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FROM: S J DAVIES
20 August 1985

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NATIONAL INSTITUTE ECONOMIC REVIEW FOR AUGUST

1. The August National Institute Economic Review will be published at 9 pm this evening. As well as the usual economic forecasts the Review contains four papers concerned with various aspects of government borrowing and economic policy. These include a paper contributed by John Odling-Smee and Chris Riley. MP1 are submitting a separate brief on these papers.

The Forecast

2. The Institute are slightly more optimistic about output growth this year and next than they were three months ago, and markedly more optimistic about inflation next year than they

were in May. The revision to the inflation forecast reflects a much higher projection for the UK exchange rate. The forecast is constructed on the assumption that the authorities set monetary policy so as to keep the sterling index close to its current level. The table attached compares the new NIESR forecast with the published FSBR forecast and the Treasury's unpublished June forecast.

Demand and Output

3. The Institute expect GDP (as measured by the output estimate) to rise by about 3½% in 1985. They note that over the past quarter of a century no other period of expansion has lasted as long as the present one. However they also suggest that this phase of expansion "may soon be coming to an end". Output is expected to be more or less flat during 1986; the 1½ per cent increase in GDP they forecast between 1985 and 1986 mainly reflects growth during 1985.

4. Manufacturing output is forecast to fall marginally between 1985 and 1986 after a 2 per cent rise this year. (The Institute's forecast was completed before the CSO's upward revision to 1985 manufacturing output statistics, published last week. The Institute can take credit for suggesting in the text of the Review that the previously published figures for manufacturing output this year were too low. Their own estimates, based on responses to the CBI Survey question on the trend in output, are of a 2 per cent rise in manufacturing output in the four months up to July. This is above the CSO's estimate even as revised, and may well suggest further upward revisions to the official statistics still to come).

5. The components of demand that have been strongest in 1985 - business investment and exports - are expected to be much weaker in 1986, with just a 1 per cent rise in exports of goods and services and about a 2 per cent rise in business investment. With private residential investment flat and further sharp falls in public investment total fixed investment rises by only about ½ per cent in 1986.

6. While the high exchange rate forecast depresses exports, the sharp fall in inflation that it helps to secure means that real incomes rise fast next year. Even without any tax cuts next year, real personal disposable income rises by 4 per cent in 1986. Consumers' expenditure, forecast to grow by 3 per cent next year, is the only component of demand that makes a significant contribution to growth next year.

7. The Institute have halved their forecast of stockbuilding in 1985 as compared with their May forecast. But the 2/3 per cent contribution it makes to growth in 1985 still seems rather high, especially in light of the information now available for the second quarter; and with lower stockbuilding in 1985 there might be rather more contribution to growth from this source in 1986 than shown in the Institute forecast.

8. The Institute's inflation forecast may attract some attention, particularly in view of their record of very pessimistic inflation forecasts in recent years. They now forecast that the RPI will increase by 5½ per cent in the year to the fourth quarter of 1985, and by 3½ per cent in the year to the fourth quarter of 1986. For 1986 as a whole, inflation averages just 3 per cent.

Employment and Unemployment

9. The Institute expect employment growth to flatten during 1986, reflecting the flat path of output. Unemployment may be roughly flat on the narrow definition - ie excluding school leavers - but there may be some fall in the broad definition next year as a result of the extension of the YTS.

Trade and the Current Account

10. Like us, the Institute now expect a current account surplus of some £4½ billion this year (they have revised their forecast up by some £3 billion since May). The forecast shows the current account remaining in healthy surplus (£3 billion) next year as gains in the terms of trade offset the weak performance of exports.

Government Expenditure and the PSBR

11. As has generally been the case in recent NIESR forecasts, the Institute are projecting a much less satisfactory fiscal position in financial year 1986-87 than shown in either the FSBR forecast or in our internal June forecast. It is of some comfort that the Institute, who had earlier on been much more pessimistic about the current financial year, are now in broad agreement with official forecast. But the scale of the disagreement with us on 1986-87 is as great as ever: even with no tax cuts next year, the PSBR is forecast to be some £3½ billion larger than shown in the FSBR forecast.

12. For 1985-86 the Institute's forecast for oil revenues - at over £14 billion - is £½ billion higher than the FSBR forecast and £2 billion above the internal June forecast. For 1986-87, the Institute forecast a sharp fall in oil revenues to £9-9½ billion as sterling appreciates to over $1.50. But this figure for oil revenues is less than £1 billion below our internal June forecast, and hence explains only a small part of the overall discrepancy between the two PSBR forecasts. The main differences are that the National Institute have a lower forecast of non oil taxes on income (reflecting their low employment forecast) and a higher current expenditure forecast (8 per cent growth in current expenditure on goods and services in both years, well ahead of the general rate of inflation).

Monetary growth and interest rates

13. The Institute expect £M3 to continue growing at a rate well outside the MTFS target range. MO growth is expected to pick up slightly and is projected at around the top of the target range next year. Short term interest rates are forecast to fall by some 3½ points from current levels by the end of 1986: the Institute think that the behaviour of sterling will be the main determinant of how fast the authorities allow interest rates to fall. They do not expect any significant fall in world interest rates: the scope for such a sizeable fall in UK rates

must therefore be contingent on quite a marked improvement in sentiment towards sterling.

Assessment and line to take

14. While there are clearly some factors which may point towards slower growth next year, some areas of demand may be more buoyant than the Institute suggest. Housing sales have been surprisingly high in recent months and, helped by falling interest rates, residential investment could well pick up more strongly over the next year than shown in the Institute's forecast. Personal consumption could also be significantly stronger, benefitting - as in 1982 and 1983 - from lower inflation and interest rates; and also from the tax cuts which we still expect for next year.

15. The Institute's forecast of a halving in the inflation rate is particularly welcome given their record of pessimistic inflation forecasts. The deterioration in the fiscal prospects that they show is not something that we would accept as a central forecast: their expenditure projections seem very high relative to the general rate of inflation.

S J DAVIES

SECRET

	NIESR August forecast	Treasury Unpublished June forecast	Treasury Published FSBR forecast
PSBR (£bn)			
1985-86	7½	7	7
1986-87	11	7½	7½
Fiscal Adjustment (£bn)			
1986-87	0	5½	3½
World Trade in manufactures			
1985	6	7	5½
1986	5	3½	4½
GDP (%)			
1985	3½	3½	3½
1986	1½	2½	2½*
RPI Inflation (%)			
1985 Q4	5½	6	5
1986 Q4	3½	4	4½**
Current Account (£bn)			
1985	4½	4½	3
1986	3	4	3***
Sterling Index			
1985	79	76½	73-74
1986	81	76	73-74

* First half of 1986 on first half of 1985

** 1986 Q2 not Q4

***First half of 1986 at annual rate

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