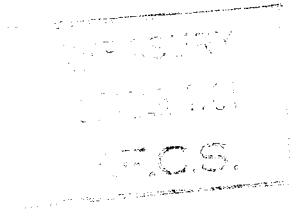


59)

EFFECTS OF THE BUDGET : PART C
16TH MARCH 1981 - 20TH MARCH 1981



MISS BROWN

HTS

33/016

cc Principal Private Secretary
PS/Chief Secretary
Sir D Wass
Sir A Rawlinson
Mr Ryrie
Mr Burns
~~Mr Middleton~~
Mr Monck
Mr Unwin
Mr H P Evans
Mr R G Ward
Mr Turnbull
Mrs Gilmore
Mr Ridley
Mr Cropper
Mr Cardona

EFFECTS OF THE BUDGET: PUBLIC SECTOR ~~FINANCIAL~~ DEFICIT

One recurrent theme which the Financial Secretary has seen financial commentators emphasise in their reactions to the Budget has been its effects on the public sector financial deficit, which is of course projected to fall substantially between 1980/81 and 1981/82.

... Gordon Pepper has already referred to this in conversation; I attach another example from Michael Hughes of de Zoete Bevan.

The Financial Secretary's impression is that the expected fall in the PSFD is misleading, and that these commentators are making too much of the point. He would be grateful for a note explaining among other things the difference between the projected paths for the PSFD and the PSBR.

SAL

S A J LOCKE

16 March 1981

10043

Michael Hughes

11th March 1981

UK BUDGET - SUMMARY RESPONSE

X/

1. Attempts to reduce budget deficit from £11.8 bn. to £6.3 bn. suggests an unprecedented deflationary stance. But this forecast assumes an average unemployment rate of 2.5 million and a very modest (7%) increase in public sector earnings. If more realistic assumptions are made the planned £5.5 bn. reduction in the budget deficit virtually disappears. Nevertheless the final figure will still represent a reduction relative to GDP - an important policy stance at this stage of the cycle.
2. The higher consumer taxes are an attempt to share the cost of a high and still expanding public sector. Public spending in volume terms in 1981/82 is now estimated to be 3% higher than planned for in the March 1980 budget and still 1.3% higher than was thought likely last November. There still seems to be a strong expectation that public spending can be sharply corrected in the Spring 1982 budget - following the analysis that it is always easier to cut spending in the recovery stage of the cycle than in a recession.
3. Has the recovery been jeopardised?
Probably not but its profile has been flattened. Most of the fiscal deflation is likely to be matched by a lower savings rate and lower imports, the final effect on domestic demand being relatively small. Before the budget we were looking for a 2% growth in GDP between the fourth quarters of 1980 and 1981. We now look for 1/2-1% growth.
4. Inflation: although short-term inflation rates have been raised the longer term inflation prospects have now improved - one factor which should help the 1982 recovery.
5. Corporate Sector: although the assistance to the corporate sector was minimal it must be remembered that sterling's devaluation over the last two months is equivalent to a £3-4 bn. fiscal boost to the corporate sector. Moreover the introduction of reserve powers to impose inward controls on capital inflows provides the scope for a ceiling on sterling which could ensure that any exchange stimulus to the corporate sector is sustained.

/contd...

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6. Interest Rates: although the reduction in the budget deficit is consistent with a further fall in interest rates, the scope for any reductions will be limited by the rise in the corporate sector's financing needs. We do not believe, at this stage, that these combined financing needs will be consistent with an interest rate range below 11% this year.

7. Summary

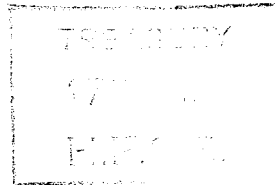
Sterling should be firm after the budget but there is potentially a ceiling on any appreciation (our guess is that this ceiling will not be higher than \$2.30). The budget is very good for the gilt market although looking further out into fiscal 1981/82 there are still unresolved issues which will concern the market. For the equity market, dampened domestic demand will obviously be a disappointment but with sterling now under a ceiling and the government's budget funding programme more firmly under control, the equity market's prospects are not as dismal as they may first appear.

MICHAEL HUGHES
11th March, 1981

PS/FINANCIAL SECRETARY

33/016

cc Principal Private Secretary
PS/Chief Secretary
PS/Minister of State (C)
PS/Minister of State (L)
Sir D Wass
Mr Burns
Mr Middleton-87/2
Mr P Dixon
Mr Monck
Mr Cassell
Mr H P Evans
Mr Unwin
Mrs Gilmore
Mr Folger
Mr Ridley
Mr Cropper



THE BUDGET JUDGEMENT

We have spotted a rather unfortunate reference in the Financial Secretary's statement of 12 March (released as a Press Notice), namely that:

"The current underlying rate of inflation is within the new monetary target".

2. This is not true. The FSBR (part III, para 6) makes it clear that while the six-monthly annualised increase in the RPI was about 7 per cent in January, the underlying increase was higher, probably in the range 10-11 per cent. This is at the top end of, or slightly above, the new £M3 target range.
3. This is unfortunate given that Ministers appear to have accepted the dangers of quoting unadjusted six-monthly inflation rates. We have also put in some work with the Department of Employment to establish a decent methodology for estimating the "underlying" rate.

12A

R I G ALLEN

EB

16 March 1981

1056/3

FINANCIAL SECRETARY

#7
cc Principal Private Secretary
PS/Chief Secretary
Sir Douglas Wass
Sir Anthony Rawlinson
Mr Ryrrie
Mr Burns
Mr Middleton —
Mr Monck
Mr Unwin
Mr Evans
Mr R Ward
Mr Turnbull
Mrs Gilmore

- 33/016
1. Mr Doggett
 2. Mr Carter (and file)
- Mr Ridley
Mr Cropper
Mr Cardona

EFFECTS OF THE BUDGET: PUBLIC SECTOR FINANCIAL DEFICIT

Mr Locke's minute to me of 16 March asked for a note explaining the difference between the paths for the PSFD and PSBR in the FSBR, comparing 1980-81 and 1981-82.

2. The public sector financial deficit is projected to fall £5½ billion between 1980-81 and 1981-82 in the FSBR, compared with a reduction of only £3 billion shown for the PSBR.
3. The difference between the changes (some £2½ billion) is, indeed, pretty artificial for two kinds of reason - but not wholly artificial.
4. First, the policy of selling council houses reduces the financial deficit; but associated mortgage lending by local authorities scores 'below the line' among financial transactions, and there is little net impact on the PSBR. This is worth perhaps £600 million.
5. Secondly, there is the effect of constraining various parts of the accounts for 1981-82, to avoid showing what we think most likely

to happen. As you know, the figures for 1980-81 are best guesses of what is happening (wrong, no doubt, but still best guesses). For 1981-82 the contingency reserve, cash underspending and the proceeds of special sales of assets are not allocated to sector or type of transaction. They amount to £1.4 billion in 1981-82. The great bulk of this is very likely to affect the PSFD eventually - whether because nationalised industries' trading surpluses are lower than shown; or because local authorities spend more than shown in PEWP (to which the FSBR was constrained); or for some other reason.

6. For the rest, there are some reasons for extra costs among financial transactions - such as increased lending to BL and fewer receipts from export credit (we have not forecast an emulator of the Sheik of Dhubai) - widening the gap between the PSFD and the PSBR.

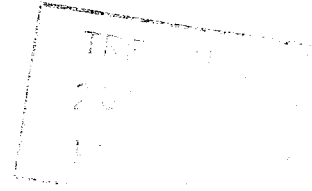
7. If we continue to publish unallocated contingencies (net) - and I do not suggest otherwise - this presentational point will recur. I have toyed with the idea of moving them up to the PSFD, but that causes more problems than it solves.

WPB

PATRICIA BROWN

17 March 1981

HFCs



MR R I G ALLEN

33/016

cc Principal Private Secretary
PS/Chief Secretary
PS/Minister of State (C)
PS/Minister of State (L)
Sir D Wass
Mr Burns
Mr Middleton
Mr P V Dixon
Mr Monck
Mr Cassell
Mr H P Evans
Mr Unwin
Mrs Gilmore
Mr Folger
Mr Ridley
Mr Cropper
Mr Cardona

THE BUDGET JUDGEMENT

The Financial Secretary has seen your minute of 16 March.

He has commented as follows:

"My estimate of the underlying rate of inflation is 10%, which is within the 6-10% range, albeit at one end of it. Moreover, there is a further margin, so far as my more general proposition is concerned, provided by the underlying secular upward trend in velocity."

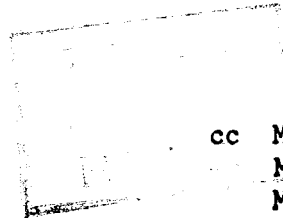
SASL

S A J LOCKE
18 March 1981

1/24/3

MR LOCKE

#FL



cc Mr Burns
Mr Middleton
Miss Brown
Mr Unwin
Mr H P Evans
Mrs Gilmore
1. Mr Doggett
2. Mr Carter

33/016

EFFECTS OF THE BUDGET: PUBLIC SECTOR FINANCIAL DEFICIT

You asked for a reference to the PSFD that the Financial Secretary might use when speaking to the Institute for Fiscal Studies on 23 March.

I suggest the following paragraph would be suitable.

"Public sector financial deficit

Some outside commentators have highlighted the considerable fall [$\pounds 5\frac{1}{2}$ billion] in the financial deficit shown in our Budget forecast between 1980-81 and 1981-82. Part of this apparent fall will not come about when the bulk of the allowance for contingencies^(net) and special sales of assets of some $\pounds 1\frac{1}{4}$ billion, excluded at present from the forecast of the financial deficit, are eventually allocated to type of transaction. For this reason it is advisable to look more at the movement forecast in the public sector borrowing requirement ($\pounds 13\frac{1}{2}$ billion in 1980-81 down to $\pounds 10\frac{1}{2}$ billion in 1981-82), a fall of $\pounds 3$ billion."

R G WARD
20 March 1981

1353/3