.0	3.6	**2.6**	
1989	5.1	4.5	**3.0**	
19. VOLUME OF NON-OIL IMPORTS OF GOODS AND SERVICES (EXCL. ERRATICS) (per cent change on a year earlier)				
1986	5.5	5.4	**5.7**	
1987	6.9	3.9	**7.2**	
1988	1.9	4.7	**4.8**	
1989	2.7	3.5	**2.9**	
20. CURRENT BALANCE £ billion				
1986	-1.1	-0.1	**-1.0**	
1987	-2.7	-0.5	**-2.4**	-1.1
1988	-1.7	-0.9	**-4.3**	-2.3
1989	-0.4	-2.3	**-5.6**	

(g) The prospects for **public finances** are again better than in earlier forecasts. The cumulative PSBR in the first six months of 1987-88 is about £3½b. below the budget profile. The major part of this shortfall is on the CGBR(O), with higher tax receipts the main explanation, but with central government expenditure below profile. Local authority borrowing has also been below profile. For 1987-88 the forecast is for a negative PSBR of £1b.

The forecasters attempt to predict the level of **public expenditure** that will occur. The forecast therefore implicitly includes judgements both on the results of the current round of Ministerial discussions (and for 1989-90 the results of the autumn 1988 discussions) and on the influence of the forecast evolution of the economy on demand led public expenditure. (Annex I summarises the assumptions on public expenditure.) The forecast has the outturn for the **planning total** (less privatisation receipts) in 1988-89 and 1989-90 respectively £5b. and £10b. above the previously announced plans (including the reserve). The emerging outcome for 1987-88 and the forecast for public expenditure in the later years implies that the ratio of general government expenditure (excluding privatisation receipts) to GDP starts off 1¾ percentage points below the value in the last PEWP and continues to fall further in 1988-89 and 1989-90.

Even with their current spending likely to exceed provision at much the same rate as in recent years and with the proportion of expenditure financed by central government grant falling, **local authorities' borrowing** should be close to its 1986-87 level during the forecast period as a result of a large increase in rates and buoyant capital receipts. **Public corporations' finances** benefit from the buoyant level of activity over the forecast. Nevertheless rising real levels of investment lead to an increased requirement for external finance, despite positive real price increases.

With the forecast levels of nominal and real demand and output higher than in earlier forecasts, forecast **tax receipts** (pre-fiscal adjustment) are higher. More real fiscal drag has contributed to slight upward revisions since June to the effective tax rates for PAYE and onshore CT. The share of pre-fiscal adjustment non-North Sea taxes in non-North Sea money GDP rises over the forecast period.

With the shares of public expenditure and pre-fiscal adjustment government revenues in GDP behaving so differently there are large fiscal adjustments. The forecast makes the stylised assumption that - after adjusting the PSBR for the higher than previously assumed level of privatisation receipts - for 1988-89 one third of the available fiscal adjustment is allocated to cuts in personal taxes and the other two thirds to reduce further the PSBR below the level in the 1987 FSBR. In 1989-90 the PSBR ratio is maintained at the assumed level for the previous year and the additional fiscal adjustment that is available is allocated to cuts in personal taxes. This produces cuts in personal taxes of £4¼b. and £2b. in 1988 and 1989 budgets. Even with these assumed cuts the share of post fiscal adjustment government revenues in money GDP does not change over the forecast period. The PSBR adjusted for privatisation receipts and the PSFD are - as proportions of money GDP - lower in 1988-89 and 1989-90 than at any time since the war except in the late 1940s and early 1950s and in 1969-70 and 1970-71. (See Annex II.)

(h) The forecast for public finances in the UK implies a markedly greater ex post tightening of fiscal policy than in the rest of the G7 taken together, as shown by the **general government deficit** - the only comparable measure of fiscal stance available for all G7 countries.

TABLE 2 : GENERAL GOVERNMENT FISCAL DEFICITS AS A SHARE OF GDP (%)

	1979-85	1986	1987	1988	1989
UK	3.1	2.6	1.8	1.1	0.6
G7 (less UK)	3.1	3.1	2.8	2.7	2.7

(ii) Main issues and risks

2. It is invidious to label individual judgements as particularly important or vulnerable. Nevertheless in the current exercise there has inter alia been detailed discussion of

- **the likely extent of the fall in the private sector surplus,**
- **the prospects for pay,**
- **the short term prospects for the current account,**

and - **the robustness of the projections for public sector finances.**

(a) The forecast implies a decline in the **financial surplus of the private sector** from its current high level. (Annex II sets out the data for sectoral surpluses and deficits over a long historical period.) Some fall in the company sector surplus seems very likely given the good prospects for capital investment revealed in intentions surveys. Indeed there must be a significant risk that, following the recent buoyancy of the economy, investment will be stronger than in the forecast.

The prospect for the personal sector is particularly uncertain. The personal sector accounts include companies' pension funds which, following the strong rise in equity markets at home and abroad, have found themselves with assets well in excess of their liabilities. The principal reaction of companies has been to attempt to rein back their surpluses by cutting employers' contributions. This reduces measured personal sector (though not household sector) saving. This process is likely to continue, particularly as companies will be taking steps to meet the requirement, introduced in the 1986 budget, that pension funds' surpluses, measured on the Government Actuary's assumptions, should not exceed 5 per cent of liabilities. To allow for this the forecast has the personal saving ratio declining slightly, even though there is a rise in the savings ratio if employers' contributions are ignored. (See Chart C on page 15.)

In normal circumstances the personal sector saving ratio would rise significiantly at a time of strong growth in disposable income. This does not appear to have happened either in 1986 or - on the basis of available data - in 1987. But despite this it is possible that, contrary to what is forecast some rise could occur in 1988, producing lower growth of domestic demand and a more favourable current account than now forecast.

While such a development is possible there is a greater risk that personal saving, adjusted for the fall in employers' contributions, will not rise as much as envisaged in the forecast. The drop in the growth of consumers' expenditure from the 5¾ per cent recorded for 1986 to the forecasts of 4¾ and 4½ per cent in 1987 and 1988 depends critically on the judgement that the saving ratio, when adjusted for the fall in employers' contributions, will rise to a level over 1½ percentage points above the recorded 1986 level. Some rise in saving by households would be expected as both inflation and interest rates rise next year, but the extent of the forecast rise does mark a major break with behaviour so far in the 1980s. A faster than forecast growth of consumers' expenditure or company spending in 1987 and 1988 would have adverse consequences for the current account and domestic inflationary pressures.

(b) While there are already signs that private sector **pay settlements** and **average earnings** have begun to accelerate, the record on **labour costs** has been satisfactory. With the economy growing rapidly and RPI inflation rising there is a risk that the acceleration of earnings could be greater than the very slight upturn envisaged in the forecast.

(c) The very strong productivity growth in recent years does suggest that the UK's industrial performance has improved relatively to the rest of the G7 and that as a result a significant trend deterioration in **trade performance** is less likely. The evidence on this is, however, far from conclusive. A stronger than forecast surge in imports in response to strong domestic demand growth in the second half of 1987 and 1988 could be evidence that the forecast is too optimistic about industrial performance. This would mean <u>both</u> weaker GDP growth (with net exports lower) <u>and</u> a worse current account than forecast.

(d) The continuous improvement in recorded and forecast **public finances** since mid 1986-87 almost strains credulity. The prospect for onshore corporation tax is particularly important with increases on a year earlier of £3-3½b. forecast for both 1987-88 and 1988-89. By 1989-90 forecast CT receipts are approximately three times the 1984-85 level. If public expenditure were to over run the last published plans by less than the forecast assumes the improvement in public finances would be even more marked and the scope for fiscal adjustment correspondingly greater.

Most of the improvement since the June forecast in the overall prospect for public finances in 1988-89 and 1989-90 is the result of a higher forecast level of activity. The share of pre-fiscal adjustment of non-oil taxes in money GDP is about ½ a percentage point higher in both 1988-89 and 1989-90, whereas the level of real GDP is 2 per cent higher in 1989. If growth were less than forecast the <u>ex post</u> fiscal position would obviously be a good deal less favourable. Nevertheless, with a total fiscal adjustment in 1988-89 of £13½b. there would still be scope for some combination of further reductions in borrowing and tax cuts, even if taxes were markedly less buoyant than in the forecast.

(2) THE WORLD ECONOMY

3. There was a slowdown in the first half of 1987 in domestic demand growth in the United States, Germany and France that was not offset elsewhere among the major industrial countries. Exports of the group as a whole are, however, picking up and their import growth is slowing, so that the gap between domestic demand growth and real GNP growth in 1987 should be much lower than in 1986. Stockbuilding was particularly strong in the major countries in the first half of 1987 and, to the extent that this was involuntary, subsequent destocking could depress growth. This could be offset by the effects of the Japanese Government's fiscal package and, in 1988, tax cuts in Germany. The WEP sees real domestic demand in the other

major countries as a whole growing by 2.6 per cent in 1987, and real GNP growing by 2.5 per cent, with similar growth rates over the next two years. This is broadly in line with our latest estimates of growth in productive potential.

4. The forecast for the world economy incorporates the judgement that downward pressure on the dollar exchange rate will be fairly mild. This would enable the Federal Reserve to keep interest rate rises to the minimum necessary to control domestic inflationary pressures. With only a modest reduction in the Federal budget deficit in prospect (despite the new Gramm-Rudman deficit reduction programme), the resulting forecast shows the US current account deficit declining only gradually. There is a significant risk that such a slow turnaround would lead to a serious weakening of confidence in the dollar and a sharp drop in its exchange rate, causing the Fed to raise US interest rates substantially. In Japan and Germany the monetary authorities remain very reluctant to lower interest rates, and they may want to raise them for domestic reasons. Nevertheless strong upward pressure on their exchange rates might force them into further modest cuts. The forecast has German and Japanese short rates at their current levels, which with the assumed rise in US rates, involves a small rise in average world short rates.

5. Prospects for **oil prices** are clouded by developments in the Gulf and doubts about OPEC's ability to restrict production. The forecast is that the oil price (North Sea average) will be around $18 per barrel in the period to end-1988, and that the real price will be constant thereafter. **Non-oil commodity prices** have been rising in real terms during 1987. The forecast is for a further gradual rise in real non-food commodity prices until the end of 1988 as world industrial production strengthens, but food prices are expected to remain weak.

TABLE 3 : G7 (excluding UK) GROWTH AND INFLATION
(IMF World Economic Outlook in brackets)

Percentage changes on a year earlier	1986	1987	1988	1989
Real GNP	2.7	2.5(2.5)	2.6(2.7)	2.4
Domestic Demand	3.8	2.6(2.6)	2.6(2.7)	2.5
Industrial Production	0.9	2.8	4.4	4.3
Consumer prices	1.8	2.6(2.9)	3.0(3.4)	2.8

Note: IMF figures include UK

6. Total imports grew by almost 5 per cent in 1986 when oil trade was very buoyant following the fall in the price. Imports of manufactures are estimated to have grown by only 2 per cent. In 1987 the forecast is for

lower total world import growth, of about 3½ per cent, but a pick up in the growth of imports of manufactures to around 4 per cent. In later years world trade is expected to pick up as NODCs, and to a much lesser extent OPEC, increase their imports.

7. Total world trade in manufactures continues to grow more quickly than developed countries exports of manufactures throughout the forecast period because it is assumed that developing countries, and the Asian NICs in particular, will continue to increase their market share. Weighting developed countries exports by UK market share also reduces their growth, because OPEC is a relatively important UK market. Of the difference in 1987-88 and 1988-89 between growth in total world trade in manufactures and the UK market weighted version of developed countries trade in manufactures roughly two thirds results from the difference of coverage (ie the developed countries' loss of share to the NICs) and one third from the weighting.

TABLE 4 : THE VOLUME OF WORLD VISIBLE TRADE

(IMF World Economic Outlook in brackets)

percentage change on year earlier	1986	1987	1988	1989
Total world imports	4.7(4.9)	3.5(3.6)	4.2(4.5)	4.0
of which:-				
- Major seven	9.1	4.9	3.9	3.3
- OPEC	-20.5	-10.1	0	2.5
- Non-OPEC developing countries	1.2	3.3	5.5	6.0
Total world imports of manufactures	1.9	3.8	4.9	4.8
Main developed countries' exports of manufactures weighted by UK market share	1.3	2.6	3.4	3.8

(3) TRADE AND THE BALANCE OF PAYMENTS

8. The current balance, which recorded a surplus in the first four months of the year, returned to deficit in May and has shown average monthly deficits since then averaging £400 million, although individual monthly figures have been erratic. A return to deficit in the latter half of the year had always seemed likely. The scale of the deterioration, however, has been greater than expected at the time of the June forecast, although the current account for the year as a whole could still be close to the £2½ billion deficit forecast in the FSBR.

TABLE 5 : UK CURRENT ACCOUNT (£bn)

	Visible trade balances			Net invisibles			Current balance
	Manufactures	Oil	Other	Services	IPD	Transfers	
1986	-5.5	4.1	-7.0	5.0	4.7	-2.2	-1.0
1987	-7.9	4.3	-6.4	5.6	5.5	-3.4	-2.4
1988	-10.2	3.3	-6.3	5.5	6.8	-3.4	-4.4
1989	-11.6	2.4	-6.2	5.7	7.6	-3.5	-5.8

9. The forecast current deficit of £2½ billion for 1987 compares with a revised estimated deficit of £1 billion in 1986. The widening in the deficit is more than accounted for by a larger deficit on trade in manufactures, which is offset only in part by a higher surplus on oil trade, a smaller deficit on trade in other goods, and a modest improvement in invisibles. In 1988 the forecast is for the current account deficit to increase to around £4½ billion followed by a further widening to £5¾ billion in 1989, with an increasing deficit on manufactured trade and a worsening in the oil balance more than offsetting a rise in the invisibles surplus.

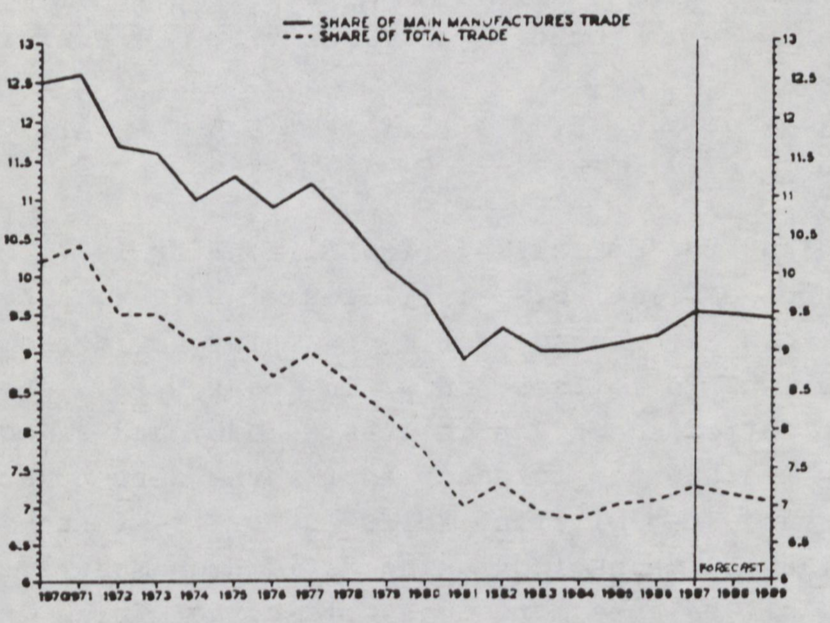
Non-oil visible trade

10. The rising deficit on trade in manufactures in 1987 and 1988 mainly reflects faster domestic growth in the UK compared to overseas. While labour cost competitiveness has deteriorated since the end of 1986, it is still significantly better than the average for 1984 and 1985. Over the forecast period there is a slight deterioration. (See Table 26.)

11. The volume of manufactured exports, which remained flat in the first half of 1987 after the surge towards the end of last year, appears to have begun rising again in recent months. Recorded growth, which may benefit from residual seasonal factors in the rest of this year, seems likely to continue at a modest rate to the end of next year, reflecting the slow rise in the world trade and the effects of the competitiveness loss during 1987. Growth may quicken thereafter as world trade rises more rapidly.

12. The UK's share of developed countries' exports of manufactures, which rose during 1986, may be slipping slightly during 1987, with further small falls forecast for 1988 and 1989. The forecast is for a slight fall also in the UK's share of the wider measure of world manufactured trade which includes NICs' exports. (See Chart A.). This projected share performance reflects mainly an assumption that the loss of competitiveness early this year has tended to restrain export growth fairly quickly, despite the fact that the forecast gives weight to the UK's improved export supply performance since 1981.

CHART A : UK VOLUME SHARES OF TRADE IN MANUFACTURES



13. The volume of manufactured imports which fell sharply in the first quarter of 1987, has risen rapidly again since April. Some of this volatility may reflect residual seasonal factors, but a strong rise in domestic demand for manufactures, rising capacity utilisation, and some loss of recorded competitiveness since the end of 1986 have probably been important factors. The erratic nature of the monthly figures makes difficult the assessment of the underlying trend. The forecast has a further rise in imports during the rest of this year followed by a more gradual rise during 1988 and 1989 as domestic growth falls.

14. Non-manufactured exports and imports have fallen back recently, following the exceptionally rapid growth of trade in wheat and olive oil towards the end of 1986 and in early 1987. (This rapid growth of imports and exports, largely the result of the peculiarities of the CAP, had little effect on the current balance.) Exports are projected to resume growth in 1988 and 1989 as world demand rises, but imports may be rather sluggish as the recent surge in basic material imports ends and imports of food, drink and tobacco return to their modest trend growth.

15. The non-oil terms of trade rose sharply in the first half of this year from the trough at the end of 1986 reflecting partly sterling's appreciation and partly the weakness of world food prices. The forecast is for little change in 1988 and 1989.

Oil trade

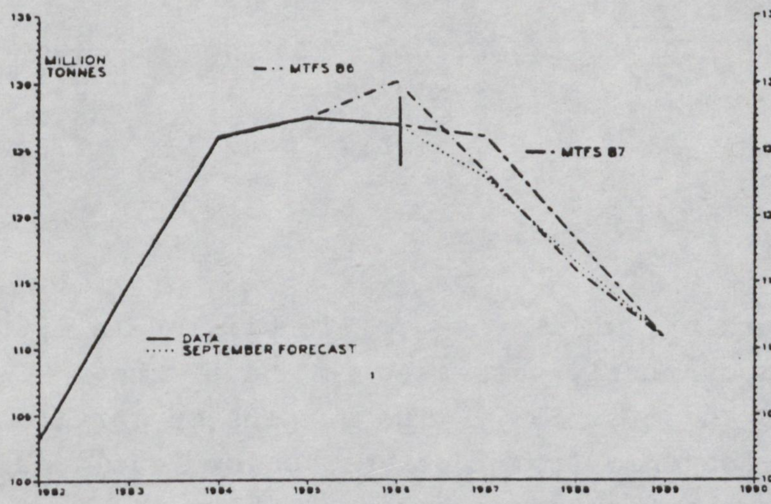
16. The strengthening in world prices during the first half of 1987 has helped to offset a lower than expected volume of North Sea output. On the assumption that oil prices remain close to their present level for the rest of the year and that some - but not all - of the production shortfall is made good, the oil trade balance should be a little higher than last year's £4 billion surplus.

TABLE 6: NORTH SEA OIL

	Average N.Sea oil price $/barrel	Average N.Sea oil price £/barrel	N.Sea output mn.tonnes	Oil trade balance £ bn	N.Sea* taxes £ bn
1986	14.2	9.7	126.9	4.1	4.8
1987	17.7	11.0	122.9	4.3	4.6
1988	18.0	10.7	116.5	3.3	4.5
1989	18.7	10.8	110.8	2.4	4.5

* financial year totals

CHART B : FORECASTS FOR NORTH SEA OIL PRODUCTION



17. The forecast that the average North Sea oil price will remain at $18 a barrel until the end of 1988 and then rise in line with world inflation implies a small fall in North Sea sterling prices next year as the dollar weakens and little change in 1989. North Sea output falls by 5 per cent a year in 1988 and 1989. The fall will largely be reflected in lower exports. The oil trade surplus is forecast to fall by about £1 billion in 1988 and a further £0.9 billion in 1989.

18. Table 7 summarises the forecast for trade volumes. Changes in aggregate exports and imports of goods and services mask divergent movements in components. The projected 3½ per cent a year growth in the volume of manufactured exports excluding erratics in 1988 and 1989 is offset partly by lower arms shipments to Saudi Arabia, a fall in oil exports and a reduction in the recent exceptionally high level of gold exports, together with a more modest growth in services credits, so that total exports only rise by 1½ per cent a year. Total imports are forecast to rise less rapidly than manufactured imports excluding erratics. This reflects mainly a decline in non-manufactured imports partly as a result of the ending of exceptional trade in olive oil and a fall in gold imports (offsetting the fall in exports).

TABLE 7 : EXPORTS AND IMPORT VOLUMES
(per cent changes on previous year)

	Manufactures excl. erratics	Erratics	Oil	Other goods	Total goods	Services	Total goods and services
Exports							
1986	1.1	28.0	2.0	5.5	3.7	1.0	3.1
1987	6.6	2.4	-0.6	6.9	5.2	4.5	5.0
1988	3.5	1.9	-4.0	0.7	1.5	1.9	1.6
1989	3.5	1.6	-6.5	2.2	1.6	1.8	1.6
Imports							
1986	5.6	-0.1	13.8	8.5	6.5	4.9	6.2
1987	9.6	+4.0	0.2	1.6	7.2	3.3	6.5
1988	7.5	-1.4	11.2	-3.0	5.3	3.6	5.0
1989	4.0	0.1	6.7	-0.7	3.2	2.6	3.1

10. Invisibles

19. The invisibles surplus, which rose to £7½ billion in 1986' compared to £5 billion in 1985, is currently estimated to have shown little further growth in the first half of 1987. The surplus on services has risen as travel earnings have recovered from last year's low level and earnings from financial services are estimated to have continued to rise. Net earnings from interests, profits and dividends (IPD), however, have fallen from the high level of late-1986 as the pound's appreciation has reduced the sterling value of overseas earnings, and margins on banks' overseas business have been squeezed.

TABLE 8 : THE BALANCE OF INVISIBLES (£ billion)

	Services	N.Sea IPD	Other IPD	EC transfers	Other transfers	Total invisibles
1986	5.0	-1.6	6.3	-0.7	-1.5	7.5
1987	5.6	-1.7	7.2	-1.7	-1.7	7.6
1988	5.5	-1.2	7.8	-1.6	-1.8	8.7
1989	5.7	-0.2	8.2	-1.7	-1.9	9.6

20. The invisibles surplus is forecast to rise from about £7½ billion this year to £8¾ billion in 1988 and £9½ billion in 1989. The services surplus is unlikely to rise in 1988 as UK growth remains buoyant compared to overseas, but may improve in 1989 as the growth gap narrows. The main increase in the invisibles surplus seems likely to reflect falling payments abroad, North Sea oil companies - as oil output declines - and a rise in other net IPD earnings as portfolio yields rise abroad and banks' margins return to more normal levels. Net transfers to the European Community are projected to show little change in 1988 and 1989 from this year's level. The precise profile of payments and receipts will of course depend on a number of factors on which decisions have not yet been taken.

(4) DOMESTIC DEMAND AND ACTIVITY

(a) Personal income and expenditure

21. Published figures for the first half of 1987 and retail sales for the year to August show consumer spending relatively sluggish at the start of the year, but picking up strongly since the spring. However, discrepancies in the national accounts for the first half of 1987 indicate a significant underrecording of one or more components of expenditure, so that growth of consumer spending growth may well not have fallen to 4 per cent as the recorded figures currently suggest. The figures for retail sales show growth as high as in 1986. Consumer spending seems to have been very strong in the third quarter of the year, and car registrations in August were 6 per cent higher than in August 1986.

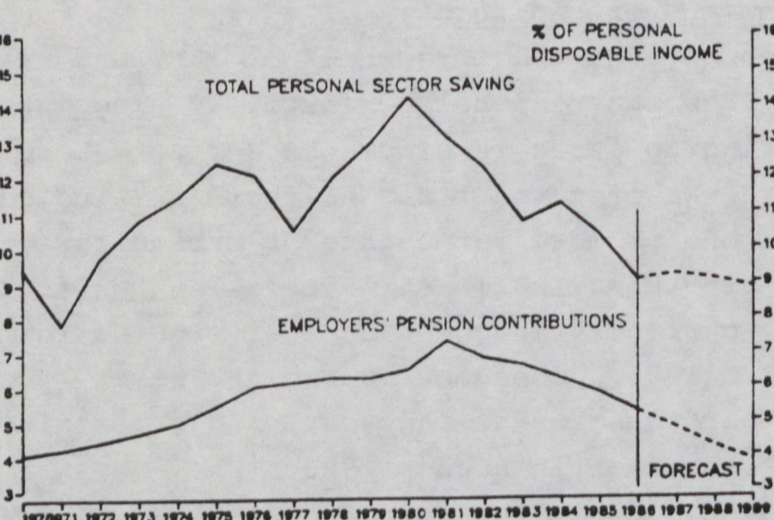
TABLE 9: RETAIL SALES AND CONSUMERS EXPENDITURE

		Retail Sales			Consumers' expenditure	
			Percentage change on			
		1980=100)	previous period	year earlier	(£ billion 1980)	(percentage change on year earlier)
1986	Q1	119.3	1.7	4.3	39.5	5.1
	Q2	121.3	1.7	4.7	40.1	6.6
	Q3	123.7	2.0	5.5	40.7	5.8
	Q4	126.5	2.3	7.3	40.9	5.6
1987	Q1	125.4	- 0.9	5.1	41.1	4.1
	Q2	128.2	2.3	5.8	41.8	4.2
	Q3*	131.9	3.2	7.0		
	Jan	123.6	- 2.4	4.6		
	Feb	127.0	2.8	7.1		
	Mar	125.5	- 1.2	3.8		
	Apr	130.0	3.6	7.7		
	May	125.4	- 3.5	4.8		
	June	129.4	3.2	5.0		
	July	131.2	1.4	7.0		
	Aug	132.5	1.0	6.9		

* Average of July and August

22. Between 1980 and 1986 the personal saving ratio has fallen by about a third, and it is currently close to the levels recorded in the latter part of the 1960s and in the early 1970s, before the dramatic rise in inflation. Part of the recent fall in the saving ratio (and part of its rise in the second half of the 1970s) is probably attributable to the behaviour of employers' contributions to pension funds. (See Chart C). Employers' pension contributions are recorded as part of personal income, but short-term fluctuations in them are unlikely to affect personal expenditure to anything like the extent that changes in after tax wages and salaries do. Instead they are likely to show up in fluctuations in the personal saving ratio.

CHART C. EMPLOYERS' PENSION CONTRIBUTIONS AND THE PERSONAL SAVING RATIO

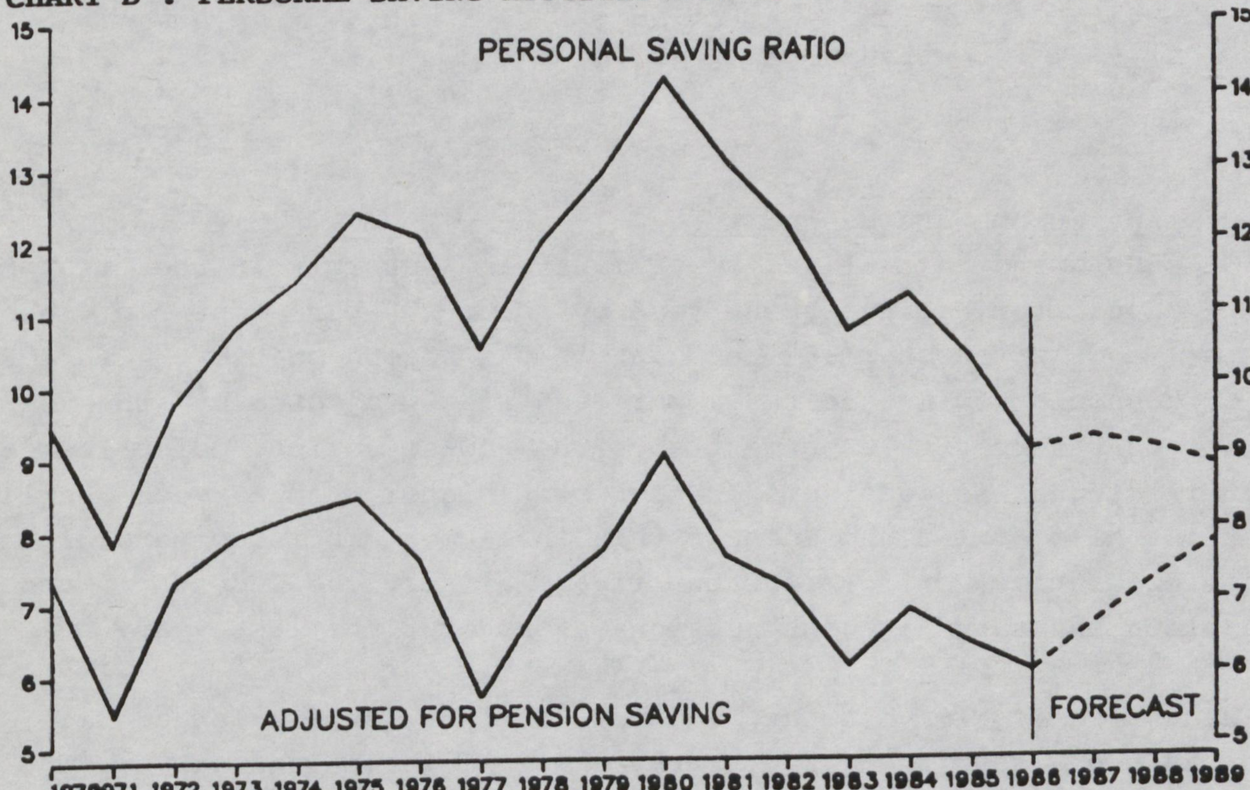


23. The rise to 1981 in pension fund contributions as a proportion of personal disposable income reflected expanding coverage of schemes and topping up payments made to cover actuarial deficits caused by the rise in inflation and the plunge in the stock market in the mid 1970s. In 1980 and 1981 there was also a rise in redundancy payments and an effect from the composition of employment. The fall in employment in this period particularly affected manual workers who would be less likely to be covered by private pension schemes.

24. The subsequent fall in pension contributions relative to wages and salaries must reflect in large part the impact on pension funds of the recovery in profitability and stock markets and the fall in inflation experienced since 1981. This has led to large actuarial surpluses, and an increasing number of firms have temporarily stopped making pension contributions. The 1986 Budget, which required reductions in actuarial surpluses where these exceeded liabilities by more than 5 per cent, and the

continuing rise in profitability and dividends are likely to ensure a further fall in pension contributions relative to pay. This in turn is likely to mean that the personal saving ratio is likely to fall a little further between 1987 and 1989, even though higher inflation and interest rates may be tending to restrain spending (see chart D). (The apparent rise in the recorded personal saving ratio so far in 1987 may be an illusion, reflecting under-recording of consumer spending.)

CHART D : PERSONAL SAVING ADJUSTED FOR PENSION FUND CONTRIBUTIONS



25. The published figures show real personal investment in dwellings weak in the first half of 1987, falling some 4 per cent from the second half of 1986. Spending on both improvements and investment in new dwellings was apparently lower than a year earlier in the second quarter of 1987, a development that is hard to understand given the general buoyancy of personal spending and in particular given the rise in the rate of house completions over the last year.

26. Nevertheless it does look as though housing starts, which were rising through 1986 and into the first quarter of 1987, have now flattened out. Even so for 1987 as a whole housing starts may be at least 5 per cent higher than last year. Completions should go on rising into 1988. In spite of the surprising investment figures for the first half of 1987, the forecast is for a 10 per cent rise in investment in dwellings in the year as a whole, followed by a 6 per cent rise in 1988. By 1989 investment in new dwellings may have stopped rising, although expenditure on improvements should continue to grow quite strongly.

27. Fast growth in both house prices and real personal investment combined with a falling saving ratio mean that the personal sector's financial surplus, which has already declined from about 6 per cent of GDP in 1980 to just over 1 per cent in 1986, is likely to fall further.

TABLE 10: REAL PERSONAL INCOME AND EXPENDITURE

	Real personal disposable income	Real consumers' expenditure	Real investment in dwellings	Persons' net acquisition of financial assets	Personal saving ratio	Saving ratio excluding pension saving
	(Percent changes on previous year)			(£ bn)	(per cent)	(per cent)
1985	2.7	3.7	-3.9	9.0	10.4	6.4
1986	4.3	5.8	11.8	4.7	9.1	6.0
1987	4.9	4.7	9.4	3.6	9.2	6.7
1988	4.4	4.6	6.1	2.6	9.1	7.3
1989	3.1	3.4	3.9	1.4	8.8	7.8

(b) <u>Company income and expenditure</u>

28. Company spending on fixed investment rose sharply in the first half of 1987. Manufacturing investment rose by about 7 per cent in the first quarter and a further 6½ per cent in the second quarter. In 1987 as a whole it should now exceed the 4 per cent rise projected by the June DTI intentions survey. Investment by the construction, distribution and financial industries was some 12½ per cent higher than a year earlier in the first half of 1987. Much of this investment is in commercial building (shopping centres, offices for the financial services industry) and helps to explain the surge in construction output over the last year.

29. Manufacturing investment is also likely to show a larger rise in 1988 than the 6 per cent suggested by the June DTI intentions survey. The latest quarterly CBI survey indicated a substantial upward revision during the summer to intended expenditure on both buildings and plant and machinery. Other private sector business investment may also rise quite strongly again next year, and the build up of work on the Channel Tunnel will contribute to a further rise in construction work. Table 11 summarises the forecast for investment. Nationalised industry investment is much less buoyant than private sector investment, and reduces the growth of "other business" investment shown in table 11.

TABLE 11: GROSS FIXED CAPITAL FORMATION

(percentage changes on previous year)

	1986	1987	1988	1989
Business	- 3	6½	5½	3½
of which				
North Sea	- 14½	- 20	4	- 4½
Manufacturing	- 5	7	10½	8
Other business	- 1	8½	4	2½
Private dwellings	7½	7	5½	3
General government	5½	- 2½	- 3	0
Total	½	5	4½	3

30. Manufacturers reduced their stocks during the first half of 1987. Some of this destocking may have been unintended: by the summer manufacturers were telling the CBI for the first time this decade that on balance they no longer held excessive stocks. This year has also seen a decline in the balance of firms expecting stocks to fall. Distributors' stocks rose during the first half of 1987, though not enough to prevent a fall in the ratio of stocks to sales. The rise in consumer goods imports in the third quarter may indicate a stronger rebuilding of stocks. The forecast is for some further gradual fall in the stock output ratio, but at a slower pace than recorded in recent years. (The main reaction to the tax changes in the 1984 which raised the cost of stockholding should now have taken place.) This implies an increased rate of stockbuilding over the forecast period, though stockbuilding remains on a modest scale compared with many years of the 1960s and 1970s.

31. Non-North Sea industrial and commercial companies' profits net of stock appreciation rose by 13 per cent between the first halves of 1986 and 1987. Part of this rise is accounted for by reallocation of newly privatised companies (especially BGC) to the private sector. Excluding the profits of such companies the growth of profits was probably 10-11 per cent over this period - a slower rate of growth than recorded in recent years but still above the growth of money GDP. For 1987 as a whole the underlying growth of non-North Sea ICCs' profits is forecast to be similar to that experienced in the first half of the year. Profit growth may slow further in 1988, as output growth slows down and the rate of increase in costs rises slightly. This outlook for profits, at a time when company expenditure is likely to be rising strongly, implies a fall in companies' financial surplus - not, however, to an extent that should pose any general financial problems for companies.

TABLE 12: THE FINANCIAL POSITION OF INDUSTRIAL INDUSTRIAL AND COMMERCIAL COMPANIES

	Profits as a share of money GDP (per cent) Total	Non-oil	Rate of return on assets, non-oil ICCs' (per cent)	Net acquisition of financial assets (£ bn) (all ICCs)	Borrowing requirement (£ bn) (all ICCs)
1973-85 average	12.0	8.9	5.5	2.2	3.6
1986	15.0	12.5	8.9	6.4	6.1
1987	15.9	13.2	9.6	9.3	14.0
1988	15.2	13.0	9.2	4.2	11.0
1989	15.2	13.2	9.3	4.5	10.0

32. Table 13 shows the forecast for industrial and commercial companies' gross trading profits. The table also shows companies' net income - which is net of interest payments and receipts and corresponds roughly to the base for corporation tax. The slowing of net income growth in 1988 partly reflects the rise in interest rates forecast for the start of the year.

TABLE 13: PROFITS OF INDUSTRIAL AND FINANCIAL COMPANIES
(percentage changes on previous year)

	Non-North Sea Industrial and Commercial Companies* Gross Trading Profits	Net Income	Financial Companies Net Income
1986	19 (16)	26	21
1987	16 (13)	18½	19
1988	7½	3½	16½
1989	7½	6	6½

* Figures in brackets show growth of profits adjusted to exclude the effects of newly privatised companies being included.

(c) **Aggregate demand and output**

33. The average estimate of GDP grew by 3¾ per cent between the first halves of 1986 and 1987, while the output estimate grew by around 4¼ per cent (4¾ per cent non-North Sea). Output growth was particularly strong in the construction sector (up by 7½ per cent), and manufacturing output also recorded a rise of 5 per cent. The full extent of the rise in output is not explicable in terms of recorded expenditure. The expenditure estimate of GDP shows less than a 2½ per cent rise over the same period.

34. For 1987 as a whole the output measure of GDP seems likely to record a rise of 4 per cent or a little more. It is likely that the

average estimate of GDP will eventually show a similar increase. But there is some risk that, if the problems with the expenditure measure persist into the second half of the year, recorded growth could be a little under 4 per cent on the average estimate when the first figures for calendar 1987 are published by the CSO at around the time of the Budget. Given the record of upward revisions to GDP at the times of fast output growth it is quite likely that recorded growth for the average measure of GDP in 1987 will eventually settle down at a figure above 4 per cent.

35. Growth is expected to fall back to around 3 per cent in 1988 (3½ per cent non-North Sea). This slowing down is caused by a worse trade performance and by some deceleration in personal spending. After two years of above trend growth in 1987 and 1988, 1989 could see somewhat slower growth if the investment cycle has started to turn down by then.

TABLE 14: EXPENDITURE AND OUTPUT

(percentage changes on previous year)

	1986	1987	1988	1989
Domestic demand	3.8	3.9	4.1	2.9
Exports of goods and services	3.1	5.0	1.6	1.6
Imports of goods and services	6.2	6.5	5.0	3.1
Compromise adjustment	0.4	0.8	0	0
GDP(A)	3.1	4.1	3.0	2.4
Non-oil GDP(O)	3.1	4.5	3.5	2.8
Manufacturing output	1.1	5.2	2.9	3.2

(5) INFLATION

36. RPI inflation is likely to average close to 4 per cent in the fourth quarter of 1987, in line with the forecast published in the FSBR. Producer output prices, on the other hand, seem likely to rise some ½ per cent more on average this year than forecast at Budget time, principally as a result of higher input prices. In the third quarter of 1987 materials and fuel input prices were some 7 per cent higher than forecast at Budget time. Inflation as measured by the main national accounts deflators, however, was actually lower in the second quarter than expected at Budget time. There is currently an unusually large difference between inflation as measured by the RPI and inflation as measured by the national accounts consumption deflator. The national accounts deflators are subject to revision, and revisions tend to be upward.

Producer prices

37. Productivity growth of around 7 per cent has left manufacturers' unit labour costs virtually unchanged over the last year. In spite of the rise in materials costs over the last year, manufacturers' total unit costs are still no higher than they were at the start of 1985. Over the forecast period there is likely to be a modest rise in unit labour costs, as productivity growth reverts to its estimated underlying rate of increase, and real commodity prices may continue a gradual recovery from their exceptionally depressed levels of 1986. However, with a stable exchange rate for sterling, manufacturers will find it difficult to raise profit margins to anything like the extent they have done over the last three years. A slight reduction in inflation is expected during 1988, and inflation may fall further in 1989 if the economy slows down as forecast and competitive pressures intensify.

TABLE 15: MANUFACTURING COSTS AND PRICES

(percentage changes on previous year)

	Unit labour costs	Cost of materials and fuels	Estimated total costs	Domestic producer output prices*
1986 Q4	0.2	- 5.6	- 0.4	3.9
1987 Q4	0.9	7.7	2.2	4.8
1988 Q4	3.0	2.2	2.9	4.4
1989 Q4	2.8	3.1	2.4	3.2

* excluding food, drink and tobacco

Retail prices

38. Although retail price inflation in the fourth quarter of 1987 may turn out marginally below the Budget forecast, inflation is likely to rise during the first half of 1988 to around 5¼ per cent by the end of the year. This rise in inflation reflects in particular substantial electricity and gas price increases, a large rise in local authority rates, the loss of the benefits of the non-revalorisation of specific duties in the 1987 Budget, and a forecast rise in mortgage rates, as well as the effect of faster growth of unit labour costs.

39. Table 16 sets out changes in **nationalised industry** prices charged to domestic consumers over the year to 1987 Q4 and 1988 Q4, and gives real price increases over a run of financial years.

TABLE 16 : NATIONALISED INDUSTRY PRICES

(a) Nominal price increases for consumers

	Year to 1987 Q4	Year to 1988 Q4
Post	2.6	4.5
Rail	5.7	5.0
Electricity	- 0.3	8.0
Coal and coke	- 0.1	2.2
Bus	4.9	4.3
Water	5.6	6.4

(b) real price increases (weighted average for consumers and industry)

	1983-4	1984-5	1985-6	1986-7	1987-8	1988-9	1989-90
British Coal	2.3	0.0	- 1.9	- 3.1	- 4.5	- 2.9	- 2.4
Electricity	- 3.8	- 2.0	- 2.2	- 1.9	- 3.9	2.9	0.0
BSC	- 8.1	1.1	- 4.6	- 1.8	- 1.6	- 2.3	- 1.7
Post Office	- 2.0	- 1.5	- 4.2	- 2.0	- 0.8	- 0.4	- 1.0
Water	1.5	1.0	4.7	4.4	1.7	1.4	2.0
LTR	-15.7	- 3.2	1.5	2.2	2.1	4.4	4.1
British Rail	- 4.5	0.4	0.0	2.8	1.2	- 0.2	- 0.9

* Nominal changes deflated by the RPI

40. The larger increases in nationalised industry prices charged to consumers in 1988 will raise RPI inflation in 1988(4) by about ¼ per cent compared with inflation in 1987(4). Other factors that contribute to the rise in RPI inflation between 1987(4) and 1988(4) are as follows:

(i) The formula relating **gas prices** to oil prices and the RPI should give almost a 4 per cent rise in domestic prices next year, following a 4½ per cent fall this year (the difference is worth about 0.2 per cent on inflation).

(ii) The rate support grant settlement is assessed as implying an 12 per cent rise in average **local authority rate** poundages next year, compared with 7¾ per cent this year (the difference is worth 0.18 per cent on inflation).

(iii) A 1 point rise in **mortgage rates** compared with their end September level means that the path of mortgage interest payments adds about 0.4 per cent more to RPI inflation next year than this.

(iv) The assumed **indexation of specific duties** in the 1988 Budget will add a little over 0.3 per cent to RPI inflation in the latter part of 1988 compared with the latter part of 1987.

(v) **Food** prices are also likely to rise a little faster over the next year. Although world food prices are expected to remain relatively weak, a partial recovery in tropical beverage prices means that the prices of the foods the UK buys on world markets will rise a little more in 1988 than in 1987, and the faster rise in UK labour costs will also tend to put up food retail prices inflation.

(vi) **Petrol** prices have been unexpectedly low during the summer - the normal seasonal rise did not occur - in spite of the strength of crude oil prices. Over the next year there may be little change in petrol prices, other than that resulting from the assumed indexation of petrol duties in the 1988 Budget.

(vii) **Other private sector prices** have risen by 3½ per cent over the last year. (They would have risen by about 4 per cent but for the non-indexation of duties in the 1987 Budget.) Making a small allowance for the possibility that some of the acceleration of producer output prices in recent months has still to feed through into these prices and for the effect of the recent rise in pay settlements, these prices could rise by around 4¼ per cent over the next year.

41. The forecast for the RPI is summarised in table 17.

TABLE 17: COMPONENTS OF THE RETAIL PRICE INDEX

(Percentage changes on previous year)

	1986 Q4	1987 Q4	1988 Q4	1989 Q4
Food prices	3.2	3.4	3.9	3.5
NI prices	3.7	2.3	6.3	4.3
Housing prices	7.1	7.5	11.4	8.1
Other prices	2.6	3.4	4.1	3.5
- of which petrol	3.4	-12.6	1.8	3.4
- other items	3.8	3.4	4.2	3.4
All items RPI	3.4	3.9	5.3	4.3
RPI excluding mortgage interest payments	3.4	3.7	4.6	3.9

42. The annual rate of increase in the RPI should fall below 4 per cent in November when the mortgage rate increase that occurred in November 1986 drops out of the twelve month comparison. The inflation rate will rise again early next year on the assumption that the mortgage rate rises at the beginning of the year. Inflation is likely to rise quite sharply after March as post Budget increases in specific duties and rates and electricity price increases show up in the index. The forecast monthly path of retail price inflation up to the end of 1988 is shown below.

TABLE 18: MONTHLY PATH OF RPI INFLATION

		All items RPI	RPI excluding mortgage interest payments			All items RPI	RPI excluding mortgage interest payments
1987	August	4.4	3.7	1988	April	4.5	4.2
	September	4.2	3.5		May	4.9	4.3
	October	4.3	3.6		June	5.1	4.4
	November	3.8	3.7		July	5.2	4.5
	December	3.7	3.7		August	5.3	4.6
					September	5.5	4.7
1988	January	3.9	3.6		October	5.4	4.6
	February	3.9	3.6		November	5.3	4.5
	March	4.1	3.7		December	5.3	4.5

(c) **The GDP deflator**

43. The national accounts deflators published for 1987Q2 are surprisingly low. The CSO are currently looking at some aspects of the figure for the deflator for consumers expenditure, and have indicated that it is quite likely that the figure will be revised up. The latest published figure for the GDP deflator (showing a 4.1 rise in the GDP deflator at market prices over the year to 1987Q2) does not suggest any overrun of the Budget forecast for the current financial year which was for a 4½ per cent rise in the GDP deflator.

44. For 1988-89 most of the factors tending to push up the RPI (other than the path of mortgage rates) will also affect the GDP deflator. The GDP deflator will also be affected to the extent that the current boom in construction output feeds into construction prices and the forecast has a modest allowance for this effect in 1988-89.

SECRET

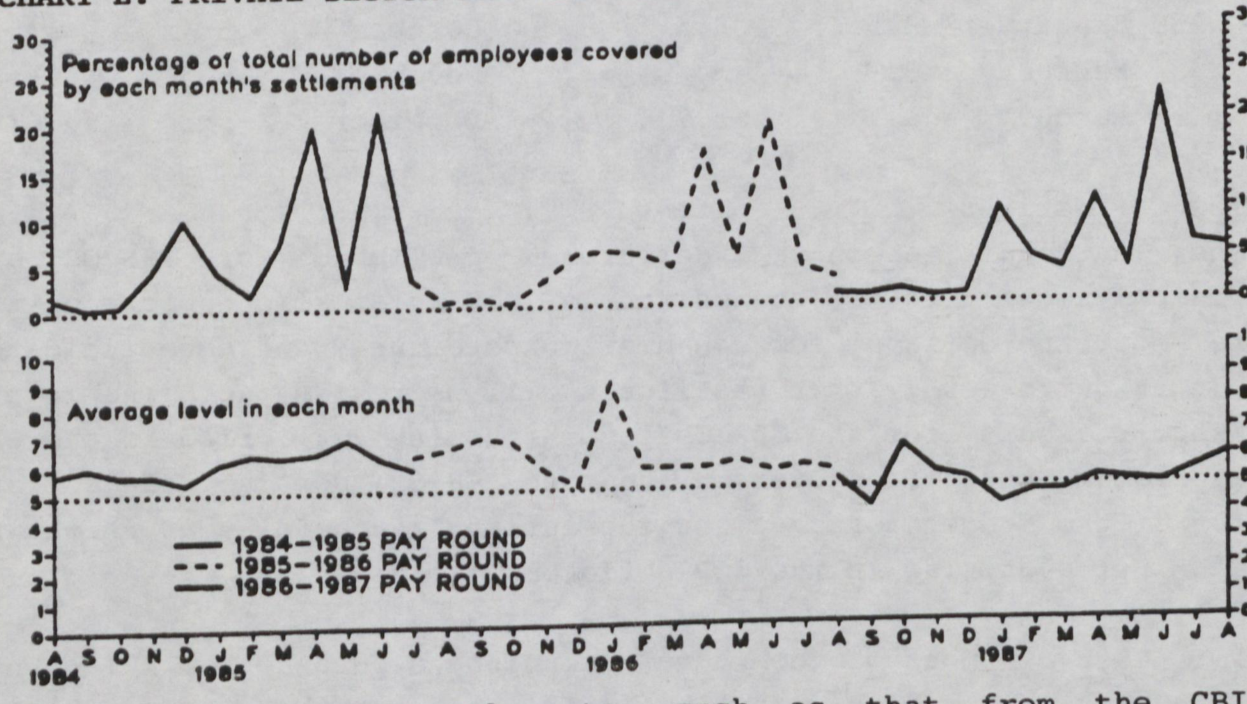
TABLE 19: FORECASTS FOR THE DEFLATOR FOR GDP AT MARKET PRICES

	1986-87	1987-88	1988-89	1989-90
MTFS				
Total	3	4½	4	3½
non-oil	6	4¼	3¾	3¼
Autumn forecast				
Total	3	4½	5½	5¼
non-oil	5¾	4	5½	5

(d) **Earnings**

45. Over the twelve months to August 1987, private sector pay settlements monitored by Department of Employment averaged 5 per cent, about ¾ per cent less than during the previous twelve month period. Settlements fell during the second half of last year, but appear to have bottomed out at around the beginning of 1987, and in the most recent month settlements averaged 6 per cent (see Chart E).

CHART E: PRIVATE SECTOR PAY SETTLEMENTS



46. Other evidence on settlements, such as that from the CBI's pay databank, tells a similar story. Although a relatively small number of employees are covered by the most recent settlements, the upward trend seems well established and it is not likely that as major settlements are concluded over the autumn they will generally be at rates below 6 per cent. This forecast assumes 6 per cent settlements on average over the next twelve months. Settlement rates may thereafter rise further (reflecting inflation at around 5½ per cent in mid 1988), but fall back in the second half of 1989 as the economy slows further and price inflation falls.

47. Overtime has been very high in recent months - at around record levels in relation to the number of operatives - and is currently estimated to be responsible for around ½ percentage point of the 8 per cent growth of private sector earnings over the last year. Over the next two years cyclical effects will tend to reduce earnings growth, and will offset the effect of rising pay settlements.

TABLE 20: PRIVATE SECTOR SETTLEMENTS AND EARNINGS
(Contributions to changes between third quarters of successive years)

	1986-87	1987-88	1988-89
Settlements	5¼	6	6½
Drift	2¾	2	1½
Increase in average earnings	8	8	8

48. Over the twelve months to August growth in local authority earnings has been roughly in line with private sector, while central government earnings has been a little lower. Over the following twelve months, local authority pay seems likely to rise somewhat faster than private sector pay. The teachers are already due for 8.2 per cent from October and a further 1 per cent next April. The forecast assumes that they receive only 4½ per cent "new money" on top of this in the light of Cabinet's decision not to pay more than the increase in the RPI. Local authority manuals have already agreed an increase of 10½ per cent. Local authority construction workers may also do well, particularly given the pressures from construction workers' pay in the private sector (up over 10 per cent in the year to June). It seems likely that some important groups of local authority workers will continue to do better than the private sector. While others (eg further education teachers) may do worse, local authority pay on average looks likely to rise a little faster than private sector pay.

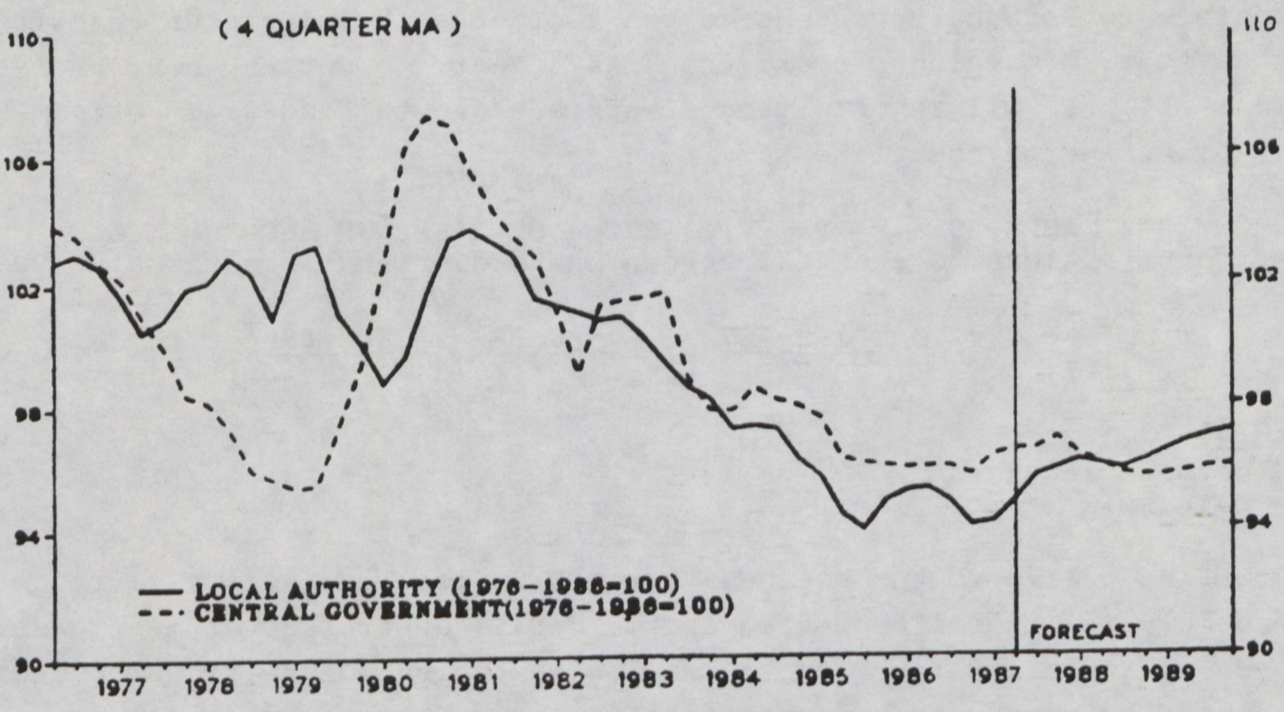
49. On the other hand, central government earnings are likely once again to rise more slowly than private sector earnings over the next year. If there is a relatively high settlement for health service employees, it could well be staged, while a settlement for civil servants below the private sector average is expected. In later years central government pay is expected to rise more closely in line with private sector pay.

TABLE 21 : PUBLIC AND PRIVATE SECTOR UNDERLYING AVERAGE EARNINGS
(percentage changes over years to August)

	Central Government	Local authorities	Private sector**
1986-87	7	8 (7)*	7½
1987-88	7	9½(9¼)*	8
1988-89	8	9 (8¾)*	8½

* figures in brackets excluding settlements for primary and secondary teachers
** adjusted for changes in overtime hours.

CHART F : RATIO OF LOCAL AUTHORITY AND CENTRAL GOVERNMENT EARNINGS TO PRIVATE SECTOR AVERAGE



(e) Labour costs

50. The forecast for private sector earnings combined with the forecast for productivity (discussed in section 6 below) produces forecast increases in labour costs in manufacturing that are modest by past standards, and close to those forecast for competitor countries.

TABLE 22 : LABOUR COST INCREASES IN MANUFACTURING
(percentage increases on previous year)

	UK	Major 7 (less UK)
1986	3.4	2.3
1987	0.0	1.3
1988	3.3	1.6
1989	2.6	2.3

(6) PRODUCTIVITY, EMPLOYMENT AND UNEMPLOYMENT

51. The latest upward revisions to manufacturing output mean that manufacturing productivity is now estimated to have risen by around 7 per cent in the first seven months of this year compared with a year earlier. While much of the recent rise in productivity is the result of a cyclical increase in the intensity of use of labour (as indicated by the rise in overtime hours), it seems that underlying productivity growth may have been a little higher recently than has been previously assumed. For this forecast the projection of underlying productivity

growth has been raised from 4 to 4¼ per cent a year.

52. Employment outside manufacturing rose by over 130,000 during the first quarter of 1987. Current indications are that the second quarter showed an increase of around 120,000. Growth in output per man outside manufacturing was unusually strong during 1986 - reflecting, among other things, redundancies in the coal industry and good productivity gains in other public corporations -, but as far as can be discerned has been much slower this year. Underlying growth in private sector non-manufacturing productivity is projected at around 1¾ per cent a year (about 2½ per cent a year in terms of full time equivalents).

TABLE 23: RECORDED AND FORECAST GROWTH OF OUTPUT PER HEAD

Annual averages, percentage changes

	1964-73	1973-79	1979-86	1986-89
Manufacturing	5¾	¾	3¾	5
Non-manufacturing*	3	½	1¼	1½
Total non-oil economy	2¾	½	1¾	2¼
Whole economy	2¾	1	2	1¾

* Includes private sector and nationalised industries other than in manufacturing and oil.

53. Labour supply is forecast to grow by about 680 thousand over the three years to 1989, about 200 thousand less than in the previous three years. This projection is somewhat higher than growth shown in the projections published in the Employment Gazette because the UK's relatively strong economic performance is likely to lead to both higher net inward migration and higher participation ratios than allowed for in the Department of Employment's projections.

TABLE 24: PRODUCTIVE POTENTIAL

(Annual averages; percent changes)

	Trend non-North Sea productivity growth	Labour supply	Non-North Sea productive potential	Contribution of North Sea	Whole economy productivity potential
1973-79	1	½	1½	½	2¼
1979-86	1½	½	2	¼	2¼
1986-89	2	¾	2¾	- ½	2½

54. Growth in the "working population" - the sum of employment and unemployment - has been very low over the past year: around 40,000 between mid 1986 and mid 1987, below the projected growth in labour supply, and down from increases of over 500,000 a year between mid 1983 and mid 1985. This is the phenomenon publicised by Layard and Clarke. The employment programmes which have been expanding recently and other measures such as Restart have tended to reduce the working population. (This is not the case with the Community Programme, whose participants are generally counted as employees and so remain in the working population).

55. But government programmes and Restart are not the only factors responsible for the recent slow growth of the working population. One important factor has been that the composition of employment growth has changed somewhat in favour of areas where most of the jobs are filled by men. Construction employment has started to rise, manufacturing employment has flattened out, and the programme of redundancies in the coal industry has - at least for a while - come to an end. Thus a higher proportion of new jobs have been going to claimants, and a smaller proportion to non-claimants. Moreover, the growth of the "working population" between 1983 and 1985 was quite exceptional relative to growth in the population of working age. It was never likely to be sustained and does not provide a reasonable benchmark against which to assess the impact of Restart and other recent measures. Between mid 1986 and mid 1987 the shortfall of growth in the working population relative to the projected increase in population of working age was some 130,000 - much less than the fall in unemployment over this period (roughly 290,000 including school-leavers). As shown in table 25, on our estimates of the effects of the various measures, about two thirds of the improvement in the adult unemployment trend as between the year to mid 1986 and the year to mid 1987 is attributable to underlying economic factors rather than to the effect of measures.

56. Unemployment is likely to fall more slowly during the forecast period. This is primarily because the 5 per cent growth in manufacturing output and 7 per cent rise in construction output forecast for this year are not forecast to be repeated over the next two years and so male employment growth will slow down. Nevertheless, helped by the removal from the count in September 1988 of everyone under 18, unemployment could go on falling into 1989.

TABLE 25 CHANGES IN ADULT UNEMPLOYMENT

(seasonally adjusted 000s)

	Unemployment	Effects of employment and training measures, restart and availability testing	Underlying unemployment
1985(2)-1986(2)	+ 88	- 64	152
1986(2)-1987(2)	- 238	- 173	- 65
1987(2)-1988(2)	- 322	- 117	- 205
1988(2)-1989(2)	- 135	- 64	- 71

(7) FINANCIAL CONDITIONS

57. WEP has a rise in US interest rates during 1988, which is judged sufficient to limit the fall in the dollar exchange rate to modest proportions. With interest rates in the other major economies flat the average world interest rate rises. Because this rise in the average world interest rate is the consequence of likely downward pressure on the dollar exchange rate there could be some upward pressure on sterling against the dollar. However, the prospect that the UK current account deficit will widen in 1988 and 1989 could raise expectations of some decline in the sterling exchange rate with a need for an increase in interest rates in order to achieve a constant sterling index.

CHART G : STERLING AND THE CURRENT BALANCE

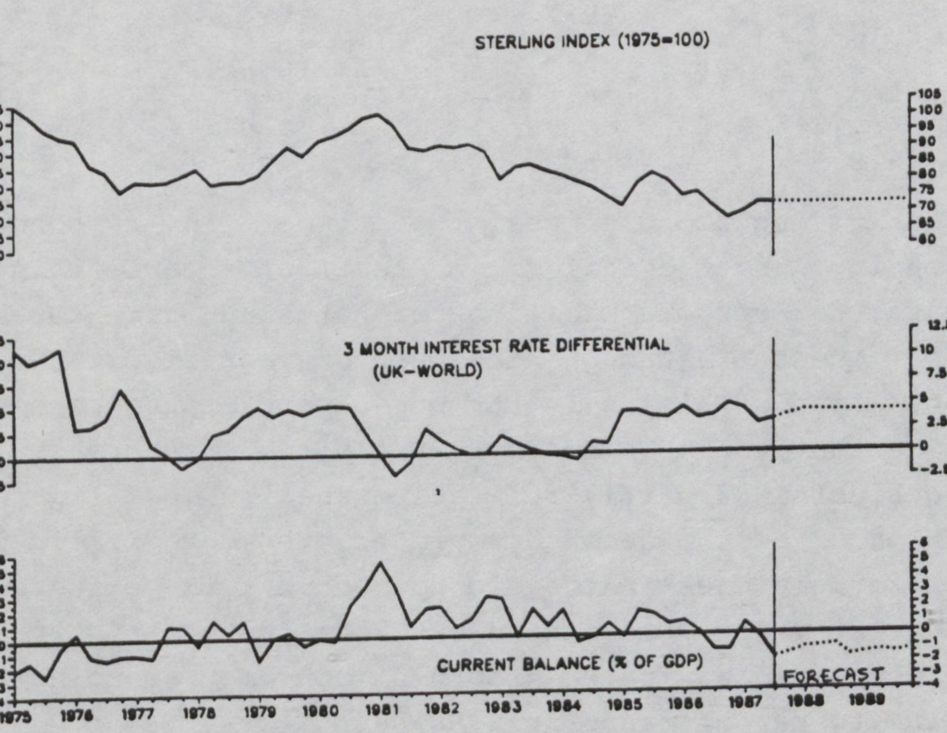


TABLE 26: EXCHANGE RATES AND COMPETITIVENESS
(average yearly rates)

	US dollar index (1975=1000)	Sterling index (1975=100)	$/£	DM/£	Relative unit labour costs (1980=100)
1984	134.6	78.6	1.34	3.79	82.9
1985	140.7	78.2	1.30	3.78	84.5
1986	114.8	72.8	1.47	3.19	77.3
7 Oct	101.5	73.3	1.64	2.998	75.4
1987	102.4	72.0	1.61	2.94	74.8
1988	98.1	72.5	1.68	2.94	76.7
1989	94.6	72.5	1.73	2.87	76.9

58. Domestic factors also point to upward pressure on interest rates. M0 will be very close to the top of its target range in the near future, reflecting strong growth in consumers' expenditure. Money GDP growth is expected to overshoot the objectives set in the 1987 FSBR in every year in the forecast period. Continued strong credit demand from the private sector - both companies and persons - tends to offset the decline in the needs of the public sector. The forecast has short-term interest rates rising over the next few months to reach 11 per cent by the middle of 1988Q1. This rise, however, is not sufficient to bring the growth of money GDP back to its MTFS path.

TABLE 27: INTEREST RATES

	3-month US interest rates	3-month world rates	3-month sterling LIBOR	Mortgage rate
7 October	7.9	6.9	10.2	11.3
1986-87	6.2	6.3	10.5	11.7
1987-88	7.3	6.6	10.1	11.5
1988-89	8.4	6.9	11.0	12.3
1989-90	8.5	6.9	11.0	12.3

59. M0 has been rising rapidly over the summer in response to buoyant consumer spending and the fall in interest rates earlier in the year. In the three months to September holdings of notes and coin rose at an annual rate of 8 per cent, although the year on year figures for M0 have been closer to 5 per cent. This is in the upper part of the target range, and the forecast is that the year-on-year rate for M0 may breach its ceiling in the early months of 1988 partly reflecting the low M0 figures in early-1987. (A breach of the ceiling would be even more likely if the assumed rise in short term interest rates did not occur.) The effects of the recent rise in interest rates together with the further rise projected in the forecast and the slowdown in the growth of consumer spending should bring M0 back within its target range in 1988-89.

TABLE 28: MONETARY AGGREGATES AND CREDIT

(per cent change on a year earlier)

	M0 MTFS range	M0 Actual forecast	M3	M4	Lending by banks and building societies
August 1987	-	4.7	22.1	15.6	18.8
1986-87	2-6	4.3	19.0	14.9	18.5
1987-88	2-6	5.1	20.4	14.9	18.9
1988-89	1-5	4.4	16.2	13.8	17.2
1989-90	1-5	3.4	13.0	12.7	14.8

60. Broad money has continued to grow rapidly, with M3 increasing by 22 per cent in the year to August reflecting a continued strong rise in deposits by persons, ICCs, and building societies with some slowdown in deposits by other financial institutions after the surge early in the year. The forecast is that M3 growth may slow next year. Persons' deposits may continue to rise rapidly reflecting rising personal incomes and the relative attractiveness of high-interest bank accounts. Companies' deposits, however, may increase less rapidly than in the recent past as their investment in real asset rises. Deposits by financial institutions may grow markedly less quickly than recently as a result of lower inflows to pension funds and a slower rise in their total portfolio. The growth of M4 which contains a greater proportion of personal sector deposits, continues to rise less rapidly than M3 initially, but the gap closes later in the forecast period.

61. Lending by banks and building societies which rose by 19 per cent in the year to August, is forecast to rise by a further 17 per cent in 1988-89 before slowing in 1989-90. Lending to companies is projected to rise as less buoyant securities markets limit at least to some extent companies' scope to rely on equity issues. Lending to persons is also projected to rise steadily for both housing and other purposes. Competitive pressures on building societies and the limit on their access to wholesale funds continues to erode their share of new mortgage advances.

62. The PSBR is assumed to be funded fully outside the banking system, but the move to a negative borrowing requirement leads to net gilt repayments of £7 billion in 1988-89 and £6½ billion in 1989-90 - even on the assumption that receipts from National Savings are reduced to £1 billion a year. Gross gilt sales fall from £9½ billion in the current financial year to £3½ billion in 1988-89 and £1½ billion in 1989-90.

63. The emergence of a growing current account deficit coupled with continued net direct investment outflows and further portfolio investment abroad by financial institutions implies the need for substantial

offsetting capital inflows. The precise form of these is difficult to judge. The forecast assumes that corporate security issues on both the euro currency and US commercial paper market will play a significant role. Banks are also assumed to increase both their foreign currency and sterling borrowing from abroad for on-lending to residents. Net overseas sales of gilts are projected at zero. The forecast assumes that £1 billion of the intervention so far in 1987-88 is unwound before the end of the financial year with a further £1 billion in 1988-89.

TABLE 29: NET EXTERNAL CAPITAL FLOWS

	Direct invest -ment††	Non bank port-folio*	Banks' foreign currency†	Banks' ster-ling	Other	Official reserves	Balan-cing item	Current balance
1986	-6.0	-7.1	2.9	-0.4	2.8	-2.9	11.7	-1.0
1987	-10.0	7.1	6.2	3.8	2.8	-5.7	-1.8	-2.4
1988	-5.3	0.8	2.2	2.2	2.1	1.3	1.0	-4.3
1989	-5.5	0.9	4.2	2.2	2.5	0.3	1.0	-5.6

* includes gilts
† includes securities
†† includes oil

(8) PUBLIC FINANCES

64. Table 30 summarises the forecast and compares it with the numbers in the FSBR, and with the internal June forecast. The projections in the FSBR were on the basis of certain conventional assumptions and not a central forecast.

TABLE 30 : PUBLIC SECTOR EXPENDITURE, REVENUE, AND BORROWING (£ billion)

	1986-87	1987-88			1988-89			1989-90		
	Outturn	FSBR	June Fore-cast	Oct. Fore-cast	FSBR	June Fore-cast	Oct. Fore-cast	FSBR	June Fore-cast	Oct Fore-cast
General Government Expenditure	165	174	173	**172½**	180	185	**184**	188	198	**197**
General Government receipts	160	169	172	**173**	178	187	**192**	187	201	**206**
Assumed cuts in personal taxes (cumulative)					3	3	**4**	5	5	**6**
GGBR	5	5	2	**-½**	5	2	**-3**	6	2	**-4**
Public corporations' overseas and market borrowing	-1½	-1	-1	**-½**	-1	-1	**-2**	-1	-1	**-2**
PSBR	3½	4	1	**-1**	4	1	**-5**	5	1	**-5**
(per cent of GDP) brackets)	(1)	(1)	(¼)	**(-¼)**	(1)	(¼)	**(-1)**	(1)	(¼)	**(-1)**

(a) <u>1987-88</u>

65. The PSBR for 1987-88 is now forecast to be a <u>surplus</u> of £1b. The

margins of error attached to PSBR forecasts made at this time of the year, whilst lower than those for the Budget forecast, are still very high. The <u>average</u> absolute error is around 0.8 per cent of GDP (£3b.).

66. The latest forecast represents an undershoot on the FSBR forecast of £5b., and a reduction of £2b. from the June forecast. Table 31 shows the main components of the £5b. reduction in the PSBR forecast since the Budget. Over three-quarters of the predicted undershoot of the FSBR forecast is accounted for by lower central government own account borrowing, with most of the remainder due to lower local authorities' borrowing. The forecast of public corporations' market and overseas borrowing is little changed. Looked at another way three-quarters of the downward revision to the forecast has been on general government receipts, and one-third to general government expenditure.

TABLE 31 : CONTRIBUTION TO THE CHANGE IN THE 1987 PSBR FORECAST SINCE JUNE AND THE FSBR

	£ billion Changes since	
	FSBR	June
- higher North Sea revenues from a higher North Sea oil price;	-¾	-
- higher non-North Sea corporation tax reflecting upward revisions to 1986 profits data and higher dividend payments (generating ACT) in 1987;	-1	-½
- higher income tax, in line with experience to date and mainly reflecting higher money incomes;	-¾	-¾
- higher national insurance contributions, reflecting higher money incomes;	-½	-
- higher VAT, in line with outturn to date, and reflecting buoyant expenditure and - we think - a larger than expected reduction in arrears as a result of the Keith reforms;	-½	-½
- higher stamp duty as a result of the buoyant housing and stock markets;	-½	-
- higher privatisation proceeds;	-¼	-¼
- a lower public expenditure planning total (excluding privatisation proceeds);	-1	-1¼
- offsetting increases, mainly lower 'other' receipts and higher national accounts adjustments	+¼	+1¼
TOTAL CHANGE IN PSBR FORECAST	-5	-2

67. Lower expenditure and higher receipts have contributed roughly equally to the £2b. reduction in the PSBR since June. The main upward revisions on the receipts side have been to income tax, non-North Sea corporation tax and VAT. On the expenditure side the main reduction is lower local authority net capital spending, reflecting higher capital receipts, but the forecasts of social security spending and nationalised industries' EFLs have also been reduced.

(b) <u>Fiscal adjustment and PSBR in 1988-89 and 1989-90</u>

68. The MTFS assumption of PSBRs of one per cent of GDP would, on present projections, imply a massive fiscal adjustment in 1988-89 of around £13½b., with a further annual fiscal adjustment of £3b. in 1989-90. The forecast makes the stylised assumption that higher than previously planned privatisation proceeds are used to reduce the PSBR and that one third of the remaining available fiscal adjustment for 1988-89, calculated on this basis, reduces personal taxes, with the remaining two thirds reducing the PSBR to a surplus equivalent to about 1 per cent of GDP. The assumed cut in taxes is a little larger than in the June forecast. In 1989-90 the PSBR is maintained at the arbitrary surplus of 1 per cent of GDP, and there is scope for a further cut in personal taxes of £2b.

(c) <u>Public expenditure</u>

69. The forecast of the planning total excluding privatisation proceeds in 1987-88 has been revised down since June, and instead of a small overspend of the 1987 PEWP plans, a £1b. undershoot is now forecast. Substantial overspends of the PEWP totals are forecast for 1988-89 and 1989-90, only a little less than those forecast in June. The forecast for these years takes account both of the differences between the economic assumptions used in the PEWP and of the economic prospects in the forecast, together with other pressures on programmes which past experience suggests are likely. The forecast is in effect attempting to anticipate not only the final outcome of the current survey (and in the case of 1989-90 the next survey as well), but also any eventual over or underspend on the finally agreed planning totals. The forecast incorporates some modest additions to expenditure in 1989-90 following the buoyant performance of the economy in general and public finances in particular in 1987 and 1988. Privatisation proceeds of £5¼b. are assumed for 1987-88, in line with PE's latest assessment. Proceeds of £6b. a year are assumed for 1988-89 and 1989-90.

70. Table 32 sets out forecast increases in actual programme spending compared with the 1987 PEWP in terms of economic rather than departmental categories. About half the projected excess above current programme plans is accounted for by social security and local authority current expenditure. These are areas over which the Government has limited direct control.

SECRET

TABLE 32 : FORECAST ADDITIONS TO PROGRAMME BASELINES

£ billion

	1987-88		1988-89		1989-90	
	PEWP 1987	Forecast Claims on Reserve	PES 1987 Base-line	Forecast additions to baseline	PES 1987 Base-line	Forecast additions to baseline
Allocated to programmes						
1. Social Security (including HB)	44.7	0.5	46.1	2.2	48.0	4.1
2. LA current (excluding HB)	32.5	1.1	33.7	2.9	34.6	5.2
3. CG pay	24.8	0.5	25.8	1.5	26.6	2.9
4. CG procurement	24.6	0.1	25.0	1.4	25.9	2.3
5. LA capital	4.3	-0.7	4.0	-0.2	4.1	0.0
6. EC	0.9	0.4	0.4	0.9	1.1	0.6
7. Nationalised industries	0.7	-0.1	0.3	0.3	-0.1	0.7
8. Other	17.8	0.6	18.3	0.9	18.8	1.5
9. Total programmes	150.1	2.5	153.7	9.9	9.0	17.3
10. **Expenditure met from existing reserve**						
(i) allocated to programme baseline	0.0	2.5	0.0	5.5	0.0	7.5
(ii) unallocated	3.5	0.0	5.5	0.0	7.5	0.0
11. **Underspend (-) Addition to Reserve(+)**	0.0	-1.0	0.0	4.4	0.0	9.8
12. PLANNING TOTAL excluding privatisation proceeds	153.6	-1.0	159.2	4.4	166.5	9.8

71. The forecast of social security spending assumes that the underlying growth in spending - ie the growth after allowing for the effects of changes in unemployment, upratings, policy changes, demographic factors etc - which is projected to have risen rapidly in 1987-88, falls back somewhat in 1988-89 and 1989-90. The forecast of local authority current spending, most of which is pay, assumes that numbers employed will rise at much the same average rate as in the last 2-3 years and that earnings increases will be somewhat above the private sector average (see para 48). This, together with the RSG settlements announced in July, implies average rates increases of about 11 per cent in 1988-89.

72. The forecast of central government pay assumes little change in numbers and earnings increases averaging below the private sector in 1988-89 and much the same as the private sector in 1989-90 (see para 49). The forecast of central government procurement assumes that non-defence spending will rise in real terms at much the same rate as over the past 5 years, and that defence spending will rise at ½ per cent a year in real terms. Local authority capital receipts and gross capital spending are assumed to be higher than in the 1987 PEWP, but by roughly equal amounts in 1988-89 and 1989-90. The forecast has partially smoothed out the projected dip in net EC contributions in 1988-89 and the rebound in 1989-90.

73. The large upward revision to the planning total forecasts for 1988-89 and 1989-90 since the Budget are largely matched by a higher inflation forecast. Consequently the increase in the planning total in real terms is less than the cash increase. In real terms the planning total and GGE (see table 33) are much the same as earlier internal forecasts. The forecast of GGE in real terms is almost identical to that made a year ago for 1988-89 and less than 1 per cent higher for 1989-90.

TABLE 33 PAST AND CURRENT FORECASTS OF GGE EXCLUDING PRIVATISATION PROCEEDS

£ billion

Forecast	1986-87		1987-88		1988-89		1989-90	
	Current prices	Real Terms*	Current Prices	Real Terms*	Current Prices	Real Terms*	Current Prices	Real Terms*
Jan 1986	169	169	176	169	186	169	-	-
June 1986	169	169	177	170	186	171	-	-
Oct 1986	170	170	178	171	188	172	200	173
Jan 1987	170	170	179	171	190	173	202	175
FSBR 1987	169	170	179	171	185	171	193	172
June 1987	169	169	179	170	190	171	203	174
Oct 1987	170	170	178	170	190	172	203	175

* in 1986-87 prices

74. The ratio of GGE (excluding privatisation proceeds) to money GDP is forecast to show a sharp fall in 1987-88 and more modest falls in 1988-89 and 1989-90. It is below the PEWP/MTFS paths in all three years.

TABLE 34 : RATIO OF GGE EXCLUDING PRIVATISATION PROCEEDS TO MONEY GDP

per cent

	1985-86	1986-87	1987-88	1988-89	1989-90
1987 PEWP	44¾	44½	44	42¾	42½
1987 FSBR	44¾	44¼	43½	42½	41¾
Oct forecast	44¾	44	42¼	41¾	41¼

(d) General Government Receipts

75. The recent history of forecasts of general government receipts has been a series of successive upward revisions. The current forecast continues this pattern, with substantial upward revisions to 1988-89 and 1989-90

compared the with June forecast. The upward revision since June to the forecast for 1987-88 has been smaller (about £1b.), though this still leaves the 1987-88 forecast of revenues £4b. higher than that in the FSBR.

76. Part of the upward revision to 1987-88 receipts since the FSBR can be attributed to higher economic activity, including stronger than expected stock and housing markets, which have boosted stamp duty receipts. Higher non-North Sea corporation tax for the most part reflects stronger than previously estimated activity and profits in 1986. Higher non-North Sea corporation tax is the most important single factor behind the higher total receipts now forecast for 1988-89 and 1989-90, accounting for around half of the revision since June to 1988-89 and one-third of the revision to 1989-90. The revision to the forecasts partly reflects higher profits growth for 1987 (and thus higher tax receipts for 1988-89). The remainder of the upward revision since June to the receipts forecasts for 1988-89 and 1989-90 are for the most part attributable to higher income and expenditure (income tax, VAT and NICs account for between one-third and half of the total upward revision in each year), but the forecast of local authorities rates has been raised by between £¾ to £1b. in each year.

TABLE 35: COMPARISON OF FORECASTS OF GENERAL GOVERNMENT RECEIPTS (PRE-FISCAL ADJUSTMENT FOR 1988-89 AND 1989-90)*

£ billion

Forecast:	1986-87		1987-88		1988-89		1989-90	
	Cash	Real Terms	Cash	Real Terms	Cash	Real Terms	Cash	Real Terms
January 1986	157	153	166	159	178	162	188	164
June 1986	156	156	164	158	179	164	188	166
October 1986	156	156	165	159	181	165	196	169
January 1987	158	158	169	162	184	168	197	171
FSBR 1987	159	159	169	162	178	164	187	167
June 1987	159	160	172	164	187	168	201	172
October 1987	160	160	173	165	192	174	206	178

* Forecasts made before this and last year's Budgets have been adjusted to be consistent with current tax rates and allowances. Real terms figures are at 1986-87 prices.

77. Table 36 shows non-oil taxes and national insurance contributions (NICs) as a percentage of non-oil GDP. The changes to the tax forecast since the FSBR mean that the forecast now shows a substantial rise in the pre-fiscal adjustment tax burden for 1988-89, but this is offset by the assumed cut in taxes. The projected rise for 1989-90 is smaller, and is

again offset by the assumed tax cut. Thus with the stylised assumption used here on the allocation of the fiscal adjustment, the tax burden for 1989-90 is the same as the level for 1987-88. With oil revenues as a percentage of GDP expected to be broadly flat at the projected 1987-88 level, the ratio of total taxes to money GDP is forecast to follow a similar pattern to the non-oil ratio.

TABLE 36: NON-OIL TAXES AND NICs AS A PERCENTAGE OF NON-OIL GDP

	1985-86	1986-87	1987-88	1988-89	1989-90
FSBR					
(a) pre-fiscal adjustment	37.2	37.3	37.8	37.9	37.7
(b) post fiscal adjustment	37.2	37.3	37.8	37.1	36.6
June Forecast					
(a) pre-fiscal adjustment	37.3	37.7	38.0	38.4	38.8
(b) post fiscal adjustment	37.3	37.7	38.0	37.5	37.9
October Forecast					
(a) pre-fiscal adjustment	37.0	37.5	38.0	39.1	39.4
(b) post-fiscal adjustment	37.0	37.5	38.0	38.0	38.0

ANNEX I: PUBLIC EXPENDITURE ASSUMPTIONS

The forecast of public expenditure in 1987-88 takes account of the latest monthly data on expenditure, the expected evolution of the economy over the rest of the year (which affects such programmes as social security) and Treasury expenditure divisions' assessments of the likely final outturn. For 1988-89 and 1989-90 the forecasters attempt to predict the level of public expenditure that will occur (as opposed to the programme plans which will eventually be agreed). The forecast therefore implicitly includes judgements both on the results of the current round of Ministerial discussions (and for 1989-90 the results of the autumn 1988 discussions) and on the influence of the forecast evolution of the economy on demand led public expenditure.

2. In constructing the forecast it is necessary to make detailed assumptions in certain areas. The main ones were as follows:

(i) The outturn percentage for local authorities' Aggregate Exchequer Grant, which on the basis of the forecasters' view of relevant expenditure, is forecast to fall from 45¾ per cent (GB, accruals) in 1987-88 to 45[illegible] per cent in 1988-89, is assumed to fall a further ½ percentage point in 1989-90.

(ii) The forecast assumes an increase in the VAT ceiling for EC own resources contributions from 1.4 to 1.6 per cent with effect from 1 January 1988 and that a Community Budget is agreed before 31 March 1988.

(iii) Privatisation proceeds are assumed to be £6 billion per annum in 1988-89 and 1989-90. For 1987-88 PE's latest best estimate of £5¼ billion is used.

(iv) The Treasury Supplement to the National Insurance Fund is assumed to be reduced by 2 per cent in 1988-89 and a further 2 per cent in 1989-90, to a level of 3 per cent.

3. The table below compares the forecast with the main economic assumptions used in the 1987 PEWP, the 1987 MTFS, and with assumptions which have either already been agreed, or proposed (Mr Davies' minute of 2 October to the Chancellor) for use in the forthcoming Autumn Statement and PEWP.

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	1986-87	1987-88	1988-89	1989-90	1990-91
GDP Deflator (%)					
1987 PEWP	3	3¾	3½	3	
1987 MTFS	3¼	4½	4	3½	
October Forecast	3	4½	5½	5¼	
Proposed New Assumption	3	4½	5	3½	3
Money GDP (%)					
1987 PEWP	5½	7	6	5½	
1987 MTFS	6	7½	6½	6	
October Forecast	6½	9	8½	7¾	
Money GDP (£b)					
1987 PEWP	380.2	407.0	431.4	455.2	
1987 MTFS	382.4	411.0	437.2	463.8	
October Forecast	385.3	419.5	455.1	490.4	
Unemployment (Adult, GB millions)					
1987 PEWP	3.1	3.05	3.05	3.05	
October Forecast	3.0	2.7	2.5	2.5	
Agreed New Assumption	3.0	2.7	2.6	2.6	
RPI* (%)					
1987 PEWP			3¾	3½	
October Forecast			4.2	5¼	
Proposed New Assumption			4.2	5	3¼
Average Earnings (%)					
March Assumptions		6½	6	5½	5
October Forecast	8	8¼	8	8	
Agreed New Assumption		7½	6½	5½	5
UK 3 month LIBOR					
March Assumptions		9¾	9½	9½	9
October Forecast		10	11	11	
Proposed New Assumption		10	10	9½	9
UK 20 year gilt rate					
March Assumptions		9	9	9	9
October Forecast		10	11	11	11
Proposed New Assumption		10	10	9	9
6 month dollar LIBOR					
March Assumptions		7	8½	9	9½
October Forecast		7¾	8¾	9	
Proposed New Assumption		7½	8½	9	9

* increases in year to previous September

ANNEX II : SECTORAL SURPLUSES AND DEFICITS

Table IIA compares sectoral net acquisition of financial assets by sector (sectoral surpluses and deficits) as proportions of money GDP since 1948. The overseas sector surplus is the current account deficit with the sign changed. Similarly the public sector's surplus is the PSFD with the sign changed.

The large forecast residual error reflects and continues discrepancies between the measures of GDP in the first half of 1987. Normally the residual error comes down as the CSO reduces measurement of errors for a particular period.

For 1988-89 and 1989-90

(i) The **total private sector surplus** is lower than in any year since 1974-75. It is not particularly low compared with earlier experience.

(ii) The **personal sector surplus** is low in comparison with experience in the years from 1960. It is not low in comparison with the earlier period.

Table IIB shows the PSBR, the PSBR adjusted for privatisation receipts, and the PSFD (public sector financial deficit) as proportions of money GDP.

For 1988-89 and 1989-90

(i) The **PSBR** ratio, at -1 per cent, is lower than in every year since 1952 except 1969-70.

(ii) The **PSFD** ratio is lower than in every year except 1968-69, 1969-70, and the three years to 1950.

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TABLE IIA: NET ACQUISITION OF FINANCIAL ASSETS BY SECTOR (AS PER CENTAGE OF GDP)

	Personal (1)	ICC (2)	Financial (3)	Total Private Sector (4)	Public (5)	Overseas (6)	Residual Error (7)
Calendar Years							
1948	- 2.8	1.8	0.3	- 0.7	2.2	- 1.4	- 0.2
1949	- 2.6	2.1	0.3	- 0.1	2.4	- 1.2	- 1.1
1950	- 2.1	3.1	0.3	1.3	2.6	- 3.3	- 0.6
1951	- 3.2	2.5	0.3	- 0.4	- 1.6	2.2	- 0.2
1952	0.1	4.0	0.5	4.6	- 3.4	- 1.0	- 0.1
1952	- 0.4	3.7	0.3	3.7	- 4.1	- 0.8	1.2
1954	- 1.6	3.6	0.4	2.3	- 2.4	- 0.6	0.7
1955	- 1.4	2.1	0.4	1.1	- 2.0	+ 0.8	0.1
1956	0.2	2.0	0.3	2.6	- 2.6	- 1.0	1.0
1957	0.0	1.5	0.4	1.9	- 2.4	- 1.0	1.5
1958	- 0.6	2.1	0.3	1.8	- 1.9	- 1.6	1.7
1959	- 0.3	1.8	0.2	1.6	- 2.2	- 0.7	- 1.3
1960	1.1	0.9	0.2	2.3	- 2.7	+ 0.9	- 0.4
1961	2.3	- 0.2	0.2	2.4	- 2.6	- 0.2	0.5
1962	2.0	0.0	0.2	2.1	- 1.8	- 0.5	0.2
1963	1.9	1.4	- 0.2	3.0	- 2.6	- 0.4	0.0
Financial Years							
1963/64	1.9	1.8	- 0.3	3.4	- 3.3	0.0	- 0.1
1964/65	2.6	- 0.6	- 0.5	1.5	- 2.4	1.0	- 0.1
1965/66	3.6	- 1.0	- 0.5	2.1	- 1.7	0.2	- 0.6
1966/67	2.5	0.8	- 0.7	2.6	- 2.6	- 0.4	0.4
1967/68	2.0	1.6	- 0.8	2.8	- 4.2	1.1	0.2
1968/69	1.2	0.5	- 1.1	0.6	- 0.8	0.3	- 0.1
1969/70	1.5	0.7	- 1.6	0.6	1.7	- 1.5	- 0.8
1970/71	2.1	0.8	- 1.2	1.7	0.4	- 1.1	- 1.0
1971/72	0.1	2.4	- 0.7	1.8	- 1.1	- 1.7	1.1
1972/73	1.4	2.5	- 0.5	3.3	- 3.0	0.4	- 0.7
1973/74	3.4	0.0	- 0.7	2.7	- 4.6	2.0	- 0.1
1974/75	4.3	- 1.7	- 0.7	2.0	- 6.7	3.6	1.2
1975/76	4.1	0.9	- 0.7	4.3	- 7.3	1.0	2.0
1976/77	3.4	- 0.5	0.2	3.1	- 5.7	1.1	1.5
1977/78	2.6	1.1	0.3	4.0	- 4.4	0.0	0.4
1978/79	4.5	0.3	0.2	5.0	- 4.8	- 0.3	0.1
1979/80	4.4	- 0.3	0.2	4.2	- 3.9	0.1	- 0.4
1980/81	6.6	0.3	- 0.3	6.6	- 5.0	- 2.5	0.8
1981/82	4.9	0.3	- 0.2	5.0	- 2.0	- 1.8	- 1.2
1982/83	3.5	2.0	0.1	5.6	- 2.9	- 1.6	- 1.0
1983/84	2.9	2.4	0.4	5.7	- 3.7	- 0.9	- 1.1
1984/85	3.2	2.2	0.0	5.4	- 4.0	0.0	- 1.4
1985/86	2.3	1.9	0.3	4.6	- 2.3	- 1.1	- 1.2
1986/87	1.3	1.7	1.4	4.5	- 2.5	0.2	- 2.2
Forecast							
1987/88	0.5	1.9	0.9	3.2	- 1.0	1.0	- 3.1
1988/89	0.5	0.8	1.1	2.4	- 0.5	1.0	- 3.0
1989/90	0.2	1.0	0.9	2.1	- 0.3	1.2	- 3.0

NB: Columns 1 + 2 + 3 = 4
Columns 4 + 5 + 6 + 7 = 0

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Table IIB: PUBLIC SECTOR BORROWING as a percentage of GDP

	PSBR	PSBR less Privatisation proceeds	PSFD
1948			-2.2
1949			-2.4
1950			-2.6
1951			1.6
1952	5.0		3.5
1953	3.4		4.1
1954	2.0		2.4
1955	2.4		2.0
1956	2.7		2.6
1957	2.2		2.4
1958	2.1		1.9
1959	2.3		2.2
1960	2.7		2.7
1961	2.5		2.6
1962	1.9		1.8
1963	2.7		2.6
1963-64	3.3		3.4
1964-65	2.7		2.4
1965-66	2.6		1.7
1966-67	2.9		2.6
1967-68	4.9		4.2
1968-69	0.8		0.8
1969-70	-1.2		-1.7
1970-71	1.5		-0.4
1971-72	1.6		1.1
1972-73	3.6		3.0
1973-74	5.8		4.6
1974-75	9.0		6.7
1975-76	9.3		7.3
1976-77	6.4		5.7
1977-78	3.6	3.9	4.4
1978-79	5.3	5.3	4.8
1979-80	4.8	5.0	3.9
1980-81	5.4	5.5	5.0
1981-82	3.3	3.5	2.0
1982-83	3.1	3.3	2.9
1983-84	3.2	3.5	3.7
1984-85	3.1	3.7	4.0
1985-86	1.6	2.3	2.3
1986-87	0.9	2.0	2.5
		Forecast	
1987-88	-0.3	1.0	1.0
1988-89	-1.1	0.2	0.5
1989-90	-1.1	0.1	0.3