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PART E

CHANCELLOR'S PAPERS ON MONEY FIGURES AND INTEREST RATES

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FROM: A C S ALLAN

DATE: 7 August 1988

Pg

MR OWEN

cc PS/Chief Secretary
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Sedgwick
Mr Odling-Smee
Mr Hibberd
Mr Gieve
Mr Mowl
Mr Grice
Mr Patterson

1988 BLUE BOOK

The Chancellor was grateful for your minute of 2 September. He is content for the CSO to mention in the Blue Book press notice that they are constructing a set of balanced accounts.

ACSA

A C S ALLAN

2716/20

CONFIDENTIAL

FROM: ROBERT CULPIN
DATE: 16 August 1988

CHANCELLOR

cc: Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Scholar
Mr Cropper
Mr Gilhooly o/r
Mr Riley
Mr Macpherson
Mr Lawton

Thanks

MORTGAGE INTEREST RELIEF

The latest increase in the mortgage rate made me wonder what proportion of mortgage debt is still sheltered from the full increase by tax relief. You may already know the answer. If not, here it is.

2. We often talk loosely of allowing mortgage relief to wither on the vine, by freezing the £30,000 limit. This is a measure of how fast it is withering.

Stock

3. The ceiling was set at £30,000 in 1983-84. Since then the proportion of loans attracting tax relief has declined as follows:

	%
1983-84	91
1987-88	86

The statisticians forecast approximately:

1988-89	81
1989-90	76.

4. If the ceiling had remained at £25,000, but (implausibly) all other things such as house prices were exactly as they are now, the forecast for 1989-90 would be 70 per cent instead of 76 per cent.

5. Comparable numbers are not readily available before 1983-84 because the introduction of MIRAS created a break in the series.

Flow

6. In the first quarter of 1988:

- 76 per cent of new loans attracted tax relief
- 68 per cent would have done so with a £25,000 ceiling.

RC

ROBERT CULPIN

91/G.LCLD.221.8

SECRET AND PERSONAL

FROM: S BROOKS/M H WHEATLEY

DATE: 17 August 1988

Approved in draft

1. MR ~~PERETZ~~

2. PAYMASTER GENERAL

cc: Chancellor
Economic Secretary
Sir G Littler o/r
Mr Peretz
Mr Sedgwick
Mr Bush
Mr Cropper
Mr Gray (No 10 Personal)

PROVISIONAL MONEY FIGURES - JULY

(All figures are unadjusted unless specified otherwise)

The provisional money supply figures for July will be published by the Bank at 11.30 am on Thursday 18 August. As usual M3, M4, and M5 broad money figures are subject to revision.

Summary

Monetary aggregates for July (per cent)

	Annual Growth Rate	Previous Month		Six month Growth (annualised)	Monthly Growth Rate	Previous Month
M0	7.0	7.7			2.2	1.2
	6.9	7.3	s.a.*	8.5	0.9	1.1
M3	20.6	20.2			2.8	2.6
			s.a.	23.8	2.7	2.4
M4	17.4	16.8			2.4	2.1
			s.a.	20.1	2.1	1.9
M5	16.7	16.1			2.4	2.0
			s.a.	18.8	2.0	1.8

* Seasonally adjusted

Lending

		£ billion			Per cent Growth Rates	
		This Month	**Last Month**	**Average Of Last 6 Months**	**Annual (Monthly) (unadjusted)**	**Previous Month Annual (Monthly) (unadjusted)**
Banks		6.3	7.3	4.9	27.9 (2.7)	27.7 (3.2)
	s.a.	6.5	6.2	4.9		
Banks and building societies		9.2	9.8	6.5	23.6 (2.4)	22.9 (2.7)
	s.a.	9.3	8.6	7.1		
Building Societies		2.7	2.9	2.3	17.2 (1.9)	16.2 (2.0)

Table 2 attached gives the historical growth rates for M0, M3, M4, M5, NIBMI, M1 and the wider sterling aggregates. Table 3 and 4 (attached) show respectively the components and counterparts for broad money together with the average changes over the last twelve months.

M0

2. The seasonally adjusted 12 month growth rate for M0 was 6.9% in July (unadjusted, 7.0 percent), a little lower than in June (7.3%) but higher than in any other month over the last year. The fall in the 12 month growth rate in July was however accounted for by fluctuations in bankers' balances at the Bank of England, the most erratic element of M0. Twelve month growth of notes and coin, the other component of M0, rose to 7.3% in July from 7.1% in June. This growth remains well outside the Government's 1-5% target range for M0. The Budget Red book said M0 was likely to be above its target range early in the year: but the prospects of getting it bank within the range later in the year are beginning to look less promising.

Broad money and credit

3. The seasonally adjusted 12 month growth rate of M4 - the measure of broad money which we emphasise - increased again in

July to 17.0% compared to 16.3% in June and 15.8% in May. Bank and building society lending was 23.7% higher than a year earlier, compared with an increase of 22.8% in the year to June. We thought last month that the fast growth of M4 in June might have reflected to some extent the tax rebates following the Budget, which meant that firms made bigger net wage payments in June. M4 would have been inflated if personal sector deposits with banks and building societies increased by more than company deposits fell, particularly if companies temporarily increased their borrowing in June. These effects could have been expected to unwind in July. In the event there is no sign of this in the lending figures. Moreover the sharp increase in banks' retail deposits in June of 2½% has been followed by a further rise of 1¾% in July. (In the 10 months to May 1988 banks retail deposits increased by 1% per month on average). It is possible that the further acceleration in July may have resulted from the redemption that month of £1.2 billion of 3% Transport Stock, which was largely held by small investors. But taking the June and July figures together, it is beginning to look as if we have had a real underlying acceleration on the growth of broad money, and retail deposits in particular.

4. Within the M4 counterparts there was an overfund of the PSBR of £0.2 billion. Sterling lending by banks and building societies' (before seasonal adjustment) fell back to £9.2 billion in July, from £9.8 billion in June. But the decline probably reflected seasonal factors - after seasonal adjustment lending is thought to have increased from £8.6 billion in June to £9.3 billion in July. We have not yet received figures from the Committee of London and Scottish Banks (CLSB), so we do not have any breakdown of lending by sector. But the figures do show that the clearing banks accounted for a lower proportion than is usual of sterling advances. Since the non-clearing banks are more likely to have been lending to companies, this may indicate that more than usual of the growth in Bank lending in July was to firms rather than to persons. Advances by building societies increased by about 1¾% (seasonally adjusted) in July, continuing the past increases over the last few months - reflecting, no doubt, in part the temporary effects of the budget measures.

Presentation

5. Though neither the M0 figures nor the unadjusted lending figures are as high as last month, the lending figure is well above average market expectations. There has been some speculation that the interest rate increase on 8 August was stimulated by official foreknowledge of these figures. And there is now some expectation in the market that there may be futher interest rate rises to come. Market rates have been around 11½% for the last few days, ½% above the present level of base rates. These figures, in conjunction with the RPI, labout market and other figures to be released this week, can therefore be expected to attract a fair amount of attention, especially given the seasonal absence of other financial news.

6. Given the slightly jumpy market background, and the silly season in the press, we think the immediate answer should be to present the figures as calmly as possible. The message to get across is that they add little to our assessment of monetary conditions, we have already acted by raising base rates by 3½%, and that we would not expect the effects of that yet to be showing up in published statistics. We can also point to one special factor that will have affected lending in July: the change of mortgage tax relief to a residence basis only came into effect on 1 August and the July figures, like the previous months' figures, were affected by borrowing to beat the 1 August deadline.

Suggested Line to Take

7. Figures are in line with authorities' assessment of monetary conditions which has led to 3½% rise in interest rates since beginning of June. Effects of this tightening will not yet be coming through in published statistics.

8. We should be grateful for approval of the line to take and comments on the attached more detailed briefing as early as possible tommorrow morning. The Bank's draft press release is also attached.

T. Pike MHW

pp S BROOKS/M H WHEATLEY

cc Bank of England

Mr George

Mr Thorp (Financial Statistics Division)

TABLE 2

S E C R E T (Until Publication) £ million

GROWTH RATES OF MONETARY AGGREGATES

			1987 AUG	SEP	OCT	NOV	DEC	1988 JAN	FEB	MAR	APR	MAY	JUNE	JULY
M0 -	Monthly change	sa	39	120	99	49	139	-46	-18	133	139	77	185	141
	Monthly % change	nsa	0.1	0.1	-0.2	0.3	7.0	-6.0	-1.0	1.8	1.7	0.1	1.2	2.2
	Monthly % change	sa	0.3	0.8	0.6	0.3	0.9	-0.3	-0.1	0.8	0.9	0.5	1.1	0.9
	6-month annualised % change	sa	6.2	7.0	7.3	7.0	8.5	5.3	4.5	4.6	0.0	0.0	0.0	0.0
	Annual % change	sa	4.7	4.9	5.6	4.9	4.3	4.6	5.3	5.8	6.2	6.2	7.3	6.9
M3 -	Monthly change	nsa	2147	1658	5797	1206	2583	-2025	693	8639	1411	2547	5124	5715
	Monthly % change	nsa	1.2	1.0	3.3	0.7	1.4	-1.1	0.4	4.7	0.7	1.3	2.6	2.8
	Monthly % change	sa	1.3	1.4	3.7	-0.1	1.4	0.6	0.5	3.0	1.6	0.6	2.4	2.7
	6-month annualised % change	sa	25.2	22.0	25.6	21.9	21.8	17.9	16.0	19.6	14.8	16.4	18.8	23.8
	Annual % change	nsa	22.2	19.7	22.5	21.5	22.9	22.5	20.6	20.9	19.4	18.6	20.3	20.6
M4 -	Monthly change	nsa	2606	2980	5474	1527	4902	429	1400	9643	1983	4213	6831	8001
	Monthly % change	nsa	0.9	1.0	1.9	0.5	1.6	0.1	0.5	3.2	0.6	1.3	2.1	2.4
	Monthly % change	sa	1.3	1.2	2.3	0.3	1.3	0.3	1.0	2.2	1.1	0.9	1.9	2.1
	6-month annualised % change	sa	18.4	17.3	18.9	17.3	16.9	14.0	13.3	15.6	12.9	14.4	15.8	20.1
	Annual % change	nsa	15.6	15.0	15.8	15.3	16.3	16.6	16.1	16.8	16.0	16.1	16.8	17.4
M5 -	Monthly change	nsa	2720	3043	5607	1481	5212	109	1125	10582	1478	4127	6712	8160
	Monthly % change	nsa	0.9	1.0	1.8	0.5	1.7	0.0	0.4	3.3	0.4	1.2	2.0	2.4
	Monthly % change	sa	1.3	1.2	2.2	0.3	1.3	0.3	0.9	2.2	0.8	0.9	1.8	2.0
	6-month annualised % change	sa	17.9	17.1	18.9	16.8	16.3	13.8	12.9	15.4	12.3	13.7	14.9	18.8
	Annual % change	nsa	15.0	14.4	15.3	14.7	15.9	16.3	15.7	16.6	15.7	15.5	16.1	16.7
NIBM1 -	Monthly change	nsa	-132	338	288	440	390	-1387	858	2150	1	1148	472	85
	Monthly % change	nsa	-0.3	0.8	0.7	1.0	0.9	-3.1	2.0	4.8	0.0	2.5	1.0	0.2
	Monthly % change	sa	0.2	0.6	3.7	-2.4	-0.2	3.7	1.4	1.2	-0.1	1.2	-0.2	0.8
	6-month annualised % change	sa	9.7	13.5	24.7	14.0	4.2	11.4	14.1	15.4	7.2	15.2	15.3	9.1
	Annual % change	nsa	11.8	5.5	11.6	10.2	10.2	11.8	12.6	15.2	13.8	13.4	10.7	10.7
M1 -	Monthly change	nsa	1030	1568	2969	456	-258	-971	-267	5156	1080	2448	1728	899
	Monthly % change	nsa	1.2	1.8	3.3	0.5	-0.3	-1.1	-0.3	5.7	1.1	2.5	1.7	0.9
	Monthly % change	sa	1.5	1.6	5.0	-1.1	-1.0	2.3	-0.4	3.6	1.2	2.0	1.0	1.3
	6-month annualised % change	sa	28.2	23.2	36.4	24.9	15.6	17.9	13.4	17.9	9.6	16.4	21.2	18.8
	Annual % change	nsa	23.8	20.5	24.9	21.9	23.0	21.9	21.0	21.0	21.2	19.8	18.9	18.4
WIDER £ AGGREGATE	Monthly change	nsa	1373	1782	7801	-41	3514	652	323	8316	3858	3092	6081	5020
	Monthly % change	nsa	0.7	0.9	3.8	0.0	1.7	0.3	0.2	3.9	1.7	1.4	2.6	2.1
	Monthly % change	sa	0.7	1.3	4.2	-0.6	1.6	1.7	0.2	2.4	2.5	0.8	2.5	2.0
	6-month annualised % change	sa	21.9	20.3	25.1	18.2	20.9	19.4	18.2	20.8	16.9	20.2	22.2	22.9
	Annual % change	nsa		18.6	22.4	20.5	21.6	21.7	20.1	20.7	20.3	18.8	21.6	20.9

SECRET AND PERSONAL

TABLE 3:PROVISIONAL BROAD MONEY COMPONENTS

£ million

	JULY	AVERAGE GROWTH IN PREVIOUS 12 MONTHS
Notes and coins in circulation (nbps)	550	110
Bank deposits (nbps)		
Retail		
non-interest bearing	-465	280
interest bearing	1305	600
Wholesale	4325	1850
Change in M3	5715	2840
Building society holdings of M3 (-)	288	-440
Buildings society deposits (M4ps)		
Retail	1940	1480
Wholesale	58	60
Change in M4	8001	3940
Money market instruments (M4ps)	83	-70
National Savings Bank (M4ps)	76	100
Change in M5	8160	3970

M4ps = non-bank, non-building society private sector

SECRET AND PERSONAL

TABLE 4: PROVISIONAL BROAD MONEY COUNTERPARTS

JULY 1988 £ million

	M3	M4	M5
1. PSBR	-1688	-1688	-1688
2. Debt sales to private sector (-)			
Gilts	971	1192	1192
Treasury bills	-25	-6	
National Savings	-165	-164	-88
CTD's	-89	-89	
Other CG debt	0	0	0
LA and PC debt	241	252	257
3. External finance of public sector (-)	316	316	316
4. Public sector contribution (1+2+3)	-439	-187	-11
5. Sterling lending to private sector	6311	9162	9145
6. Externals	720	1126	1126
7. £NNDLs	-877	-2100	-2100
8. Total change (4+5+6+7)	5715	8001	8160
(Percentage change)	(2.8	2.4	2.4)

AVERAGE CHANGE IN PREVIOUS 12 MONTHS

	M3	M4	M5
1. PSBR	-540	-540	-540
2. Debt sales to private sector (-)			
Gilts	-140	-150	-150
Other public debt	-10	-60	20
3. External finance of public sector (-)	460	460	460
4. Public sector contribution (1+2+3)	-230	-290	-210
5. Sterling lending to private sector	4280	5810	5760
6. Externals	-860	-1000	-1000
7. £NNDLs	-350	-560	-560
8. Total change (4+5+6+7)	2840	3960	3990
(Percentage change)	(1.6	1.3	1.3)

MONEY SUPPLY IN JUNE: PRESS BRIEFING

A. FACTUAL

(i) **Changes in main monetary aggregates**

	M0	M3	**M4**	M5
			per cent	
12 month growth rate	**+7.0**	+20.6	**+17.4**	+16.7
	(+6.9)	(+20.8)	**(+17.0)**	(+16.3)
Annualised six-month growth	**(+8.5)**	(+23.8)	**(+20.1)**	(18.8)
one month change	**+2.2**	+ 2.8	+ 2.4	+ 2.4
	(+0.9)	(+ 2.7)	**(+ 2.1)**	+ 2.0

(Figures in brackets seasonally adjusted s.a.)

(ii) **MO**

Figures (+7.0 and +6.9 s.a.) above target range, but show some moderation from June figures. Six month growth rate (sa) 2.5% higher than June (6.9%).

(iii) **Broad money**

(a) 1 month growth rates. Higher than previous 3 months.

(b) 3 and 6 month growth rates. Highest this (calendar) year, reflecting acceleration in May, June and July.

(c) 12 month growth rates. Highest since March.

12 month growth rates

	M3		M4	
	u/a	s/a	u/a	s/a
Feb	20.6	(20.5)	16.1	(15.8)
Mar	20.9	(20.8)	16.8	(16.4)
Apr	19.4	(20.1)	16.0	(15.9)
May	18.6	(19.1)	16.1	(15.8)
Jun	20.2	(20.2)	16.8	(16.3)
July	20.6	(20.8)	17.4	(17.0)

(d) M4 gives less erratic signals than M3. Hence MTFS' emphasis on measures including liabilities of building societies as well as banks.

(iv) **Lending**

(a) One month changes: Unadjusted figures show slight moderation from record levels of June; but adjusted figures highest ever.

	Bank and building society lending £ billion	Bank and building society lending %	Bank lending £ billion	Bank lending %
May	+5.4 (+5.4)	+1.5 (+1.5)	+3.1 (+3.1)	+1.4 (+1.4)
June	+9.8 (+8.6)	+2.7 (+2.3)	+7.2 (+6.1)	+3.1 (+2.6)
July	+9.2 (+9.3)	+2.4 (+2.5)	+6.3 (+6.5)	+2.7 (+2.8)

(Figures in brackets seasonally adjusted)

(b) Continuing increase in 12 month growth rates (unadjusted).

	Bank and building society %	Bank %
February	+19.9	+24.3
March	+20.9	+25.2
April	+21.9	+26.9
May	+22.3	+27.0
June	+22.8	+27.7
July	+23.6	+27.9

(c) Figures probably inflated temporarily by Budget measures on mortgage tax relief, as house purchase brought forward to meet August deadline.

(d) Should not read too much into individual counterparts, which are hard to interpret.

(v) **Funding**. Overfund (on M4 definition) in July of £187 million; PSBR surplus in July of £1688 million.

(vi) **Monetary Policy - Recent Statements**

(a) **Chancellor in Autumn Statement debate (14 January)**

"Keeping the economy on track involves keeping a constant watch on all the indicators of how the economy is developing and then taking action as necessary. I have never hesitated to act in the past when I have judged that there was a risk to our inflation objectives. I can assure the House that I shall not hesitate to do so in future. It is precisely by acting promptly that we have been able to avoid the need for drastic and destabilising lurches in policy. Our track record speaks for itself."

(b) **Chancellor on interest rates (Budget speech, 15 March)**

"Short term interest rates remain the essential instrument of monetary policy. Within a continuous and comprehensive assessment of monetary conditions, I will continue to set interest rates at the level necessary to ensure downward pressure on inflation."

(c) **Chancellor on exchange rates (Budget speech, 15 March)**

"Exchange rates play a central role in domestic monetary decisions as well as in international policy co-operation. I believe that most businessmen have welcomed the greater exchange rate stability over the past year. It is important that they also accept the financial discipline inherent in this policy."
(Also see MTFS, 2.11)

(d) **Chancellor on inflation and exchange rates (This Week Next Week interview, 24 April).**

"Our ultimate aim is certainly the total eradication of inflation."

"We are certainly interested in the maximum possible exchange rate stability, within the context of sound anti-inflationary policy."

(e) **Prime Minister on anti-inflation strategy, exchange rates and interest rates, House of Commons 17 May**

"My rhf [Chancellor] and I entirely agree that we must maintain a firm monetary policy and a downward pull on inflation. I totally agree with my rhf's Budget speech, every bit of it ..... Exchange rate policy ..... is a part of total economic policy ..... We use the available levers, both interest rates and intervention, as seems right in the circumstances .... It would be a great mistake for any speculator to think at any time that sterling was a one-way bet"

(f) **Chancellor on anti-inflationary policy, Cities of London and Westminster Annual Luncheon, 7 July**

"The objective of policy remains as it has always been: to maintain monetary conditions that create downward pressure on inflation."

(g) **Chancellor on inflation, oral PQs Thursday 14 July (OR Vol 137, No 187 Col 540)**

"I am still not satisfied with the rate of inflation in Britain and, despite the fact that it is only a fraction of what it was under the Labour Government, I am determined that we shall get it down, and our policy will be directed to that end."

(h) **Chancellor on interest rates, speech to IEA 21 July**

"Short-term interest rates are of course the market route to the defeat of inflation. At one time it was feared that Governments would not be prepared to adjust interest rates sufficiently often, sufficiently promptly, or sufficiently far to enable this process to work. It has been one of the most important achievements of this Government over the years to demonstrate that this is not so, and that interest rates are indeed an effective weapon."

(i) **Chancellor on recent interest rate increases, End of Term Letter, 27 July**

"I have thus had to take prompt action to tighten monetary conditions, by raising interest rates sharply. This will moderate the expansion of demand and in due course enable inflation to resume its downward trend."

B. DEFENSIVE

(i) **Lending**

(a) **Increases in lending still high, particularly when taken with previous months' figures.**

- Budget measures on mortgage tax relief likely to be inflating lending temporarily, as house purchase brought forward to beat the August deadline.

- lending for house purchase generally still buoyant. High building society commitments figures earlier in year now feeding through into lending.

- Some evidence of continued high lending to industrial and commercial companies - consistent with strong investment.

(b) **Credit card boom?**

- Vast bulk of personal borrowing takes form of mortgages which represented 2/3 of outstanding personal debt at end of 1987. Mortgage lending accounts for half of all of bank and building society lending. In 1980s, 2½ million increase in households buying own home. In each year since 1981, growth in consumer credit has been no more than a quarter of growth in borrowing for house purchase.

- Consumer credit only some 15 per cent of total personal debt. Less than 5 per cent of personal debt takes form of credit card lending (including interest-free component). (See Chancellor's speech to FHA, 17 June 1987). Some credit card payments simply displacing cash and cheque payments - over 40 per cent of credit card users settle within interest-free period.)

(c) **Mortgage lending out of control?** The housing market has been buoyant recently, although some signs that London prices are stabilising. Rises in mortgage rates, taken with changes in tax relief from 1 August, should act to cool housing market.

(d) **Why not impose controls on lending?** Direct controls were not effective in past, and even less likely to work now, given increasing sophistication of modern financial markets. In any case, Government believes lenders and borrowers should be free to make own decisions.

(e) **Bring back hire purchase controls?** Abolished in 1982 because easily and legally avoided. Given even greater sophistication of financial markets now, likely to be even less effective. Controls would also discriminate in favour on consumers with access to overdraft facilities (ie better off)

(ii) **Money Supply**

(a) **M0 growth outside target range?** As result of considered judgement of all relevant indicators including M0 in relation to target range, have raised interest rates 3½% since beginning of June.

(b) **Surely latest figures for level of M0 suggest negative growth needed during rest of the year if target is to be met?** [Unadjusted July on March rise (not annualised) of 5.4%, but sa equivalent 3.4%)] Over only five months of the year these (unadjusted) figures bound to be more volatile, particularly given bank holiday and summer holiday distortions. Seasonally adjusted growth rather lower. See (a).

(c) **Why six-month growth rate so high?** Six month growth rates tend to be more volatile than longer series, reflecting fluctuations in component one month figures. Increase in six-month growth rate partly reflects disappearance from figures of January - when there was negative growth in M0. See (a).

(d) **Why growth in broad money aggregates highest since March?** A special factor was redemption of 3% Transport Stock, with high proportion of small personal sector holdings will probably have boosted retail deposits by as much as £1.2 billion in July.

(e) **Money figures indicate overheating?**

- Economy has been growing at an unsustainably rapid rate and needs to slow down a bit. But that can be achieved without any drama

- as OECD 1988 Survey [published 16/17 August] says, "no convincing evidence that output growth is yet constrained by capacity shortage or supply bottlenecks to a degree comparable to that of previous cyclical peaks."

- Government determined to take no risks with inflation - evidence of recent interest rate rise.

(f) **Significance of broad money**. No explicit broad money target in 1988-89. But growth of broad money still taken into account. See MTFS 2.09 and 3.11.

(iii) **Policy response**

(a) **Interest rate increases have failed to moderate growth in credit, consumer spending etc?** Early days yet: policy has tightened considerably, with interest rates 3½% higher than beginning of June and ERI around same level; but full impact will take some months to come through. For example, rise in mortgage rates only took effect on 1 August.

(b) **What will Government do if interest rate increases fail to have desired effect?** Hypothetical question. Government committed to maintain monetary conditions which keep downward pressure on inflation.

(c) **Adjusting fiscal policy only once a year leaves Government dangerously short of flexibility?** PSDR figures scarcely suggest that fiscal policy is lax. Task of fiscal policy is to buttress monetary policy, with expenditure and tax decisions taken in medium term context to deliver prudent sustainable fiscal position. Notion that fiscal policy could or should be used to fine-tune demand is to hark back to failures of 1960s and 1970s.

(iv) **Interest rate increases since beginning of June**

(a) **Why increase rates?** Tightening of monetary conditions needed to keep bearing down on inflation. Base rates now 1% above level before stock market collapse last October.

(b) **½% moves too small to create impact on economy?** No reason to make larger moves. Appropriate to move cautiously and keep monetary conditions under close review. Successive small rises have been reflected in largest rise in mortgage rates since 1984.

(c) **Why raise interest rates when exchange rate over DM 3.20?** Government working for exchange rate stability in context of keeping downward pressure on inflation. Assessment that tightening needed since beginning of June. Although pay attention to exchange rate against DM, not exclusive attention. ERI about the same as in early June. Rate against dollar is rather lower.

(d) **Why move rates in ½ point steps in quick succession?** 18 out of last 19 interest rate movements have been 1/2%; this has become the normal practice.

(e) **Further movements on way?** Never speculate.

(f) **Government being pushed around by the markets?** No. Prime Minister said on 17 May that "it would be a great mistake for any speculator at any time to think that sterling was a one way bet." Subsequently events have confirmed this.

(g) **Increase will damage industry?** Industry has more to fear from resurgence of inflation. 1% rise in interest rates, even if sustained for whole year, increases costs by far less than amount by which 1% rise in pay settlements increases them.

(h) **Why defend level of sterling which is damaging industry?** If firms accept financial discipline inherent in Government strategy and contain their costs, no need for any loss of competitiveness. Greatest threat to output and employment would come if Government relaxed its anti-inflationary stance.

(i) **Will interest rate rise harm investment?** Investment very buoyant. But in any case, it is in industry's power to reduce costs and make investment more profitable (see (h)).

(j) **Mortgage rate increase harmful?** As Chancellor said recently [Cities of London and Westminster Conservative Luncheon, 2 July] "I can understand that many people will not welcome the higher mortgage rates which are now in prospect." But far less damaging than a resurgence of inflation.

(k) **Increases in interest rates do not affect demand for consumer credit?** Consumer credit only small part of total personal debt. Certainly some borrowers not responsive to interest rate changes, but by no means all, and interest rate changes do influence borrowers' behaviour overall. In any case, rises in interest rates affect economy in variety of ways - not only through demand for consumer credit.

(l) **Lowering rates in March-May was a mistake?** No. Right to avoid an unsustainable appreciation of sterling. Low rates were short lived, and taken with exchange rate, will not have taken risks with inflation.

(v) **UK's real interest rates out of line with competitors?** Real interest rates bound to move higher when base rates have increased 3½% since beginning of June. Now 1.9 percentage points above G7 average (see table below)). Recent interest rate movements demonstrate Government's determination to keep a downward pull on inflation.

Nominal and real interest rates in G7

Country	Nominal(1)	Real(2)
UK	11.5	6.6
US	8.6	4.4
Japan	4.0	3.8
Germany	5.3	4.2
France	7.8	5.0
Italy	11.3	6.1
Canada	9.9	5.8
Average	7.7	4.7

(1) 3 month interbank rate.

(2) deflated by latest increase in RPI or equivalent.

DRAFT. SECRET until 1130 am Thursday 18. 8. 88

Provisional estimates of monetary aggregates: July 1988

1 Provisional information suggests the following:

% changes		M0	M3	M4	M5
12 months to July (not seasonally adjusted)		+7.0	+20.6	+17.4	+16.7
July	- not seasonally adjusted	+2.2	+ 2.8	+ 2.4	+ 2.4
	- seasonally adjusted	+0.9	+ 2.7	+ 2.1	+ 2.0

2 Provisional counterparts to the changes in M3, M4 and M5 are:

£ billions, not seasonally adjusted	M3		M4		M5	
	July	latest 12 months	July	latest 12 months	July	latest 12 months
A PSBR	−1.7	− 7.8	−1.7	− 7.8	−1.7	− 7.8
B debt sales to private sector (−) (1)	+1.0	− 1.7	+1.2	− 2.2	+1.4	− 1.1
C external flows to public sector (−)	+0.3	+6.6	+0.3	+6.6	+0·3	+6.6
D public sector contribution (A+B+C)	−0.4	− 2.9	−0.2	− 3.4	−	− 2.3
E sterling lending (2)	+6.3	+53.1	+9.2	+73.1	+9.2	+72.4
F other counterparts (3)	−0.2	−14.7	−1.0	−19.7	−1.0	−19.7
Total (D+E+F)	+5.7	+35.5	+8.0	+50.0	+8.2	+50.4
Sterling lending (seasonally adjusted)	+6.5		+9.3		+9.3	
(average of previous 6 months)	+4.7		+6.7		+6.7	

(1) Sales of public sector debt to the private sector other than banks (and, for M4 and M5, building societies), with an adjustment in the case of M5 for private sector holdings of certain liquid government debt.

(2) Lending by the monetary sector (and, for M4 and M5, by building societies) to the rest of the private sector. For M5, an adjustment is necessary for private sector holdings of certain money-market instruments etc.

(3) External and foreign currency transactions and net non-deposit liabilities of banks (and, for M4 and M5, of building societies).

3 Full monetary statistics for July, including revised estimates of the figures given above, will be published on 30 August.

Bank of England
18 August 1988

SECRET AND PERSONAL

From : D L C Peretz
Date : 17 August 1988

PAYMASTER GENERAL

Mr P
Pls let me have a note setting out the expected path of MO over the rest of the FY. M.

cc Chancellor
Economic Secretary
Sir G Littler o/r
Mr Sedgwick
Mr Bush
Mr Brooks
Mrs Ryding
Mr Wheatley

MONEY FIGURES

I attach MG's note about tomorrow's monthly money figures, together with a briefing line (and detailed Q and A briefing for IDT) for clearance.

2. We will be examining the figures - and the situation more generally - over the next few weeks in our normal monthly monetary assessment. But at first sight they do not look very good. The prospects of getting MO back within its target range before the end of the financial year are receding month by month. And it looks as if there has been some acceleration in the last two months in the already rapid growth of M4 and credit. The story seems to be of a piece with other economic statistics being published, it seems, almost daily at present. (Mr Sedgwick is writing a separate note about these).

3. This background to my mind should confirm us in the asymmetric attitude to interest rate moves that we decided upon before the last rise in base rates. With sterling around its present level, if strong market pressures were to emerge for higher interest rates we should be reluctant to resist them; but were market pressures to emerge for lower interest rates we should resist them quite strongly.

4. Publication on Monday this week of the buoyant July retail sales figures (taken together with the latest industrial output figures) caused market interest rates (3 month interbank) to rise from a little over 11% (where they had been since the 8 August base rate rise) to 11½%. Inevitably one "surprise" rise in the

Bank's dealing rates leads the market to fear another. This does not yet constitute any real upward pressure on interest rates : the Bank anticipate no difficulty in continuing to deal at their current dealing rates for the time being. But it is possible that the situation could develop in a way that would require a clear signal of resistance from the Bank of England to avoid a rise : not a signal we would particularly want to give in the circumstances. The most likely trigger would be were sterling to come under downward pressure. The most likely trigger for that - which might however manifest itself directly in a rise in market interest rates rather than an actual fall in sterling - is probably the 25 August trade figures.

5. No immediate action or decision needed. But given the background I think we want to present tomorrow's figures fairly carefully. The obvious line - which should also avoid sounding complacent - is the one suggested below : that we have already tightened policy considerably, and that it is too soon to expect this to be affecting the published figures. I suggest that in response to calls IDT try to concentrate on getting that message across, and mentioning the special factors that may have affected the figures, and that they try to avoid getting drawn much on other points.

DLCP

D L C PERETZ

SECRET AND PERSONAL

FROM: S BROOKS/M H WHEATLEY

DATE: 17 August 1988

Approved in draft

1. MR PERETZ

2. PAYMASTER GENERAL

cc: Chancellor
Economic Secretary
Sir G Littler o/r
Mr Peretz
Mr Sedgwick
Mr Bush
Mr Cropper
Mr Gray (No 10 Personal)

PROVISIONAL MONEY FIGURES - JULY

(All figures are unadjusted unless specified otherwise)

The provisional money supply figures for July will be published by the Bank at 11.30 am on Thursday 18 August. As usual M3, M4, and M5 broad money figures are subject to revision.

Summary

Monetary aggregates for July (per cent)

	Annual Growth Rate	Previous Month		Six month Growth (annualised)	Monthly Growth Rate	Previous Month
M0	7.0	7.7			2.2	1.2
	6.9	7.3	s.a.*	8.5	0.9	1.1
M3	20.6	20.2			2.8	2.6
			s.a.	23.8	2.7	2.4
M4	17.4	16.8			2.4	2.1
			s.a.	20.1	2.1	1.9
M5	16.7	16.1			2.4	2.0
			s.a.	18.8	2.0	1.8

* Seasonally adjusted

Lending

		£ billion			Per cent Growth Rates	
		This Month	Last Month	Average Of Last 6 Months	Annual (Monthly) (unadjusted)	Previous Month Annual (Monthly) (unadjusted)
Banks		6.3	7.3	4.9	27.9 (2.7)	27.7 (3.2)
	s.a.	6.5	6.2	4.9		
Banks and building societies		9.2	9.8	6.5	23.6 (2.4)	22.9 (2.7)
	s.a.	9.3	8.6	7.1		
Building Societies		2.7	2.9	2.3	17.2 (1.9)	16.2 (2.0)

Table 2 attached gives the historical growth rates for M0, M3, M4, M5, NIBMI, M1 and the wider sterling aggregates. Table 3 and 4 (attached) show respectively the components and counterparts for broad money together with the average changes over the last twelve months.

M0

2. The seasonally adjusted 12 month growth rate for M0 was 6.9% in July (unadjusted, 7.0 percent), a little lower than in June (7.3%) but higher than in any other month over the last year. The fall in the 12 month growth rate in July was however accounted for by fluctuations in bankers' balances at the Bank of England, the most erratic element of M0. Twelve month growth of notes and coin, the other component of M0, rose to 7.3% in July from 7.1% in June. This growth remains well outside the Government's 1-5% target range for M0. The Budget Red book said M0 was likely to be above its target range early in the year: but the prospects of getting it bank within the range later in the year are beginning to look less promising.

Broad money and credit

3. The seasonally adjusted 12 month growth rate of M4 - the measure of broad money which we emphasise - increased again in

July to 17.0% compared to 16.3% in June and 15.8% in May. Bank and building society lending was 23.7% higher than a year earlier, compared with an increase of 22.8% in the year to June. We thought last month that the fast growth of M4 in June might have reflected to some extent the tax rebates following the Budget, which meant that firms made bigger net wage payments in June. M4 would have been inflated if personal sector deposits with banks and building societies increased by more than company deposits fell, particularly if companies temporarily increased their borrowing in June. These effects could have been expected to unwind in July. In the event there is no sign of this in the lending figures. Moreover the sharp increase in banks' retail deposits in June of 2½% has been followed by a further rise of 1¾% in July. (In the 10 months to May 1988 banks retail deposits increased by 1% per month on average). It is possible that the further acceleration in July may have resulted from the redemption that month of £1.2 billion of 3% Transport Stock, which was largely held by small investors. But taking the June and July figures together, it is beginning to look as if we have had a real underlying acceleration on the growth of broad money, and retail deposits in particular.

4. Within the M4 counterparts there was an overfund of the PSBR of £0.2 billion. Sterling lending by banks and building societies' (before seasonal adjustment) fell back to £9.2 billion in July, from £9.8 billion in June. But the decline probably reflected seasonal factors - after seasonal adjustment lending is thought to have increased from £8.6 billion in June to £9.3 billion in July. We have not yet received figures from the Committee of London and Scottish Banks (CLSB), so we do not have any breakdown of lending by sector. But the figures do show that the clearing banks accounted for a lower proportion than is usual of sterling advances. Since the non-clearing banks are more likely to have been lending to companies, this may indicate that more than usual of the growth in Bank lending in July was to firms rather than to persons. Advances by building societies increased by about 1¾% (seasonally adjusted) in July, continuing the past increases over the last few months - reflecting, no doubt, in part the temporary effects of the budget measures.

Presentation

5. Though neither the M0 figures nor the unadjusted lending figures are as high as last month, the lending figure is well above average market expectations. There has been some speculation that the interest rate increase on 8 August was stimulated by official foreknowledge of these figures. And there is now some expectation in the market that there may be futher interest rate rises to come. Market rates have been around 11½% for the last few days, ½% above the present level of base rates. These figures, in conjunction with the RPI, labout market and other figures to be released this week, can therefore be expected to attract a fair amount of attention, especially given the seasonal absence of other financial news.

6. Given the slightly jumpy market background, and the silly season in the press, we think the immediate answer should be to present the figures as calmly as possible. The message to get across is that they add little to our assessment of monetary conditions, we have already acted by raising base rates by 3½%, and that we would not expect the effects of that yet to be showing up in published statistics. We can also point to one special factor that will have affected lending in July: the change of mortgage tax relief to a residence basis only came into effect on 1 August and the July figures, like the previous months' figures, were affected by borrowing to beat the 1 August deadline.

Suggested Line to Take

7. Figures are in line with authorities' assessment of monetary conditions which has led to 3½% rise in interest rates since beginning of June. Effects of this tightening will not yet be coming through in published statistics.

8. We should be grateful for approval of the line to take and comments on the attached more detailed briefing as early as possible tommorrow morning. The Bank's draft press release is also attached.

T. Pike MHW

pp S BROOKS/M H WHEATLEY

cc <u>Bank of England</u>

Mr George

Mr Thorp (Financial Statistics Division)

TABLE 2

S E C R E T (Until Publication) £ million

GROWTH RATES OF MONETARY AGGREGATES

			1987 AUG	SEP	OCT	NOV	DEC	1988 JAN	FEB	MAR	APR	MAY	JUNE	JULY
M0 -	Monthly change	sa	39	120	99	49	139	-46	-18	133	139	77	185	141
	Monthly % change	nsa	0.1	0.1	-0.2	0.3	7.0	-6.0	-1.0	1.8	1.7	0.1	1.2	2.2
	Monthly % change	sa	0.3	0.8	0.6	0.3	0.9	-0.3	-0.1	0.8	0.9	0.5	1.1	0.9
	6-month annualised % change	sa	6.2	7.0	7.3	7.0	8.5	5.3	4.5	4.6	0.0	0.0	0.0	0.0
	Annual % change	sa	4.7	4.9	5.6	4.9	4.3	4.6	5.3	5.8	6.2	6.2	7.3	6.9
M3 -	Monthly change	nsa	2147	1658	5797	1206	2583	-2025	693	8639	1411	2547	5124	5715
	Monthly % change	nsa	1.2	1.0	3.3	0.7	1.4	-1.1	0.4	4.7	0.7	1.3	2.6	2.8
	Monthly % change	sa	1.3	1.4	3.7	-0.1	1.4	0.6	0.5	3.0	1.6	0.6	2.4	2.7
	6-month annualised % change	sa	25.2	22.0	25.6	21.9	21.8	17.9	16.0	19.6	14.8	16.4	18.8	23.8
	Annual % change	nsa	22.2	19.7	22.5	21.5	22.9	22.5	20.6	20.9	19.4	18.6	20.3	20.6
M4 -	Monthly change	nsa	2606	2980	5474	1527	4902	429	1400	9643	1983	4213	6831	8001
	Monthly % change	nsa	0.9	1.0	1.9	0.5	1.6	0.1	0.5	3.2	0.6	1.3	2.1	2.4
	Monthly % change	sa	1.3	1.2	2.3	0.3	1.3	0.3	1.0	2.2	1.1	0.9	1.9	2.1
	6-month annualised % change	sa	18.4	17.3	18.9	17.3	16.9	14.0	13.3	15.6	12.9	14.4	15.8	20.1
	Annual % change	nsa	15.6	15.0	15.8	15.3	16.3	16.6	16.1	16.8	16.0	16.1	16.8	17.4
M5 -	Monthly change	nsa	2720	3043	5607	1481	5212	109	1125	10582	1478	4127	6712	8160
	Monthly % change	nsa	0.9	1.0	1.8	0.5	1.7	0.0	0.4	3.3	0.4	1.2	2.0	2.4
	Monthly % change	sa	1.3	1.2	2.2	0.3	1.3	0.3	0.9	2.2	0.8	0.9	1.8	2.0
	6-month annualised % change	sa	17.9	17.1	18.9	16.8	16.3	13.8	12.9	15.4	12.3	13.7	14.9	18.8
	Annual % change	nsa	15.0	14.4	15.3	14.7	15.9	16.3	15.7	16.6	15.7	15.5	16.1	16.7
NIBM1 -	Monthly change	nsa	-132	338	288	440	390	-1387	858	2150	1	1148	472	85
	Monthly % change	nsa	-0.3	0.8	0.7	1.0	0.9	-3.1	2.0	4.8	0.0	2.5	1.0	0.2
	Monthly % change	sa	0.2	0.6	3.7	-2.4	-0.2	3.7	1.4	1.2	-0.1	1.2	-0.2	0.8
	6-month annualised % change	sa	9.7	13.5	24.7	14.0	4.2	11.4	14.1	15.4	7.2	15.2	15.3	9.1
	Annual % change	nsa	11.8	5.5	11.6	10.2	10.2	11.8	12.6	15.2	13.8	13.4	10.7	10.7
M1 -	Monthly change	nsa	1030	1568	2969	456	-258	-971	-267	5156	1080	2448	1728	899
	Monthly % change	nsa	1.2	1.8	3.3	0.5	-0.3	-1.1	-0.3	5.7	1.1	2.5	1.7	0.9
	Monthly % change	sa	1.5	1.6	5.0	-1.1	-1.0	2.3	-0.4	3.6	1.2	2.0	1.0	1.3
	6-month annualised % change	sa	28.2	23.2	36.4	24.9	15.6	17.9	13.4	17.9	9.6	16.4	21.2	18.8
	Annual % change	nsa	23.8	20.5	24.9	21.9	23.0	21.9	21.0	21.0	21.2	19.8	18.9	18.4
WIDER £	Monthly change	nsa	1373	1782	7801	-41	3514	652	323	8316	3858	3092	6081	5020
AGGREGATE	Monthly % change	nsa	0.7	0.9	3.8	0.0	1.7	0.3	0.2	3.9	1.7	1.4	2.6	2.1
	Monthly % change	sa	0.7	1.3	4.2	-0.6	1.6	1.7	0.2	2.4	2.5	0.8	2.5	2.0
	6-month annualised % change	sa	21.9	20.3	25.1	18.2	20.9	19.4	18.2	20.8	16.9	20.2	22.2	22.9
	Annual % change	nsa		18.6	22.4	20.5	21.6	21.7	20.1	20.7	20.3	18.8	21.6	20.9

TABLE 3: PROVISIONAL BROAD MONEY COMPONENTS

£ million

	JULY	AVERAGE GROWTH IN PREVIOUS 12 MONTHS
Notes and coins in circulation (nbps)	550	110
Bank deposits (nbps)		
Retail		
non-interest bearing	-465	280
interest bearing	1305	600
Wholesale	4325	1850
Change in M3	5715	2840
Building society holdings of M3 (-)	288	-440
Buildings society deposits (M4ps)		
Retail	1940	1480
Wholesale	58	60
Change in M4	8001	3940
Money market instruments (M4ps)	83	-70
National Savings Bank (M4ps)	76	100
Change in M5	8160	3970

M4ps = non-bank, non-building society private sector

TABLE 4: PROVISIONAL BROAD MONEY COUNTERPARTS

JULY 1988

£ million

	M3	M4	M5
1. PSBR	-1688	-1688	-1688
2. Debt sales to private sector (-)			
Gilts	971	1192	1192
Treasury bills	-25	-6	
National Savings	-165	-164	-88
CTD's	-89	-89	
Other CG debt	0	0	0
LA and PC debt	241	252	257
3. External finance of public sector (-)	316	316	316
4. Public sector contribution (1+2+3)	-439	-187	-11
5. Sterling lending to private sector	6311	9162	9145
6. Externals	720	1126	1126
7. £NNDLs	-877	-2100	-2100
8. Total change (4+5+6+7)	5715	8001	8160
(Percentage change)	(2.8	2.4	2.4)

AVERAGE CHANGE IN PREVIOUS 12 MONTHS

	M3	M4	M5
1. PSBR	-540	-540	-540
2. Debt sales to private sector (-)			
Gilts	-140	-150	-150
Other public debt	-10	-60	20
3. External finance of public sector (-)	460	460	460
4. Public sector contribution (1+2+3)	-230	-290	-210
5. Sterling lending to private sector	4280	5810	5760
6. Externals	-860	-1000	-1000
7. £NNDLs	-350	-560	-560
8. Total change (4+5+6+7)	2840	3960	3990
(Percentage change)	(1.6	1.3	1.3)

SECRET AND PERSONAL
UNTIL 11.30 AM ON THURSDAY 18 AUGUST 1988

MONEY SUPPLY IN JUNE: PRESS BRIEFING

A. FACTUAL

(i) **Changes in main monetary aggregates**

per cent

	M0	M3	**M4**	M5
12 month growth rate	**+7.0** **(+6.9)**	+20.6 (+20.8)	**+17.4** **(+17.0)**	+16.7 (+16.3)
Annualised six-month growth	**(+8.5)**	(+23.8)	**(+20.1)**	(18.8)
one month change	**+2.2** **(+0.9)**	+ 2.8 (+ 2.7)	+ 2.4 **(+ 2.1)**	+ 2.4 + 2.0

(Figures in brackets seasonally adjusted s.a.)

(ii) **MO**

Figures (+7.0 and +6.9 s.a.) above target range, but show some moderation from June figures. Six month growth rate (sa) 2.5% higher than June (6.9%).

(iii) **Broad money**

(a) 1 month growth rates. Higher than previous 3 months.

(b) 3 and 6 month growth rates. Highest this (calendar) year, reflecting acceleration in May, June and July.

(c) 12 month growth rates. Highest since March.

12 month growth rates

	M3		M4	
	u/a	s/a	u/a	s/a
Feb	20.6	(20.5)	16.1	(15.8)
Mar	20.9	(20.8)	16.8	(16.4)
Apr	19.4	(20.1)	16.0	(15.9)
May	18.6	(19.1)	16.1	(15.8)
Jun	20.2	(20.2)	16.8	(16.3)
July	20.6	(20.8)	17.4	(17.0)

SECRET AND PERSONAL
UNTIL 11.30 AM ON THURSDAY 18 AUGUST 1988

(d) M4 gives less erratic signals than M3. Hence MTFS' emphasis on measures including liabilities of building societies as well as banks.

(iv) **Lending**

(a) One month changes: Unadjusted figures show slight moderation from record levels of June; but adjusted figures highest ever.

	Bank and building society lending		Bank lending	
	£ billion	%	£ billion	%
May	+5.4 (+5.4)	+1.5 (+1.5)	+3.1 (+3.1)	+1.4 (+1.4)
June	+9.8 (+8.6)	+2.7 (+2.3)	+7.2 (+6.1)	+3.1 (+2.6)
July	+9.2 (+9.3)	+2.4 (+2.5)	+6.3 (+6.5)	+2.7 (+2.8)

(Figures in brackets seasonally adjusted)

(b) Continuing increase in 12 month growth rates (unadjusted).

	Bank and building society %	Bank %
February	+19.9	+24.3
March	+20.9	+25.2
April	+21.9	+26.9
May	+22.3	+27.0
June	+22.8	+27.7
July	+23.6	+27.9

(c) Figures probably inflated temporarily by Budget measures on mortgage tax relief, as house purchase brought forward to meet August deadline.

(d) Should not read too much into individual counterparts, which are hard to interpret.

(v) **Funding.** Overfund (on M4 definition) in July of £187 million; PSBR surplus in July of £1688 million.

(vi) **Monetary Policy - Recent Statements**

(a) **Chancellor in Autumn Statement debate (14 January)**

"Keeping the economy on track involves keeping a constant watch on all the indicators of how the economy is developing and then taking action as necessary. I have never hesitated to act in the past when I have judged that there was a risk to our inflation objectives. I can assure the House that I shall not hesitate to do so in future. It is precisely by acting promptly that we have been able to avoid the need for drastic and destabilising lurches in policy. Our track record speaks for itself."

(b) **Chancellor on interest rates (Budget speech, 15 March)**

"Short term interest rates remain the essential instrument of monetary policy. Within a continuous and comprehensive assessment of monetary conditions, I will continue to set interest rates at the level necessary to ensure downward pressure on inflation."

(c) **Chancellor on exchange rates (Budget speech, 15 March)**

"Exchange rates play a central role in domestic monetary decisions as well as in international policy co-operation. I believe that most businessmen have welcomed the greater exchange rate stability over the past year. It is important that they also accept the financial discipline inherent in this policy."
(Also see MTFS, 2.11)

(d) **Chancellor on inflation and exchange rates (This Week Next Week interview, 24 April).**

"Our ultimate aim is certainly the total eradication of inflation."

"We are certainly interested in the maximum possible exchange rate stability, within the context of sound anti-inflationary policy."

(e) **Prime Minister on anti-inflation strategy, exchange rates and interest rates, House of Commons 17 May**

"My rhf [Chancellor] and I entirely agree that we must maintain a firm monetary policy and a downward pull on inflation. I totally agree with my rhf's Budget speech, every bit of it ..... Exchange rate policy ..... is a part of total economic policy ..... We use the available levers, both interest rates and intervention, as seems right in the circumstances .... It would be a great mistake for any speculator to think at any time that sterling was a one-way bet"

(f) **Chancellor on anti-inflationary policy, Cities of London and Westminster Annual Luncheon, 7 July**

"The objective of policy remains as it has always been: to maintain monetary conditions that create downward pressure on inflation."

(g) **Chancellor on inflation, oral PQs Thursday 14 July (OR Vol 137, No 187 Col 540)**

"I am still not satisfied with the rate of inflation in Britain and, despite the fact that it is only a fraction of what it was under the Labour Government, I am determined that we shall get it down, and our policy will be directed to that end."

(h) **Chancellor on interest rates, speech to IEA 21 July**

"Short-term interest rates are of course the market route to the defeat of inflation. At one time it was feared that Governments would not be prepared to adjust interest rates sufficiently often, sufficiently promptly, or sufficiently far to enable this process to work. It has been one of the most important achievements of this Government over the years to demonstrate that this is not so, and that interest rates are indeed an effective weapon."

(i) **Chancellor on recent interest rate increases, End of Term Letter, 27 July**

"I have thus had to take prompt action to tighten monetary conditions, by raising interest rates sharply. This will moderate the expansion of demand and in due course enable inflation to resume its downward trend."

B. DEFENSIVE

(i) **Lending**

(a) **Increases in lending still high, particularly when taken with previous months' figures.**

- Budget measures on mortgage tax relief likely to be inflating lending temporarily, as house purchase brought forward to beat the August deadline.

- lending for house purchase generally still buoyant. High building society commitments figures earlier in year now feeding through into lending.

- Some evidence of continued high lending to industrial and commercial companies - consistent with strong investment.

(b) Credit card boom?

- Vast bulk of personal borrowing takes form of mortgages which represented 2/3 of outstanding personal debt at end of 1987. Mortgage lending accounts for half of all of bank and building society lending. In 1980s, 2½ million increase in households buying own home. In each year since 1981, growth in consumer credit has been no more than a quarter of growth in borrowing for house purchase.

- Consumer credit only some 15 per cent of total personal debt. Less than 5 per cent of personal debt takes form of credit card lending (including interest-free component). (See Chancellor's speech to FHA, 17 June 1987). Some credit card payments simply displacing cash and cheque payments - over 40 per cent of credit card users settle within interest-free period.)

(c) **Mortgage lending out of control?** The housing market has been buoyant recently, although some signs that London prices are stabilising. Rises in mortgage rates, taken with changes in tax relief from 1 August, should act to cool housing market.

(d) **Why not impose controls on lending?** Direct controls were not effective in past, and even less likely to work now, given increasing sophistication of modern financial markets. In any case, Government believes lenders and borrowers should be free to make own decisions.

(e) **Bring back hire purchase controls?** Abolished in 1982 because easily and legally avoided. Given even greater sophistication of financial markets now, likely to be even less effective. Controls would also discriminate in favour on consumers with access to overdraft facilities (ie better off)

(ii) **Money Supply**

(a) **M0 growth outside target range?** As result of considered judgement of all relevant indicators including M0 in relation to target range, have raised interest rates 3½% since beginning of June.

(b) **Surely latest figures for level of M0 suggest negative growth needed during rest of the year if target is to be met?** [Unadjusted July on March rise (not annualised) of 5.4%, but sa equivalent 3.4%)] Over only five months of the year these (unadjusted) figures bound to be more volatile, particularly given bank holiday and summer holiday distortions. Seasonally adjusted growth rather lower. See (a).

(c) **Why six-month growth rate so high?** Six month growth rates tend to be more volatile than longer series, reflecting fluctuations in component one month figures. Increase in six-month growth rate partly reflects disappearance from figures of January - when there was negative growth in M0. See (a).

(d) **Why growth in broad money aggregates highest since March?** A special factor was redemption of 3% Transport Stock, with high proportion of small personal sector holdings will probably have boosted retail deposits by as much as £1.2 billion in July.

(e) **Money figures indicate overheating?**

- Economy has been growing at an unsustainably rapid rate and needs to slow down a bit. But that can be achieved without any drama

- as OECD 1988 Survey [published 16/17 August] says, "no convincing evidence that output growth is yet constrained by capacity shortage or supply bottlenecks to a degree comparable to that of previous cyclical peaks."

- Government determined to take no risks with inflation - evidence of recent interest rate rise.

(f) **Significance of broad money.** No explicit broad money target in 1988-89. But growth of broad money still taken into account. See MTFS 2.09 and 3.11.

(iii) **Policy response**

(a) **Interest rate increases have failed to moderate growth in credit, consumer spending etc?** Early days yet: policy has tightened considerably, with interest rates 3½% higher than beginning of June and ERI around same level; but full impact will take some months to come through. For example, rise in mortgage rates only took effect on 1 August.

(b) **What will Government do if interest rate increases fail to have desired effect?** Hypothetical question. Government committed to maintain monetary conditions which keep downward pressure on inflation.

(c) **Adjusting fiscal policy only once a year leaves Government dangerously short of flexibility?** PSDR figures scarcely suggest that fiscal policy is lax. Task of fiscal policy is to buttress monetary policy, with expenditure and tax decisions taken in medium term context to deliver prudent sustainable fiscal position. Notion that fiscal policy could or should be used to fine-tune demand is to hark back to failures of 1960s and 1970s.

(iv) **Interest rate increases since beginning of June**

(a) **Why increase rates?** Tightening of monetary conditions needed to keep bearing down on inflation. Base rates now 1% above level before stock market collapse last October.

(b) **½% moves too small to create impact on economy?** No reason to make larger moves. Appropriate to move cautiously and keep monetary conditions under close review. Successive small rises have been reflected in largest rise in mortgage rates since 1984.

(c) **Why raise interest rates when exchange rate over DM 3.20?** Government working for exchange rate stability in context of keeping downward pressure on inflation. Assessment that tightening needed since beginning of June. Although pay attention to exchange rate against DM, not exclusive attention. ERI about the same as in early June. Rate against dollar is rather lower.

(d) **Why move rates in ½ point steps in quick succession?** 18 out of last 19 interest rate movements have been 1/2%; this has become the normal practice.

(e) **Further movements on way?** Never speculate.

(f) **Government being pushed around by the markets?** No. Prime Minister said on 17 May that "it would be a great mistake for any speculator at any time to think that sterling was a one way bet." Subsequently events have confirmed this.

(g) **Increase will damage industry?** Industry has more to fear from resurgence of inflation. 1% rise in interest rates, even if sustained for whole year, increases costs by far less than amount by which 1% rise in pay settlements increases them.

(h) **Why defend level of sterling which is damaging industry?** If firms accept financial discipline inherent in Government strategy and contain their costs, no need for any loss of competitiveness. Greatest threat to output and employment would come if Government relaxed its anti-inflationary stance.

(i) **Will interest rate rise harm investment?** Investment very buoyant. But in any case, it is in industry's power to reduce costs and make investment more profitable (see (h)).

(j) **Mortgage rate increase harmful?** As Chancellor said recently [Cities of London and Westminster Conservative Luncheon, 2 July] "I can understand that many people will not welcome the higher mortgage rates which are now in prospect." But far less damaging than a resurgence of inflation.

(k) **Increases in interest rates do not affect demand for consumer credit?** Consumer credit only small part of total personal debt. Certainly some borrowers not responsive to interest rate changes, but by no means all, and interest rate changes do influence borrowers' behaviour overall. In any case, rises in interest rates affect economy in variety of ways - not only through demand for consumer credit.

(l) **Lowering rates in March-May was a mistake?** No. Right to avoid an unsustainable appreciation of sterling. Low rates were short lived, and taken with exchange rate, will not have taken risks with inflation.

(v) **UK's real interest rates out of line with competitors?** Real interest rates bound to move higher when base rates have increased 3½% since beginning of June. Now 1.9 percentage points above G7 average (see table below)). Recent interest rate movements demonstrate Government's determination to keep a downward pull on inflation.

Nominal and real interest rates in G7

Country	Nominal(1)	Real(2)
UK	**11.5**	**6.6**
US	8.6	4.4
Japan	4.0	3.8
Germany	5.3	4.2
France	7.8	5.0
Italy	11.3	6.1
Canada	9.9	5.8
Average	7.7	4.7

(1) 3 month interbank rate.

(2) deflated by latest increase in RPI or equivalent.

ORAFT. SECRET until 1130 am Thursday 18.8.88

Provisional estimates of monetary aggregates: July 1988

1 Provisional information suggests the following:

% changes		M0	M3	M4	M5
12 months to July (not seasonally adjusted)		+7.0	+20.6	+17.4	+16.7
July	- not seasonally adjusted	+2.2	+ 2.8	+ 2.4	+ 2.4
	- seasonally adjusted	+0.9	+ 2.7	+ 2.1	+ 2.0

2 Provisional counterparts to the changes in M3, M4 and M5 are:

£ billions, not seasonally adjusted	M3		M4		M5	
	July	latest 12 months	July	latest 12 months	July	latest 12 months
A PSBR	−1.7	− 7.8	−1.7	− 7.8	−1.7	− 7.8
B debt sales to private sector (−) (1)	+1.0	− 1.7	+1.2	− 2.2	+1.4	− 1.1
C external flows to public sector (−)	+0.3	+6.6	+0.3	+6.6	+0.3	+6.6
D public sector contribution (A+B+C)	−0.4	− 2.9	−0.2	− 3.4	−	− 2.3
E sterling lending (2)	+6.3	+53.1	+9.2	+73.1	+9.2	+72.4
F other counterparts (3)	−0.2	−14.7	−1.0	−19.7	−1.0	−19.7
Total (D+E+F)	+5.7	+35.5	+8.0	+50.0	+8.2	+50.4
Sterling lending (seasonally adjusted)	+6.5		+9.3		+9.3	
(average of previous 6 months)	+4.7		+6.7		+6.7	

(1) Sales of public sector debt to the private sector other than banks (and, for M4 and M5, building societies), with an adjustment in the case of M5 for private sector holdings of certain liquid government debt.

(2) Lending by the monetary sector (and, for M4 and M5, by building societies) to the rest of the private sector. For M5, an adjustment is necessary for private sector holdings of certain money-market instruments etc.

(3) External and foreign currency transactions and net non-deposit liabilities of banks (and, for M4 and M5, of building societies).

3 Full monetary statistics for July, including revised estimates of the figures given above, will be published on 30 August.

Bank of England
18 August 1988

mg2.cc/Viv/91g10.21.7

CONFIDENTIAL

MP

FROM: T PIKE

DATE: 18 August 1988

1. MR PERETZ

2. PAYMASTER GENERAL

These figures are more up to date than the July monthly figures published today. They show no sign of MO growth slackening.

DLCP 18/8

cc PS/Chancellor
PS/EST
Sir P Middleton o/r
Sir T Burns o/r
Mr Scholar o/r
Mr Sedgwick
Mr Culpin o/r
Mrs Lomax o/r
Mr Grice o/r
Miss O'Mara o/r
Ms Ryding
Mr Hurst
Ms Bronk

File: MAMC C9

MO FIGURES

The latest weekly figures for MO, covering the third week of August, are attached. They show that the 12 month growth rate of MO to the latest four week period was 7.4 per cent (7.5 per cent not seasonally adjusted). The 12 month growth rate of notes and coin to the same period was 7.5 per cent (7.6 per cent not seasonally adjusted).

2. Six month annualised growth of notes and coin to the latest four week period was 9.4 per cent, compared with 8.5 per cent in July. Both of these figures are probably being distorted somewhat by unusually low levels of notes and coin in January and February. However, the three month annualised rate to the latest four week period was 11.4 per cent, indicating the rapid growth of MO that has occurred over the summer.

T. Pike

T PIKE

TABLE 16

CONFIDENTIAL (Until Publication)

MO : THE WIDE MONETARY BASE

Monthly data	Level £ million (Change in brackets)							Percentage change on previous month		6 month % growth annualised		Percentage change on previous year			
	Notes and Coin (nsa)	Notes and Coin (sa)		Bankers' Deposits	MO (nsa)	MO (sa)		Notes(sa) and Coin	MO (sa)	Notes & Coin (sa)	MO (sa)	Notes and Coin (nsa)	Notes and Coin (sa)	MO (nsa)	MO (sa)
December	16447	15661	(136)	186	16633	15846	(139)	0.9	0.9	7.9	8.5	4.7	4.8	4.2	4.3
1988 January	15458	15620	(-41)	181	15638	15801	(-45)	-0.3	-0.3	6.1	5.3	4.7	4.5	4.8	4.6
February	15353	15659	(39)	124	15477	15783	(-18)	0.2	-0.1	5.3	4.5	5.7	5.7	5.3	5.3
March	15588	15753	(94)	162	15750	15915	(133)	0.6	0.8	5.0	4.6	6.9	6.4	6.4	5.8
April	15797	15826	(73)	229	16026	16055	(139)	0.5	0.9	4.8	5.1	5.8	6.1	5.9	6.2
May	15870	15954	(128)	178	16048	16132	(77)	0.8	0.5	5.6	5.5	6.0	6.5	5.7	6.2
June	16073	16143	(189)	174	16247	16317	(185)	1.2	1.1	6.3	6.0	7.5	7.1	7.7	7.3
July	16411	16271	(128)	188	16599	16459	(142)	0.8	0.9	8.5	8.5	7.5	7.3	7.0	6.9
August (3/5) a	16481	16391	(120)	193	16675	16585	(126)	0.7	0.8	9.6	10.4	7.5	7.4	7.4	7.4
Latest 4 weeks a	16492	16369	(119)	210	16702	16579	(145)	0.7	0.9	9.4	10.4	7.6	7.5	7.5	7.4

Weekly data	Level £ million (Change in brackets)					Percentage change on previous week
	Notes(sa) and Coin		Bankers' Deposits	MO (sa)		MO (sa)
July						
6th	16276	(56)	212	16488	(26)	0.2
13th	16230	(-46)	169	16399	(-89)	-0.5
20th	16273	(43)	112	16385	(-14)	-0.1
27th	16303	(30)	259	16562	(177)	1.1
August						
3rd	16360	(57)	217	16577	(15)	0.1
10th	16399	(39)	187	16586	(9)	0.1
17th	16415	(16)	176	1659[illegible]	(5)	0.0

a W[illegible]ly data for the current month so far include estimates for the unbacked note issue. The latest week also includes an estimate for coin.

* T[illegible] changes for the current month so far use as a base the previous full month and the full month a year ago.
The latest four week changes use as a base the four week averaged level four weeks ago and a year ago.

Moira

Being fixed you might like to have these back.

Julie.

~~BF 14/9~~

[signature]

4387/3

[Do we have ~~x or visit with~~ Cu?] Can't ~~find it~~ out here SM

EST to be invited Friday not so good.

FROM: S M A JAMES

DATE: 18 August 1988

PS/CHANCELLOR

Sarah now behind. First mtg on BF.

① pl copy this + my minute behind to Adviser also ② then begin to set up mtg with all recipients

cc PS/Chief Secretary
Ps/Financial Secretary
PS/Paymaster General
PS/Sir P Middleton
Mr Anson
Sir T Burns
Mr Monck
Mr Byatt
Mr Phillips
Mr Odling-Smee
Mr Robson
Mr Spackman
Mr Turnbull
Mr Grice
Mr Cave
John Gieve

DISCOUNT RATES

The Economic Secretary has seen Sir P Middleton's submission of 5 August enclosing the Working Group's report.

2. The Economic Secretary has commented that setting two different discount rates with a lower one for non-traded projects will be seen as

(i) a deliberate attempt to exclude private participation in such projects;

(ii) pampering the public sector;

3. The Economic Secretary does not find the rationale convincing. Frequent reference is made to "analysing risk separately". But no explanation is given of how. The essence of risk is that it relates to the unknown - which cannot be systematically analysed in advance. But on balance unknown events are adverse!

≤ 1½ hrs sometime in Sept

M.

S M A JAMES

Private Secretary

4387/3

FROM: S M A JAMES

DATE: 18 August 1988

PS/CHANCELLOR

cc PS/Chief Secretary
Ps/Financial Secretary
PS/Paymaster General
PS/Sir P Middleton
Mr Anson
Sir T Burns
Mr Monck
Mr Byatt
Mr Phillips
Mr Odling-Smee
Mr Robson
Mr Spackman
Mr Turnbull
Mr Grice
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SMAJ

S M A JAMES

Private Secretary

ANNEX C

FROM: S J DAVIES
DATE: 19 August 1988

MR PICKFORD

cc Sir P Middleton
Sir T Burns
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Hibberd, o/r -36^13

USE OF OFFICIAL STATISTICS IN MACROECONOMIC POLICY

You asked for a note on why the Treasury needs good statistics and on the cost of bad ones. I hope the attached reply will be of use in your scrutiny. When we spoke you said you would want to arrange to talk to us about all this in more detail.

SJD

S J DAVIES

USE OF OFFICIAL STATISTICS IN MACROECONOMIC POLICY

The Government makes use of official statistics on the economy in formulating, implementing, and monitoring economic policy. The description in this note of the role of statistics in policy-making is set within the current approach to policy but an equivalent story could be told for other approaches.

2. Policy is set in a medium term framework, so that the Government does not react to what the statistics show about short term movements in the economy by adjusting fiscal instruments to "fine tune" the economy. However, the Government does continually monitor monetary conditions: if developments seem to be out of line with the path set at budget time, the Government can take steps to bring things back on track by varying interest rates. Moreover, the judgments that the Chancellor makes at budget time and the annual reformulation of the Medium Term Financial Strategy are affected by what the official statistics suggest about the recent performance and prospective course of the economy.

3. The Government's ability to keep monetary conditions on track is only as good as its ability to assess what is currently happening in the economy. The unreliability of money GDP data for the recent past and the history of downward bias in early estimates of GDP growth mean that the Government cannot put very much weight on these data in assessing monetary conditions. There is a range of indicators - the targeted monetary aggregate (MO), the exchange rate, asset prices etc - that provide an indication of current monetary conditions, as well as of likely trends in inflation and growth, but the faster availability of accurate data on money GDP would clearly assist monitoring of outturn against the Government's objectives.

Internal coherency of statistics

4. Both assessment and control of monetary conditions and the fiscal decisions taken at Budget time require a <u>coherent</u> picture of what is going on in the economy. If the whole range of statistics on the economy are internally inconsistent it becomes very difficult to have confidence in those statistics that are of

most direct importance to policy, and the basis for taking decisions is undermined. Such inconsistency has been a major problem in the recent past. In particular, the large discrepancies between the income, output and expenditure based estimates of GDP growth and the associated unidentified flows in the sectoral financial accounts cause major problems in interpreting recent developments.

5. The residual error has recently been around 2 per cent of GDP (ie the income estimate of GDP has exceeded the expenditure estimate by this amount). The output estimate is relatively close to the income estimate and so points to underrecording of expenditure rather than overrecording of income. Thus consumer spending and/or investment have probably been substantially higher in the recent past than currently estimated; or the balance of payments current account has been much stronger than the published figures have shown. These inaccuracies make it impossible to have confidence in any particular interpretation of private sector behaviour sector that may be advanced to explain what has happened to the current account in the last 2 years. Is the current account deficit (if there really is one) a counterpart almost entirely of a domestic investment boom? Or to what extent is it the counterpart of unusually high consumer spending (stimulated by the 1980s bull market in equities, increased availability of credit or whatever)? These are basic questions that simply cannot be answered with any certainty at present.

6. There have also been very large revisions to the official estimates of personal saving in the last two years. For example, the personal saving ratio for 1986 was estimated at 11 per cent when national accounts for the whole of 1986 were first published; the latest figures put the 1986 saving ratio at just 7.2 per cent. The discrepancies in the financial accounts for the personal sector have led some commentators to suggest that personal saving may be higher than shown in the latest statistics. However, the effect of increasing the figure for personal saving would be to add further to the required adjustment of the figures for the company sector or for the current account. For example if the

latest statistics are understating personal saving by 2 per cent of GDP over the last year, the total adjustment required to the company sector and overseas sector figures - which could take the form of higher domestic investment and an improved current account - would rise to 4 per cent of GDP.

Medium term projections

7. The annual updating of the MTFS necessarily involves :

- the assessment of recent economic performance (in particular the rate of growth of money GDP) in relation to the path set a year earlier;

- a revised assessment of the future path of money GDP that is consistent with the Government's objectives of eventually eliminating inflation.

This latter process involves, for example, taking some view of the real rate of growth that the economy is likely to be able to sustain over the medium term, and the level of inflationary pressures currently in the economy. The view of sustainable growth is inevitably based to a considerable extent on estimates of recent developments in the economy: the rate of growth of productivity, the rate at which capacity is growing. These estimates in turn depend on figures for output, employment, investment and the capital stock which are all subject to considerable uncertainty and liable to substantial revision.

8. Revisions to investment on the scale that paragraphs 5 to 6 have suggested is possible could have a significant effect on projections of actual and potential output growth; and this could affect the formulation of policy in various ways. If it turned out that investment had been running at a much higher rate than the statistics currently show, it could well be appropriate to revise up estimates of future potential growth and hence of the path of money GDP that would be consistent with the Government's objectives for reducing inflation. And any data revisions which

changed the projections of saving and domestic investment would have implications for the mix of fiscal and monetary policies that would be needed to achieve a particular path for money GDP.

Budget forecasts

9. Budget forecasts of the level of public sector borrowing in the year ahead are heavily influenced by the statistics available at the time of the Budget. The clearest example is the forecast of corporation tax that is made at Budget time. Because of the lag between profits being earned and tax being paid on them, the forecast of corporation tax receipts for the year ahead is crucially dependent upon the estimate of profits over the most recent year. More generally, the lags involved in many economic relationships, eg between personal income and consumption, mean that forecasts of the level of economic activity, income, expenditure, and hence tax receipts on income and expenditure, are highly dependent on estimates for the recent past. Likewise, the forecast of public expenditure on those areas where spending is not cash limited also depends in part on economic statistics for the recent past; although here the Reserve is available to cope with unanticipated developments.

10. Recent statistics have an important influence on the wide range of short term economic projections shown in the Industry Act Forecasts (published in the Financial Statement and Budget Report and in the Autumn Statement). Inaccurate data for the recent past can be an important source of error in these projections. An example is the substantial underforecast of growth in 1987 in the 1987 FSBR: the projections of 3 per cent growth in GDP and 4 per cent growth of manufacturing output were well below the currently estimated outturns of almost 4½ per cent and 5½ per cent growth respectively. This error was attributable in part to understatement of the buoyancy of recent economic activity in the statistics available in early 1987 . Figures for manufacturing output published in February 1987 showed 1 per cent growth between the third and fourth quarters of 1986; this estimate has subsequently been revised up to 2½ per cent. The preliminary (output based) estimate of GDP in 1986Q4, published in February

1987, showed output broadly unchanged between the third and fourth quarters of 1986; as now revised the statistics for the average estimate of GDP show a 1¾ per cent increase between the third and fourth quarters of 1986.

Effects on markets

11. Quite apart from their direct effect on policy formulation, the official statistics can affect the economy and policy through their effects on markets. For example, at times the markets pay a great deal of attention to statistics for the current account of the balance of payments. While the monthly visible trade figures are normally regarded as relatively accurate, the overall balance of payments figures often contain large discrepancies and are subject to very substantial revision. Moreover, as noted above, the size of the residual error in the national accounts may well reflect in part errors in the current account statistics. The risk certainly exists of markets' reacting to inaccurate figures in such a way that the Government has to take measures which it would not have to take if accurate figures were published.

53/2/LPD/3774/014

SECRET AND PERSONAL

Sarah - can you dig out for me a note from Peretz to us which answers x [1 July, I think] M.

FROM: S M A JAMES
DATE: 22 August 1988

PS/CHANCELLOR

cc PS/Paymaster General
Sir G Littler
Mr Sedgwick
Mr Peretz
Mr Bush
Mr Brooks
Mrs Ryding
Mr Wheatley

M
~~Irving~~ SMAJ

Thanks S.
pnp

MONEY FIGURES

The Economic Secretary has seen Mr Peretz's minute to the Paymaster General of 17 August attaching MG's note on the Monthly Money Figures. The Economic Secretary has commented that we should x consider the case for a period of deliberate overfunding.

SMAJ

S M A JAMES
Private Secretary

CONFIDENTIAL

FROM: MARTIN HURST
DATE: 22 AUGUST 1988

MR SEDGWICK

cc: Mr Peretz
Mr Grice o/r
Mr O'Donnell o/a
Miss O'Mara
Mr Bush
Mr Owen
Mr Pike
Mrs Ryding
Miss Turk
Mr Williams
Mr Davis
Mr Lyon
Mr Wheatley

Congdon
Sir T. Burns

CONGDON ON FINANCING THE BALANCE OF PAYMENTS

You asked me to write a note appraising the arguments set out in Congdon's recent piece (copy attached) and discussing possible defensive briefing lines against related questioning.

2. A precis of Congdon's thesis might run as follows. Recent capital inflows to the UK have been largely in the form of inward transactions with the monetary sector and portfolio inflows, most of which (at least of the former) are highly liquid. These inflows have underlain the strength of sterling over the past year, but are most unlikely to continue at such high levels over the future. Continued balance of payments deficits of similar orders of magnitude to those recently experienced will therefore cause heavy downward pressure on sterling.

3. On my reading of the data, the evidence cited behind Congdon's arguments is almost completely wrong. As shown in table 1, the capital account has in recent quarters seen a decline in inward portfolio investment, a rise in inward direct investment and lower net banking inflows. All these are contrary to movements postulated by Congdon.

Table 1: SELECTED CAPITAL FLOWS £bn

	Direct Investment (a)		Portfolio Investment (b)		Banking Flows (c)		Balancing Item
	In	Out	In	Out	In	Out	
1985	0.4	3.9	7.1	18.1	29.5	22.0	4.5
1986	2.7	7.1	8.4	23.6	63.7	53.7	12.2
1987Q1	-0.1	0.3	3.1	2.0	11.0	7.3	-2.3
Q2	-0.7	3.2	2.6	-0.1	20.6	15.0	0.4
Q3	1.3	4.1	4.7	0.2	13.3	17.0	4.3
Q4	2.1	1.1	1.6	-9.8	7.9	10.8	-2.1
1988Q1	0.5	0.8	0.1	2.4	1.6	1.5	3.5

(a) Excluding unremitted profits
(b) Includes investment in gilts
(c) Excluding direct and portfolio investment

3. There are two reasons for the difference between the story told by these figures and that related by Congdon. First, Congdon uses monetary sector figures drawn from the external counterparts to broad monetary aggregates. These do not differentiate between banks' deposit/lending activity and their portfolio and direct investments, or between outward and inward flows. In fact, banks' outward portfolio investment fell by almost £8bn between 1986 and 1987, and this alone

accounts for almost all of the worsening net bank position which lies at the heart of Congdon's argument. There was little change in net deposit related activity. There is no reason why banks' outward portfolio investments should be classed as inward inflows of 'hot money'. Second, (as seen in the above discussion) Congdon uses net figures as evidence for a thesis which is concerned purely with unidirectional (inward) flows. The real reason for most of the change in net portfolio investment is the large repatriation of overseas assets by UK institutions in the wake of the equity market crash, an explanation linked to outward flows.

4. But although Congdon is wrong to ascribe recent financing of the current account to speculative inflows, and we can probably use his mishandling of the data in defensive briefing, I do not think that we would necessarily dissent from his basic conclusions. The large repatriations of outward investments, which tie in nicely with the school of thought which cites the existence of a strong net external asset position as evidence for the sustainability of current account deficits, are most unlikely to continue. With lower levels of issues of new equities and gilts than in the past, UK institutions are likely to resume net investment abroad in the near future. Furthermore, we cannot look for an anything like sufficient improvement in the net direct investment position. Thus future current account deficits are likely to require the generation of considerable portfolio or banking inflows from abroad. If large sterling depreciation is not acceptable, and such would be seen as tantamount to an abandonment of the anti-inflation stance, then we are most unlikely to avoid continuing high real interest rates for a considerable time to come.

5. The above discussion ties in fairly well with our recently evolved briefing lines which stress the anti-inflation stance, and the attractiveness of investment in rapidly growing and profitable UK industry. But, of course, the main reason underlying future inward investment will probably be high relative real interest rates. I doubt whether Ministers would want this aspect stressed, but the relevant sections of MG and EA divisions may still wish to append some defensive points to their existing briefing on money and trade respectively.

Martin Hurst

MARTIN HURST

chex.ps/mw/8

BF 25/8

FROM: MISS M P WALLACE

DATE: 23 August 1988

SIR P MIDDLETON (o/r)

cc **Chief Secretary**
Financial Secretary
Paymaster General
Economic Secretary
Mr Anson
Sir T Burns
Mr Byatt
Mr Monck
Mr H Phillips
Mr Odling-Smee
Mr Robson
Mr Spackman
Mr Turnbull
Mr Grice
Mr Cave

DISCOUNT RATES

The Chancellor was most grateful for your minute of 5 August. He will, as you suggest, hold a meeting to discuss this. In the meantime, he would be grateful for the views of Ministers and Advisers on an issue which he thinks "almost as hot a potato politically as it is contentious economically". He would also like to have, in advance of the meeting, a note setting out what practical difference the proposed chance would have made had it been introduced, say, two years ago.

mpw.

MOIRA WALLACE

chex.ps/mw/11 **CONFIDENTIAL** BF 25/8

FROM: MISS M P WALLACE
DATE: 23 August 1988

MR PERETZ

cc Sir G Littler
Mr Sedgwick
Mrs Ryding

MP

MARKETS/MONEY FIGURES

The Chancellor was most grateful for your minute of 17 August. He also saw your minute of the same date to the Paymaster General, on which he commented that he would be grateful for a note setting out the monthly path of M0 now expected over the rest of this financial year.

MPW.

MOIRA WALLACE

[Ch/ this not copied to all at mtg - but I have kept spare + can distribute more copies if you wish first thing in morning or ~~at mtg.~~ MPW]

SECRET

~~Thanks.~~

FROM: P N SEDGWICK
DATE: 23 AUGUST 1988

CHANCELLOR

cc: Sir P Middleton o.r
Sir T Burns
Mr Peretz
Mr Owen
Mr Price

EFFECTS OF HIGHER INTEREST RATES ON RPI INFLATION

[F. 2/4, Rev non-reversed]

Introduction

This note considers the implications for RPI inflation of various hypothetical paths for short term interest rates. The calculations take as a base the 'faster rise in interest rates' variant of the June forecast. Since the completion of the June forecast the monthly figures for inflation excluding the mortgage interest rate effect have been very close to the June forecast. As in the June forecast, all the calculations assume that the sterling index remains a little above its current level for the rest of this year, and declines slightly through 1989.

The assumptions on interest rates

2. Tables 1 and 2 set out the assumptions on base rates and the mortgage rate together with those for the June exercise. The current level of interest rates differs from those in the June exercise, with base rates now ½ per cent higher than the 10½ per cent assumed then, and the mortgage rate below the 11¾per cent assumed then. The current small differential between base and mortgage rates is almost certainly not sustainable in the long run, though with the building societies now experiencing strong retail inflows this low differential could persist for some time.

3. Variant 1 has a one per cent rise in base rates, maintained until further notice, while variant 2 assumes a further 1 point increase in base rates on October 1. Variants 3 and 4 reverse these rises after the 1989 Budget. In each variant the mortgage rate changes a month after base rates. Variant 2 (and variant 4) assumes that the currently small differential between base and mortgage rates is increased by ½ point after the second base rate hike. Arguably the differential should be widened in variant 1 (and variant 3) as well, maybe towards the end of this year.

Table 1: Changes in interest rates from now on

	Base rates	Mortgage rate
Variant 1	+1 per cent end August 1988 to 12 per cent: no changes thereafter	+1 per cent October 1 1988 to 12½ per cent: no changes thereafter
Variant 2	+1 per cent August 1988 to 12 per cent: +1 per cent October 1 1988 to 13 per cent: no change thereafter	+1 per cent October 1 1988 to 12½ per cent: +1½ per cent to 14 per cent November 1 1988: no change thereafter
Variant 3	As in variant 1 to end-1988: -1 per cent April 1 1989 to 11 per cent	As in variant 1 to end-1988: -1 per cent to 11½ per cent May 1 1989
Variant 4	As in variant 2 to end-1988: -2 per cent on April 1 1989 to 11 per cent	As in variant 2 to end-1988: -2 per cent on May 1 1989 to 12 per cent

Table 2: Quarterly averages of interest rates (per cent)

		June forecast (Faster rise in interest rates variant)		Variant 1		Variant 2		Variant 3		Variant 4	
		Base Rates	Mortgage Rates	Base Rates	Mortgage Rates	Base Rates	Mortgage Rates	Base Rates	Mortgage Rates	Base Rates	Mortgage Rates
1988	3	10.25	11.08	10.89	11.08	10.89	11.08	10.89	11.08	10.89	11.08
	4	10.50	11.75	12.00	12.50	13.00	13.50	12.00	12.50	13.00	13.50
1989	1						14.00	12.00	12.50	13.00	14.00
	2							11.00	11.83	11.00	12.67
	3								11.50		12.00
	4										

4. Table 3 shows that RPI inflation reaches 7 per cent in variant 1 and just under 8 per cent in variant 2 in mid 1989. Thereafter RPI inflation falls sharply, particularly in variants 3 and 4 in which interest rates fall again. Total RPI inflation peaks in June/July 1989 because this is the period in which - by assumption - the mortgage rate is most above its level a year earlier (when the average mortgage rate was 9¾ per cent).

5. The sharp rise and - especially in variants 3 and 4 - subsequent fall in total RPI inflation is almost exclusively the result of the assumed path for the mortgage rate. RPI inflation less MIPs hardly alters between the variants and the base. The inflation rate of the RPI less MIPs is a little bit higher in the variants because higher total RPI inflation leads, by assumption, to a greater revalorisation of excise duties in the 1989 budget.

<u>Caveats</u>

6. It goes without saying that these variants can be no more accurate than the underlying forecast of RPI inflation (less MIPs) made last June. It is possible that - in the short term at least - the June forecast will be seen to have underestimated the rise in inflation as a result of the strong growth in the economy.

7. I have two other worries. <u>First</u> the relative stability of the exchange rate assumed in the variants may not occur. <u>Second</u>, rises in interest rates may exert downward pressure on inflation, eg through narrowing profit margins, sooner than assumed in these calculations. The second worry applies <u>a fortiori</u> in the case with two base rate hikes. Because of these worries and other [!] considerations I do not favour making any public statement with a quantified estimate of what RPI inflation is likely to be before we publish the Autumn Statement. The most we might say is that RPI inflation is likely to peak towards the middle of next year, and that total RPI inflation will be significantly above RPI inflation less MIPs.

P.N.S

P N SEDGWICK

SECRET

Table 3: RPI inflation

	June Forecast		Variant 1		Variant 2		Variant 3		Variant 4	
	RPI	RPI less MIPs	Total RPI	RPI less MIPs	Total RPI	RPI less MIPs	Total RPI	RPI less MIPs	Total RPI	RPI less MIPs
1988										
August	5.7	4.9	5.5	4.9	5.5	4.9	5.5	4.9	5.5	4.9
September	5.7	4.9	6.0	4.9	6.0	4.9	6.0	4.9	6.0	4.9
October	5.5	4.6	5.8	4.6	6.4	4.6	5.8	4.6	6.4	4.6
November	5.2	4.5	5.5	4.4	6.1	4.4	5.5	4.4	6.1	4.4
December	5.9	4.5	5.9	4.4	6.6	4.4	5.9	4.4	6.6	4.4
1989										
January	5.9	4.6	6.5	4.8	7.1	4.9	6.5	4.8	7.1	4.8
February	6.2	5.0	6.5	4.9	7.2	4.9	6.5	4.9	7.2	4.9
March	6.2	5.0	6.4	4.8	7.1	4.8	6.4	4.8	7.1	4.8
April	6.1	5.2	6.6	5.2	7.5	5.3	6.7	5.2	7.5	5.3
May	6.2	5.1	6.8	5.2	7.6	5.2	6.4	5.2	6.9	5.2
June	6.3	5.0	6.8	4.9	7.6	5.0	6.3	5.0	6.8	5.0
July	6.4	5.0	7.0	5.1	7.9	5.2	6.5	5.0	7.0	5.1
August	5.3	5.0	6.2	5.0	7.1	5.2	5.7	5.0	6.1	5.1
September	5.3	4.9	5.5	5.0	6.6	5.2	5.1	5.0	5.6	5.1
October	5.3	4.7	5.5	4.8	5.9	4.9	4.9	4.7	4.8	4.8
November	5.2	4.6	5.4	4.8	5.9	4.9	4.8	4.7	4.8	4.8
December	5.2	4.6	5.4	4.7	5.9	4.8	4.8	4.6	4.8	4.8

1989 5·9

chex.ps/mw/17 UNCLASSIFIED ~~BF to ACSA 5/9~~

FROM: MISS M P WALLACE
DATE: 23 August 1988

pmp.

MR CULPIN

MORTGAGE INTEREST RELIEF

The Chancellor has seen and was grateful for your minute of 16 August.

MPW.

MOIRA WALLACE

mg.ee/dlcp/24.8-rir

SECRET AND PERSONAL
UNTIL 12.00 ON 25 AUGUST

Pg

From : D L C Peretz
Date : 24 August 1988

CHANCELLOR

cc FST
Sir T Burns
Sir G Littler
Mr Bush

REAL INTEREST RATES

You asked for a table of G7 real interest rates, after tomorrow's move. The following table shows current market (3 month) rates for all countries, except the UK where I have assumed three month rates will rise tomorrow to 12%. (They may well, of course, go higher - at least for a while).

Country	Nominal interest rate	"Real Rate"	Inflation
US	8.5	4.2	4.1
Japan	4.1	3.9	0.2
Germany	5.4	4.4	1.0
UK	**12.0**	**6.9**	**4.8**
France	7.8	5.0	2.6
Italy	11.3	6.1	4.9
Canada	9.9	5.8	3.9
Average	7.8	4.6	

German rates may of course also rise. But we will have the highest nominal and real rates in the G7 - as indeed we already have this morning, with interbank rate at 11.7%.

DLP

D L C PERETZ

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pmp.

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

25 August 1988

Dominic Morris Esq
10 Downing Street
LONDON SW1

PS / FST
cc Mr Peretz
Mr I Rich

Dear Dominic

NATIONAL SAVINGS INTEREST RATES

I am writing to let you know that following today's base rate rise we shall be announcing tomorrow increases in the interest rates paid on National Savings Income and Deposit Bonds (from 9 per cent to 10¾ per cent), and on the National Savings Bank Investment Account (from 8½ per cent to 10 per cent). The Income and Deposit Bond increases will take effect by early October, since six weeks' notice of change is required in the Regulations. The Investment Account increase will be introduced in two weeks' time.

These investments have been looking unattractive since the building societies raised their deposit rates at the beginning of this month. Although it is well known we do not always move when other rates change, some investors had begun to accuse DNS of bad faith. The increases to be announced tomorrow should, once today's base rate move had fed through to retail interest rates, restore the level of competitiveness of the National Savings products to around that set at Budget time. Moving quickly in this way should also help cement in place the new pattern of interest rates following today's rise in base rates.

Yours,

Moira.

MOIRA WALLACE
Private Secretary

mg2.jw.mg1.ns

CONFIDENTIAL

FROM: IAN RICH
DATE: 25 August 1988

RC 25/8

1. MR PERETZ
2. PS/CHANCELLOR

NATIONAL SAVINGS: INTEREST RATE CHANGES

It is usual to inform No10 of changes to National Savings terms before they are announced. I attach a draft Private Secretary letter to No 10, for despatch today, about the increases in gross product rates which are to be announced tomorrow.

Ian Rich

IAN RICH

mg.ee/dlcp/25.8-gray

CONFIDENTIAL

DOMINIC MORRIS

DRAFT LETTER TO ~~PAUL GRAY~~ ESQ, 10 DOWNING STREET

NATIONAL SAVINGS INTEREST RATES

I am writing to let you know that following today's base rate rise we shall be announcing tomorrow ~~afternoon~~ increases in the interest rates paid on National Savings Income and Deposit Bonds (from 9 per cent to $10^3/_4$ per cent), and on the National Savings Bank Investment Account (from 8½ per cent to 10 per cent). The Income and Deposit Bond increases will take effect by early October, since 6 weeks' notice of change is required in the Regulations. The Investment Account increase will be introduced in two weeks' time.

These investments have been looking unattractive since the building societies raised their deposit rates at the beginning of this month. Although it is well known we do not always move when other rates change, some investors had begun to accuse DNS of bad faith. The increases to be announced tomorrow should, once today's base rate move has fed through to retail interest rates, restore the level of competitiveness of the National Savings products to around that set at Budget time. Moving quickly in this way should also help cement in place the new pattern of interest rates following today's rise in ~~the~~ base rates.

MISS M P W.

fim2.cd/ritchie/min2

FROM: ALLEN RITCHIE
DATE: 30 August 1988

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mrs Lomax
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Gieve
Mr Grice
Mr Ilett
Mr Pickford
Mr Hudson
Dr Kosmin
Mr Sharples

Thank NL.

PERSONAL SECTOR DEBT TO INCOME RATIO

In a speech to the Finance Houses Association annual dinner on 17 June 1987, you quoted a figure for the ratio of personal debt to income in 1986 of 78 per cent, which you said was "well below the equivalent measure for the household sector in the USA, which stood at 93 per cent".

2. You might like to see our latest estimates of this ratio, which are set out in the attached table. The personal sector's debt to income ratio has risen from a revised figure of 80 per cent for 1986 to nearly 90 per cent for 1987. The equivalent figures for the USA (household sector) are 90 per cent for 1986 and 93 per cent for 1987. So it is no longer true that the UK ratio is well below that of the USA.

Allen Ritchie

ALLEN RITCHIE
FIM2

fim2.cd/ritchie/table

Ratio of Personal Sector Debt to Income

1975	43.51
1976	43.56
1977	44.70
1978	44.87
1979	44.87
1980	44.84
1981	48.68
1982	54.79
1983	60.86
1984	66.71
1985	72.97
1986	80.50
1987	89.53

Definitions and Sources

Ratio of Personal Sector Debt to income

$$= \frac{\text{Total Personal Sector Borrowing outstanding at end-year}}{\text{Personal Sector Disposable Income for calendar year}}$$

Total Personal Sector Borrowing
= Consumer Credit + Loans for House Purchase + Other borrowing from Monetary Sector

Source: CSO Financial Statistics

mg2.jw.mofigs

CONFIDENTIAL Marks pp

FROM: T PIKE
DATE: 1 September 1988

1. MR GRICE

2. ECONOMIC SECRETARY

cc PS/Chancellor
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Sedgwick
Mr Peretz
Mrs Lomax
Miss O'Mara o/r
Mr Bush
Ms Ryding
Mr Brooks
Mr Hurst
Ms Dronk

File: MAMC C9

pp.

[illegible] lly adjusted) was exactly 5 per cent higher than in March 1988. Consequently, it will need not to grow at all over the rest of the financial year if the target range is not to be breached.

JWG
1.9.88

M0 FIGURES

Provisional figures show that the 12 month growth rate of M0 in August was 7.4 per cent (7.5 per cent not seasonally adjusted). The sa and nsa 12 month growth rates of notes and coin in August were 7.6 and 7.7 per cent respectively. These figures are unlikely to be revised.

T. Pike

T PIKE

CONFIDENTIAL (Until Publication)

MO : THE WIDE MONETARY BASE

Monthly data	Level £ million (Change in brackets)							Percentage change on previous month		6 month % growth annualised		Percentage change on previous year			
	Notes and Coin (nsa)	Notes and Coin (sa)		Bankers' Deposits	MO (nsa)	MO (sa)		Notes(sa) and Coin	MO (sa)	Notes & Coin (sa)	MO (sa)	Notes and Coin (nsa)	Notes and Coin (sa)	MO (nsa)	MO (sa)
December	16447	15661	(136)	186	16633	15846	(139)	0.9	0.9	7.9	8.5	4.7	4.8	4.2	4.3
1988 January	15458	15620	(-41)	181	15638	15801	(-45)	-0.3	-0.3	6.1	5.3	4.7	4.5	4.8	4.6
February	15353	15659	(39)	124	15477	15783	(-18)	0.2	-0.1	5.3	4.5	5.7	5.7	5.3	5.3
March	15588	15753	(94)	162	15750	15916	(133)	0.6	0.8	5.0	4.6	6.9	6.4	6.4	5.8
April	15797	15826	(73)	229	16026	16055	(139)	0.5	0.9	4.8	5.1	5.8	6.1	5.9	6.2
May	15870	15954	(128)	178	16048	16132	(77)	0.8	0.5	5.6	5.5	6.0	6.5	5.7	6.2
June	16073	16143	(189)	174	16247	16317	(185)	1.2	1.1	6.3	6.0	7.5	7.1	7.7	7.3
July	16411	16271	(128)	188	16599	16459	(142)	0.8	0.9	8.5	8.5	7.5	7.3	7.0	6.9
August (5/5)	16517	16419	(148)	165	16681	16583	(124)	0.9	0.8	9.9	10.4	7.7	7.6	7.5	7.4
Latest 4 weeks	16575	16474	(180)	141	16716	16615	(132)	1.1	0.8	10.5	10.5	7.7	7.6	7.2	7.2

Weekly data	Level £ million (Change in brackets)					Percentage change on previous week
	Notes(sa) and Coin		Bankers' Deposits	MO (sa)		MO (sa)
July						
6th	16276	(56)	212	16488	(26)	0.2
13th	16230	(-46)	169	16399	(-89)	-0.5
20th	16273	(43)	112	16385	(-14)	-0.1
27th	16303	(30)	259	16562	(177)	1.1
August						
3rd	16368	(65)	217	16585	(23)	0.1
10th	16407	(39)	187	16594	(9)	0.1
17th	16420	(13)	176	16596	(2)	0.0
24th	16479	(59)	78	16557	(-39)	-0.2
31st	16591	(112)	122	16713	(156)	0.9

Tim Congdon warns of the dangers in Britain's balance of payments deficit

Hot money, cold comfort

Mr Lawson has tried to dismiss alarmism about the balance of payments by claiming that the deficit will be easy to finance. He has suggested that there is a resemblance between Britain's large current account imbalance and the issue of long-term equity capital by a successful private company to support continued expansion. A better comparison is with a property developer financing his latest speculation with short-term bank loans. The Chancellor's complacency about the balance of payments is unjustified and risky.

The essential facts are easy to check and should not be in dispute. The Central Statistical Office publishes quarterly data on capital flows between Britain and the rest of the world. Although the figures have many shortcomings, stable long-term investments can be distinguished from volatile short-term currency swings. The most important long-term capital movement comes under the heading of "direct investment", which indicates changes in the direct ownership of tangible, solid things like factories and buildings. The official figures show that Britain is not now, and in recent years has not been, a net recipient of this kind of investment from abroad. From 1985 to 1987, the early years of the boom so much celebrated by Mr Lawson, Britain's direct investment overseas totalled £35.9 billion, and foreign direct investment in the UK – £14.2 billion; there was a net outflow of more than £20 billion. In the three quarters to the first quarter of 1988, when the boom reached a peak, the net outflow was more than £5 billion.

Clearly on this part of the balance of payments, Britain has been less favoured by foreign investors than British investors have favoured the rest of the world. Direct investment requires stronger and more permanent commitment than any other category of international financial flow; it is also the most difficult to reverse. There is no evidence here that Britain's situation is like that of a company issuing equity capital. It would be easier to argue the opposite and to claim that throughout the Lawson boom Britain has maintained its traditional status as a significant exporter of long-term capital.

But the balance of payments must balance. Over the last year, not only have direct investment flows been adverse, but the current account has been in the red and the official foreign exchange reserves have increased sharply. How have these items, which together exceed £20 billion, been financed? What pluses in other parts of the balance of payments match all the minuses?

There have been two main sources of financing. First, foreigners have been heavier portfolio investors in Britain than British residents have been in other countries. Since mid-1987 the surplus on this part of the balance of payments, which represents purchases and sales of financial instruments, has probably been more than £10 billion. Second, banks have raised money from foreign sources and lent it to people and companies in this country. According to the Bank of England's statistics, these inflows via the banking system have exceeded £10 billion over the last year.

It is important to understand what is happening. When foreigners buy British financial instruments (such as shares on the London Stock Exchange), they are acquiring assets which they can sell at some future date, even if the original intention was to keep them for many years. The whole point of portfolio investment is that it can be unwound quickly and without fuss. Similarly, inflows via the banking system can rapidly become outflows. Foreigners who are happy to hold sterling one day may prefer deutschmarks or dollars the next.

Portfolio investment and inflows via the banking system are therefore quite unlike direct investment. Whereas investors in shares, government securities and bank deposits can redispose their holdings at a moment's notice, companies who have committed themselves to building new factories and warehouses usually have to stick to their decisions for several years; and, whereas the inflows into Britain in recent quarters could be reversed with little warning, most outflows would continue for many months even if British companies changed their minds about the ultimate value of the overseas investments.

The vulnerability of Britain's balance of payments, and the sterling exchange rate, to a change in international sentiment is obvious. If the estimate that portfolio inflows and inflows via the banking system have been over £20 billion in the last year is correct, these favourable short-term elements in the balance of payments have amounted to about 5 per cent of gross domestic product. The scale of recent capital movements, and the severity of the adjustment problem if the inflows were to stop, is without precedent in peacetime.

It is no exaggeration to say that Britain's economy has become dependent on continued inflows of hot money. The funds have been attracted here by high interest rates and the image of economic success associated with the Thatcher Government. The latest trade figures, suggesting that the current account deficit could approach 4 per cent of GDP have begun to tarnish that image. If yet higher interest rates prove necessary to keep hot money in Britain, the subsequent inevitable slowdown in the economy would raise further questions about the durability of the UK's "growth miracle".

Of course, the Government could allow the exchange rate to fall if hot money inflows became hot money outflows. That might sustain economic growth for a time, but the result would be an acceleration in inflation which would be fair retribution for the credit and monetary excesses of the last three years.

90/G.jw.4567/A/007

MP

FROM: MS V F BRONK
DATE: 2 September 1988

1. MR PERETZ
2. ECONOMIC SECRETARY

Interesting background figures. The pension funds and insurance companies remain more liquid than a year ago.

DLP 5/9

cc PS/Chancellor
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mrs Lomax
Mr Sedgewick
Mr Odling-Smee
Mr Grice
Mr Ilett
Miss O'Mara
Mr O'Donnell (o/a)
Mr Brooks
Mr Hurst
Mr Neilson
Ms Ryding
Mr Ritchie

File MAMC L4

INSTITUTIONAL INVESTMENT IN THE FIRST AND SECOND QUARTERS OF 1988

Each quarter, we receive information on the portfolio position of the major investment institutions, albeit relating to some months before. Because of the time lag, the data are of little relevance to the analysis of current monetary conditions. But it is sometimes useful in increasing our understanding of developments retrospectively.

2. The latest crop of data consists of:

(i) DTI early estimates of life assurance and pension fund investments in the second quarter (unpublished);

(ii) investment data for unit and investment trusts in Q1 (published); and

(iii) data on securities dealers' overseas investments in Q1 (published) and Q2 (unpublished).

Summary

3. The main points to emerge from analysis are as follows:

(a) although the investing institutions built up liquidity in 1987 Q4 after the crash and unwound it in the following two quarters, there was no apparent effect on sterling liquidity as measured by M4. Some of the temporary liquidity build-up was in foreign currency deposits, while within sterling liquidity, movements in money brokers' and gilt-edged market makers' cash balances partly offset those of investing institutions;

(b) although the main investing institutions have not restored their overseas portfolios significantly after the heavy disposals in Q4, UK-based securities dealers have made substantial purchases of overseas bonds in the first two quarters. This is in sharp contrast to their behaviour throughout 1987, and more in line with earlier 1980s experience. These purchases of overseas securities will have tended to weigh against sterling, though to the extent they were financed by foreign currency borrowing the effect will be reduced.

4. Subsidiary points to note include:

(i) a switch in the second quarter by pension funds away from gilts, as well as liquidity, to UK and overseas securities;

(ii) a similar switch by life assurance companies away from gilts, but in favour of short-term liquidity and UK equities: and

(iii) the proceeds of unit and investment trusts' overseas disposals for cash in Q4 being placed in the UK equity market in Q1.

Further Detail

Securities dealers overseas transactions in the first and second quarters

5. Figures for securities' dealers overseas transactions (only) are collected for the balance of payments statistics. They show that securities dealers made net purchases of overseas assets of £2¼ billion in each of the first two quarters of 1988 (almost all in the form of bonds). This is a dramatic turnaround from disposals of £3¼ billion in Q4 and disposals of £1¼ billion on average in

the previous three quarters of 1987 (also mainly of bonds). But it is not clear how much this will have affected the exchange rate and balance of payments position because many of the securities houses involved are owned and financed from overseas.

Life assurance and pension funds: second quarter of 1988

6. Both life assurance companies and pension funds appear to have been strong buyers of UK equities in the second quarter (Table 2), further restoring their UK equity portfolio proportions (Table 1).

7. Both groups are estimated to have made small disposals of gilts, in sharp contrast to the first quarter, when pension funds had acquired £1½ billion and life companies £1 billion. Gilt portfolio proportions fell back to early 1987 levels (having risen significantly since the crash).

8. Other transactions differed between the two groups. Pension funds, having in the six months after the crash sold £2¾ billion of overseas securities and accumulated £3¾ billion in short-term assets, in the second quarter unwound this position somewhat by buying £0.6 billion of overseas securities and running down short-term assets marginally. Life companies, on the other hand, having sold a more modest £1 billion of overseas securities and accumulated £½ billion in cash after the crash, continued to make small sales of overseas securities and accumulated some £¾ billion in cash.

9. After taking account of changes in market valuation, overseas portfolio proportions rose for both groups, but remained below pre-crash levels. Pension funds' liquidity proportion, which had risen from 3¼ per cent to 5¼ per cent after the crash, and further to 5¾ per cent in the first quarter, fell back to about 5¼ per cent. Life companies' liquidity proportion, which had risen from 2½ per cent before the crash to just over 3 per cent, rose a little further to about 3¼ per cent.

Unit and investment trusts: first quarter of 1988

10. The first quarter 1988 figures for unit and investment trusts show that both groups unwound the liquidity they had built up by

selling overseas securities after the crash. They invested the proceeds in the first quarter mainly in UK equities, however, rather than restoring overseas portfolios. Unlike LAPFs, they were not significant gilt purchasers in the first quarter.

11. As a result, unit trusts' liquidity proportions fell back from a very high 10½ per cent in the fourth quarter to about 7¼ per cent. This is similar to the level earlier in 1987 (when inflows were exceptionally strong) but still above the 4½-6 per cent range in the previous five years.

12. Unit trusts' overseas portfolio proportions remained at post-crash levels of about 28¼ per cent, confirming a declining trend which began as early as the first quarter of 1987. The proportions invested in UK company securities by contrast rose strongly to about 62 per cent, having risen in the fourth quarter despite capital losses sustained in the crash (from 58¼ per cent to 59 per cent).

Effect on broad money growth

13. The build-up of institutional liquidity in the fourth quarter of 1987 and subsequent unwinding in the first and second quarters of 1988 do not appear to have been reflected in M4 growth, as shown in the table below.

Changes £ billion

		M4	OFI holdings of M4	Investing Institutions' holdings of	
				Bank deposits £ and fc	Total net Short-term assets
1987	Q1	8.7	4.0	2.8	2.9
	Q2	11.1	1.2	1.7	1.3
	Q3	10.9	2.5	0.1	1.0
	Q4	11.9	2.2	4.0	4.1
1988	Q1	11.5	2.1	-0.4	-
	Q2	13.0	2.0	N/A	0.6*

* Life assurance and pension funds only

The financial institutions' component of M4 has grown by a steady £2-2½ billion for the last four quarters, in spite of fluctuations in institutional liquidity preference. The reasons for this include:

(i) that the temporary surge in Q4 included foreign currency bank deposits. Unit and Investment trusts foreign currency deposits rose temporarily by £½ billion; and

(ii) that sterling bank deposits of gilt-edged market makers and stock exchange money brokers partly offset movements by the investing institutions. GEMMs' and SEMBs' sterling deposits fell temporarily by £¾ billion in Q4.

Vyvien Bronk

MS V F BRONK

TABLE 1 - Continued

	Cash & Term excl Short	Short Assets incl Gilts	Gilts o/w IGs	Company Securities	O'seas Securities	Property	Other	TOTAL
UNIT TRUSTS								
Level £ billion:								
end 1981	0.3	0.3	0.2	3.7	1.5		0.0	5.6
end 1982	0.3	0.4	0.3	4.6	2.3		0.1	7.7
end 1983	0.6	0.6	0.4	6.2	4.2		0.1	11.4
end 1984	0.9	1.0	0.6	8.2	5.2		0.1	14.9
end 1985	1.1	1.2	0.5	11.7	6.4		0.0	19.7
end 1986	1.4	1.4	0.5	17.5	12.4		0.1	31.9
Q1 1987*	2.6	2.6	0.6	21.7	14.5		0.1	39.5
Q2 1987*	3.3	3.4	0.6	25.6	15.1		0.1	44.8
Q3 1987*	3.4	3.4	0.5	28.9	16.7		0.1	49.6
Q4 1987*	3.8	3.8	0.7	21.4	10.2		0.2	36.3
Q1 1988*	2.7	2.7	0.7	23.1	10.5		0.2	37.1
As % of Assets:								
end 1981	4.5	4.8	3.1	65.3	26.5		0.5	100.0
end 1982	4.5	5.3	4.2	60.2	30.1		0.9	100.0
end 1983	5.0	5.5	3.6	54.1	36.6		0.6	100.0
end 1984	6.1	6.8	3.8	55.0	34.6		0.5	100.0
end 1985	5.6	5.9	2.6	59.0	32.5		0.2	100.0
end 1986	4.4	4.5	1.7	54.8	38.8		0.3	100.0
Q1 1987*	6.6	6.7	1.5	54.9	36.8		0.2	100.0
Q2 1987*	7.5	7.6	1.3	57.2	33.7		0.3	100.0
Q3 1987*	6.8	6.9	1.0	58.3	33.6		0.3	100.0
Q4 1987*	10.5	10.5	1.9	59.1	28.1		0.5	100.0
Q1 1988*	7.3	7.4	1.8	62.2	28.2		0.4	100.0
INVESTMENT TRUSTS								
Level £ billion:								
end 1981	0.3	0.3	0.2	4.9	3.7	0.0	0.1	9.2
end 1982	0.2	0.3	0.2	4.8	4.9	0.0	0.1	10.3
end 1983	0.2	0.2	0.3	5.6	7.3	0.0	0.1	13.5
end 1984	0.4	0.5	0.3	6.7	8.1	0.0	0.1	15.7
end 1985	0.4	0.5	0.5	8.6	8.7	0.1	0.3	18.5
end 1986	0.4	0.5	0.3	9.5	10.5	0.0	0.1	20.9
Q1 1987*	0.3	0.4	0.6	11.7	11.8	0.0	0.1	24.5
Q2 1987*	0.5	0.6	0.7	13.3	12.1	0.0	0.1	26.7
Q3 1987*	0.8	0.9	0.4	14.3	12.8	0.1	0.1	28.5
Q4 1987*	1.6	1.8	0.8	10.3	7.8	0.1	0.1	20.7
Q1 1988*	1.3	1.6	0.9	10.7	8.0	0.1	0.1	21.1
As % of Assets:								
end 1981	3.1	3.6	2.0	53.2	40.7	0.3	0.8	100.0
end 1982	2.4	3.0	1.9	46.8	47.5	0.3	1.0	100.0
end 1983	1.1	1.8	2.3	41.5	53.8	0.3	1.0	100.0
end 1984	2.6	3.4	2.0	42.5	51.9	0.2	0.9	100.0
end 1985	2.0	2.8	2.5	46.4	47.4	0.3	1.4	100.0
end 1986	2.1	2.5	1.5	45.5	50.2	0.2	0.5	100.0
Q1 1987*	1.2	1.6	2.5	47.7	47.9	0.2	0.5	100.0
Q2 1987*	1.8	2.2	2.5	49.8	45.2	0.2	0.5	100.0
Q3 1987*	2.8	3.2	1.5	50.2	44.8	0.2	0.4	100.0
Q4 1987*	7.8	8.9	3.8	49.7	37.6	0.3	0.7	100.0
Q1 1988*	6.2	7.6	4.2	50.6	38.1	0.3	0.7	100.0

* Estimated market values

TABLE 1 - INSTITUTIONAL INVESTMENTS: ESTIMATED LEVELS & PROPORTIONS 26/8/88

	Cash & Short Term excl Short	Assets incl Gilts	Gilts	o/w IGs	Company Securities	O'seas Securities	Property	Other	TOTAL
PENSION FUNDS									
Level £ billion:									
end 1981	2.2	2.5	12.5	1.4	28.9	6.4	9.7	3.7	63.4
end 1982	2.6	3.0	18.2	2.3	37.7	10.3	10.5	4.8	84.2
end 1983	4.1	4.9	22.6	3.0	50.6	16.2	11.3	6.3	111.0
end 1984	5.1	6.2	24.5	3.8	66.0	18.7	12.4	7.6	134.4
end 1985	5.2	5.9	27.2	4.4	80.6	22.9	12.9	7.6	156.4
end 1986	6.8	7.4	29.2	5.8	100.1	32.2	13.9	8.3	190.5
Q1 1987*	8.1	8.8	31.4	6.3	120.3	38.0	13.9	8.3	220.0
Q2 1987*	7.9	8.5	30.3	5.2	140.1	40.0	13.7	8.3	240.2
Q3 1987*	8.0	8.6	27.8	4.9	152.1	42.5	13.8	8.5	252.7
Q4 1987*	10.8	11.3	28.9	5.5	111.0	26.2	14.1	8.2	199.2
Q1 1988*	11.9	12.5	31.5	6.1	114.3	26.4	14.1	8.1	206.3
Q2 1988*@	11.8	12.4	30.4	6.2	124.1	32.0	14.1	8.1	220.4
As % of Assets:									
end 1981	3.5	3.9	19.7	2.2	45.6	10.1	15.2	5.9	100.0
end 1982	3.1	3.5	21.7	2.7	44.7	12.2	12.5	5.7	100.0
end 1983	3.7	4.4	20.4	2.7	45.6	14.6	10.1	5.7	100.0
end 1984	3.8	4.6	18.2	2.8	49.1	13.9	9.2	5.7	100.0
end 1985	3.3	3.8	17.4	2.8	51.5	14.7	8.3	4.8	100.0
end 1986	3.6	3.9	15.3	3.0	52.5	16.9	7.3	4.3	100.0
Q1 1987*	3.7	4.0	14.3	2.8	54.7	17.3	6.3	3.8	100.0
Q2 1987*	3.3	3.5	12.6	2.2	58.3	16.7	5.7	3.4	100.0
Q3 1987*	3.2	3.4	11.0	1.9	60.2	16.8	5.5	3.4	100.0
Q4 1987*	5.4	5.7	14.5	2.8	55.8	13.1	7.1	4.1	100.0
Q1 1988*	5.8	6.1	15.3	3.0	55.4	12.8	6.8	3.9	100.0
Q2 1988*@	5.3	5.6	13.8	2.8	56.3	14.5	6.4	3.7	100.0
LIFE ASSURANCE COMPANIES									
Level £ billion:									
end 1981	2.2	2.8	15.2	0.4	20.5	3.3	14.5	5.3	61.0
end 1982	2.5	3.7	22.8	1.0	27.1	5.8	16.0	5.5	79.8
end 1983	2.8	4.4	25.8	1.4	35.1	8.9	17.2	6.1	95.8
end 1984	3.0	4.9	27.6	1.7	45.1	12.0	18.7	6.4	112.8
end 1985	2.8	4.3	30.5	2.3	55.3	14.1	20.2	7.3	130.1
end 1986	3.5	5.2	31.4	2.2	74.5	18.5	22.0	8.6	158.6
Q1 1987*	4.0	5.9	34.8	2.6	90.4	21.3	22.1	8.8	181.3
Q2 1987*	4.6	6.3	34.3	2.7	104.0	22.5	22.4	9.0	196.8
Q3 1987*	5.1	6.8	32.8	3.0	113.1	24.0	22.3	9.4	206.8
Q4 1987*	5.2	7.1	34.5	3.1	82.8	15.2	22.8	9.7	170.3
Q1 1988*	5.6	7.2	36.5	3.3	87.0	15.3	23.0	10.0	177.5
Q2 1988*@	6.2		35.2		95.3	18.0	23.3	10.3	188.4
As % of Assets:									
end 1981	3.6	4.5	25.0	0.7	33.6	5.5	23.8	8.7	100.0
end 1982	3.2	4.6	28.6	1.2	34.0	7.3	20.1	6.9	100.0
end 1983	2.9	4.6	26.9	1.5	36.7	9.3	17.9	6.3	100.0
end 1984	2.6	4.4	24.5	1.5	40.0	10.6	16.6	5.7	100.0
end 1985	2.2	3.3	23.4	1.8	42.5	10.8	15.5	5.6	100.0
end 1986	2.2	3.3	19.8	1.4	47.0	11.6	13.9	5.5	100.0
Q1 1987*	2.2	3.2	19.2	1.5	49.8	11.7	12.2	4.8	100.0
Q2 1987*	2.3	3.2	17.4	1.4	52.9	11.4	11.4	4.6	100.0
Q3 1987*	2.5	3.3	15.9	1.4	54.7	11.6	10.8	4.5	100.0
Q4 1987*	3.1	4.2	20.2	1.8	48.6	8.9	13.4	5.7	100.0
Q1 1988*	3.1	4.1	20.6	1.9	49.0	8.6	13.0	5.7	100.0
Q2 1988*@	3.3		18.7		50.6	9.5	12.4	5.5	100.0

* Estimated market values   @ Based on early estimates of transactions

91/G 4497/008/cc

TABLE 2

TRANSACTIONS IN ASSETS

£ million

	TOTAL INVESTMENTS & SHORT TERM ASSETS	NET CASH AND SHORT-TERM ASSETS	GILTS	UK COMPANY SECURITIES	OVERSEAS SECURITIES	PROPERTY	OTHER
PENSION FUNDS							
1987 Q3	2174	146	- 822	2485	39	134	192
1987 Q4	2352	2796	95	2074	- 2529	231	- 315
1988 Q1	2300	1068	1593	- 177	- 177	14	- 21
1988 Q2 DTI Early Estimate	2064	- 99	- 107	1623	617	30	N/A
LIFE ASSURANCE COMPANIES							
1987 Q3	3527	497	568	2019	94	- 23	372
1987 Q4	2527	76	494	1877	- 788	480	388
1988 Q1	3209	379	930	1563	- 172	214	295
1988 Q2 DTI Early Estimate	3225‡	657	- 3	2026*	- 57	300‡	300‡
UNIT TRUSTS							
1987 Q3	2149	41	- 59	1525	600	0	42
1987 Q4	389	466	158	850	- 1115	0	30
1988 Q1	- 74	- 1111	- 33	927	131	0	12
INVESTMENT TRUSTS							
1987 Q3	176	325	- 207	108	- 53	3	3
1987 Q4	277	814	333	- 24	- 878	16	15
1988 Q1	- 113	- 327	76	42	98	- 2	0

* Includes MG guess of unit trust purchases of £700 million (compared with £623 million in Q1)

‡ MG Guess

mg.ld/Wheatley/(1)2.9.min

PP

FROM: M H WHEATLEY

DATE: 2 September 1988

1. MR PERETZ 2/9
2. PS/ECONOMIC SECRETARY

cc PPS
PS/Chief Secretary
PS/Paymaster General
PS/Financial Secretary
Miss O'Mara o/r
Mr Pickford
Mr Bush
Mr Dickson
Mrs Ryding

MORTGAGE DEMAND IN AUGUST

In his "World at One" interview on 25 August the Chancellor said that mortgage approvals in August had decreased some 30% from the July levels. This figure was derived from weekly data that will not be published for a another few weeks and as you know we have suggested that where possible the figure is best avoided in future public statements, for the time being at least.

2. However, we now have something which can be used freely in public. The attached article in yesterday's Independent by Steve Levinson reports statements by the Halifax and the Abbey National. The Halifax said that its mortgage offers in August were only two thirds of the June/July level and ascribed this to higher mortgage rates and the change to the residence basis for mortgage tax relief on 1 August (as well as the summer holidays). The Abbey described the mortgage market as "very depressed".

3. The article also draws attention to Building Societies Association figures showing a 19% fall in repossessions in the first half of the year.

M H Wheatley

M H WHEATLEY

Interest rises curb mortgage demand

By Steve Levinson
Economics Correspondent

BUILDING societies report a sharp fall in mortgage demand since the start of August — the first sign that higher interest rates may have dented consumer confidence.

The Halifax, the largest society, said its mortgage offers in August were only two-thirds the level of June and July. The Abbey National described the mortgage market as "very depressed".

Jim Birrell, the chief executive of the Halifax, told *The Independent* that the combination of higher mortgage rates, summer holidays, and the passing of August's deadline for ending dual tax relief had dampened the market. "It is now much more cautious, the period of panic buying in June and July is over. It seems that 1 August will prove to be something of a watershed in the 1980s housing boom."

Mr Birrell said the Halifax expected house prices to continue to rise but at a slower rate. However, if base rates were raised again, there was a danger that the housing market would be much harder hit. "If we overshoot and force mortgage rates up too high, it would have a dramatic effect."

While a cooling of the housing market is welcome news for Nigel Lawson, the Chancellor, it is still difficult to disentangle the various factors at work. The Building Societies Association said it was not yet clear whether the mortgage slowdown was anything more than a temporary respite after the rush to beat August's tax relief deadline. The Nationwide-Anglia, the third largest society, pointed out that the downturn could be merely seasonal.

The association also produced figures yesterday showing that despite the mortgage boom in the first half of this year, the number of homes repossessed fell 19 per cent to 9,180 — the lowest level for three years. Mortgage arrears also fell back. Mark Boleat, director general of the association, said the improvement reflected sharp falls in unemployment. "The figures put into perspective suggestions that owner-occupation has been expanding too rapidly and that people have been over-committing themselves."

5385

psf.sp/EA1/owen

RESTRICTED

Initially I had some doubts about the wisdom of announcing this 'balancing' exercise until we had a better idea of what might emerge. The Bank also showed some reluctance. But I am persuaded that the work will be finished earlier if we make the announcement now.

FROM: D W OWEN
DATE: 2 September 1988

1. SIR T BURNS

2. CHANCELLOR

Chief Secretary
Economic Secretary
Sir P Middleton o.r.
Sir T Burns
Mr Scholar
Mr Sedgwick o.r.
Mr Odling-Smee o.r.
Mr Hibberd o.r.
Mr Gieve
Mr Mowl
Mr O'Donnell
Mr Grice
Mr Patterson

Ch

Sorry, no copies yet. Will procure one

AA

1988 BLUE BOOK

The CSO's 1988 National Income and Expenditure Blue Book will be published next Friday, 9 September. The paper attached to Mr Sedgwick's minute to you of 22 August (Recent Performance of the Economy) summarised the main estimates. The revised estimates of real growth and inflation in 1986 and 1987 are little different from those currently published. The public reaction may therefore be as much a renewal of the debate on the quality of economic statistics as a discussion of the figures themselves. The huge sectoral balancing items in particular may attract adverse comment.

2. You might like to note that as part of its response to the large balancing items the CSO is proposing to construct on a one-off experimental basis, for the years 1985 to 1987, a set of balanced accounts ie. accounts in which the balancing items are fully allocated across the other items. This is something which Treasury officials have been encouraging the CSO to do although we would not want to raise expectations about what might be achieved. It is by no means a straightforward task. You might also note that the CSO intend to mention this exercise in a low key way in the press notice which will accompany publication of the Blue Book. (A copy of the latest draft of the introductory pages of the press notice is attached - the relevant paragraphs are side-lined.) Again this is an approach with which Treasury officials agree.

NB They also intend to publish the results. Terry is persuaded (see his note above), but you might want to discuss it with him first. (You are seeing him Tues. 5.30pm). AAH.

David Owen

D W OWEN

30/9/91

- PLEASE NOTE EMBARGO -

EMBARGO: NOT FOR PUBLICATION, BROADCAST OR USE ON CLUB TAPES BEFORE 00.30 HOURS FRIDAY 9 SEPTEMBER 1988

CSO(88)78
8 SEPTEMBER 1988

NATIONAL ACCOUNTS BLUE BOOK: 1988 EDITION

The 1988 edition of the United Kingdom National Accounts (the CSO Blue Book)* will be published on Friday 9 September. It contains statistics of national income, expenditure and output and of financial transactions for the years 1977 to 1987 as well as information about the size, structure and distribution between sectors of the nation's wealth. This year's edition contains summary input output tables for 1984 compatible with the 1987 Blue Book. In addition, most of the summary tables go back to 1966 on a consistent basis.

As usual, all the figures published in last year's Blue Book, together with those published in subsequent press notices and quarterly articles, have been thoroughly reviewed and revised where necessary to take account of the most up to date information and, where appropriate, changes in methodology. [Improvements have been made in the calculation and presentation of the average estimate of gross domestic product, GDP(A), which is the definitive estimate of levels of GDP, as well as of medium and long term changes.] All the constant price estimates have been moved on to a 1985 base, to ensure that current figures reflect recent patterns of output, expenditure etc. This rebasing is made every 5 years, to ensure that published figures are never too far away from their base, but on this occasion the rebasing has made little difference to the changes in the economic aggregates previously published.

The Blue Book confirms the picture of continued growth in 1987 - of 4 1/4% in GDP (at constant factor cost) between 1986 and 1987, compared with 3% between 1985 and 1986. There were substantial increases in consumers expenditure and capital investment on the expenditure side and in income from employment and self-employment and in company profits on the income side. Output grew particularly in manufacturing industries, construction, and services, compared with little change in the energy and water supply group of industries, and a fall in agricultural production.

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* United Kingdom National Accounts 1988 Edition - the CSO Blue Book - is compiled by the Central Statistical Office and published by Her Majesty's Stationery Office, price £11.95. ISBN 0 11 620295 5.

Though subject to a wider margin of error than many other figures in the accounts, estimates of the personal savings ratio point to a continued decline, reaching a level of around 5 1/2 % in 1987, the lowest since the 1950s.

Revisions to the figures have led to marked improvements in estimates of the residual error between the income and expenditure measures of GDP. Estimates for the years to 1986 are now at broadly acceptable low levels, whilst the figure for 1987 at £5.7 billion compares with the first published estimate in March of £9.2 billion and represents around 1 1/2 % of GDP.

This improvement in the residual error has not been accompanied, at least in the most recent years, by corresponding improvements in the sector balancing items, which shows a lack of consistency between the estimates made of the financial surpluses or deficits of each of the broad sectors of the economy and the corresponding changes in financial assets and liabilities, as measured from financial accounts. These balancing items remain after taking account to the fullest extent possible of the available information, and reflect a great variety of remaining problems, including the difficulties of estimating the sterling value of transactions expressed in foreign currencies in different parts of the accounts at a time of fluctuating exchange rates and the lack of detailed information in certain areas, such as transactions in UK and overseas securities. The balancing item for the personal sector is particularly large, partly because many of the financial items in this sector are estimated as residuals and reflect errors and omissions in other sectors' financial accounts.

The Government has recognised the problems these large sectoral balancing items and other inconsistencies in the national accounts pose for interpretation of economic developments by setting up a Review of Economic Statistics charged with making recommendations for achieving cost-effective improvements where necessary. The Review is to be completed by end-October.

There are also continuing attempts to improve the quality of the information available: for example, through a new survey of securities dealers, currently under discussion between the Bank of England and the Securities Association. In the meantime, as a contribution to the debate on the quality of economic statistics, the Central Statistical Office has decided to examine the feasibility of producing accounts for 1985-1987 which eliminate the residual error and the balancing items by adjusting those elements of the accounts which are known to be most uncertain or where it is suspected that there may be deficiencies in coverage. Any set of balanced accounts which emerges from the exercise will, of course, be very different from the usual objective accounts that are published by the CSO. In part they will be highly subjective, and even speculative. They will represent a

N.B. brings us close to next Bgt. Do we need to specify a time?

possible interpretation of the existing accounts and will not replace them. It is intended to publish and invite comments on this exercise within the next 6 months.

The remainder of this press notice gives a more detailed commentary on the major tables in this year's Blue Book.

chex.ps/aa/17

pg

Treasury Chambers, Parliament Street, SWIP 3AG
01-270 3000

cc Sir P Middleton
Sir G Littler
Sir T Burns
Mr Scholar
Mr Odling-Smee
Mr Peretz
Sedgwick
Mr Hibberd
Mr O'Donnell
Mr Owen
Mr M Hurst
Mr Turk

Paul Gray Esq
10 Downing Street
LONDON SW1

Dear Paul,

CONGDON ON FINANCING THE BALANCE OF PAYMENTS

... You asked for a note on Tim Congdon's article "Hot Money, Cold Comfort" in The Times on Thursday, 1 September. This is attached.

A C S ALLAN
Principal Private Secretary

CONGDON ON FINANCING THE BALANCE OF PAYMENTS

1. Congdon's thesis is that the balance of payments deficit has been financed not by increased overseas direct investment in the UK - which he regards as fairly long term, stable, finance - but by short term flows or 'hot money' which are inherently volatile.

2. Data on capital flows are available to 1988Q2 for banking flows and to 1988Q1 for portfolio flows and for direct investment. Congdon's analysis deals with the twelve months period prior to these dates and is seriously flawed for the following reasons:

(i) Congdon argues that the £10 billion net inflows to UK banks are hot money, but in fact they represent almost entirely UK banks' repatriating holdings of overseas equities in 1987Q4. Net inflows in the form of bank deposits and loans, the 'hottest' money, have been roughly nil over the last few quarters.

(ii) Gilts and equities held by foreigners have become more liquid in the last few years but many such inflows are acknowledged to be long term investments. (Hong Kong and Shanghai bank's investment in Midland is a good example.) Furthermore, almost all the increase in net portfolio inflows over the last twelve months is actually attributable to UK institutions repatriating considerable amounts of overseas assets in 1987Q4. This represents a running down of a small part of the substantial holdings of net overseas assets which have been built up over the last decade. Overseas portfolio inflows, which could arguably play the role of hot money, were very little changed from the levels of previous years.

(iii) Total direct investment continues to show a net outflow but most of this represents unremitted profits, ie earnings by overseas subsidiaries of UK companies which have been retained by the subsidiary. Net new direct investments have recently shown that investment from overseas in the UK exceeds overseas investment by UK firms.

3. Analysis of the relationship between the current account and particular types of capital flows is complicated by the existence of large variable balancing items over the past. The balancing item,

positive in all but one year since 1977, averaged £7½ billion per year between 1984 and 1987, with an abnormally large figure of £14½ billion in 1986, much of which is thought to relate to unrecorded investment from overseas associated with Big Bang. In 1987 it was £3½ billion, and 1988Q1 alone has seen a further £3½ billion. Congdon makes no mention of the balancing item, which (with positive sign) acts to 'finance' the recorded current account. Some of the balancing item may in fact represent unrecorded current account credits; and of that part which represents unrecorded capital inflows we cannot tell how much, if any, could be classified as 'hot'.

4. Abstracting from problems with the balancing item, inflows of what could perhaps be termed hot money were at most only slightly higher over the last twelve months for which data is available than in the past. But neither Congdon nor ourselves can say much about flows over the last five months and it is likely that the level of repatriations of overseas assets will decline from the unusually high level of 1987. Certainly figures for 1988Q1, and preliminary institutional data for Q2 do not show any evidence of further repatriations. But less money is likely to be required to finance exchange rate intervention. It is also probable that the United States' requirements for foreign capital will decline as their trade balance improves. The US current account is expected to improve by around $30 billion this year.

5. The current account deficit has to be seen against this reduced demand for mobile foreign capital, the current attractive level of UK interest rates and the healthy state of public finances.

FROM: MARTIN HURST

DATE: 5 SEPTEMBER 1988

PPS/CHANCELLOR ✓

cc: Sir P Middleton
Sir G Littler
Sir T Burns
Mr Scholar
Mr Peretz
Mr Sedgwick
Mr Hibberd o/r
Mr O'Donnell
Mr Owen
Ms Turk

CONGDON ON FINANCING THE BALANCE OF PAYMENTS

I attach a note which I understand that you have requested on Congdon's piece (also attached) in Thursday's edition of The Times. The arguments he uses do not differ substantially from those in his earlier work for Shearson Lehman. The criticisms of this work (which we have previously provided for the press office), notably that his use of statistics is highly selective and that the true story is almost the opposite of that which he sets out, also apply to his latest effort .

Ch
PM saw Congdon's article and asked for a note. OK to send her attached?
AA

Martin Hurst

MARTIN HURST

I am puzzled by an omission in this account, wh. surely needs to be underlined. That is, that the current deficit has been financed by the balancing item to a significant extent. Over the most recent 4 qtrs (Q2'87–Q1'88 inc — see +) this has been over £6 bn. Some of this may of course turn out to be a lower current deficit: & of the capital inflow element

We simply don't know how much has [illegible] 'lost': some may be moving Shearson Lehman or its UK subsidiary. NL

CONGDON ON FINANCING THE BALANCE OF PAYMENTS

1. Congdon's thesis is that the balance of payments deficit has been financed not by increased overseas direct investment in the UK - which he regards as fairly long term, stable, finance - but by short term flows or 'hot money' which are inherently volatile.

2. His analysis is seriously flawed for the following reasons:

(i) Congdon argues that the £10 billion net inflows to UK banks are hot money but in fact they represent almost entirely UK banks' repatriating holdings of overseas equities. Net inflows in the form of bank deposits and loans, arguably the 'hottest' money, have been roughly nil over the last few quarters.

(ii) Gilts and equities held by foreigners have become more liquid in the last few years but many such inflows are acknowledged to be long term investments. (Hong Kong and Shangai bank's investment in Midland is a good example.) Furthermore, almost all the increase in net portfolio inflows over the last twelve months is actually attributable to UK institutions repatriating considerable amounts of overseas assets. This represents a running down of a small part of the substantial holdings of net overseas assets which have been built up over the last decade. Overseas portfolio inflows, which could arguably play the role of hot money, were very little changed from the levels of previous years.

(iii) Total direct investment continues to show a net outflow but this is due to the inclusion of unremitted profits, ie earnings by overseas subsidiaries of UK companies which have been retained by the subsidiary. Net new direct investments have recently shown that investment from overseas in the UK exceeds overseas investment by UK firms.

3. Inflows of what could perhaps be termed "hot money" were at most only slightly higher over the last few quarters than in the past. It is likely that the level of repatriations of overseas assets may decline from this year's unusually high level. But less money is likely to be required to finance exchange rate intervention. It is

also probable that the United States' requirements for foreign capital will decline as their trade balance improves. The US current account is expected to improve by around $30 billion this year.

4. The current account deficit has to be seen against this reduced demand for mobile foreign capital, the current attractive level of UK interest rates and the healthy state of public finances.

Tim Congdon warns of the dangers in Britain's balance of payments deficit

Hot money, cold comfort

Mr Lawson has tried to dismiss alarmism about the balance of payments by claiming that the deficit will be easy to finance. He has suggested that there is a resemblance between Britain's large current account imbalance and the issue of long-term equity capital by a successful private company to support continued expansion. A better comparison is with a property developer financing his latest speculation with short-term bank loans. The Chancellor's complacency about the balance of payments is unjustified and risky.

The essential facts are easy to check and should not be in dispute. The Central Statistical Office publishes quarterly data on capital flows between Britain and the rest of the world. Although the figures have many shortcomings, stable long-term investments can be distinguished from volatile short-term currency swings. The most important long-term capital movement comes under the heading of "direct investment", which indicates changes in the direct ownership of tangible, solid things like factories and buildings. The official figures show that Britain is not now, and in recent years has not been, a net recipient of this kind of investment from abroad. From 1985 to 1987, the early years of the boom so much celebrated by Mr Lawson, Britain's direct investment overseas totalled £35.9 billion, and foreign direct investment in the UK – £14.2 billion; there was a net outflow of more than £20 billion. In the three quarters to the first quarter of 1988, when the boom reached a peak, the net outflow was more than £5 billion.

Clearly on this part of the balance of payments, Britain has been less favoured by foreign investors than British investors have favoured the rest of the world. Direct investment requires stronger and more permanent commitment than any other category of international financial flow; it is also the most difficult to reverse. There is no evidence here that Britain's situation is like that of a company issuing equity capital. It would be easier to argue the opposite and to claim that throughout the Lawson boom Britain has maintained its traditional status as a significant exporter of long-term capital.

But the balance of payments must balance. Over the last year, not only have direct investment flows been adverse, but the current account has been in the red and the official foreign exchange reserves have increased sharply. How have these items, which together exceed £20 billion, been financed? What pluses in other parts of the balance of payments match all the minuses?

There have been two main sources of financing. First, foreigners have been heavier portfolio investors in Britain than British residents have been in other countries. Since mid-1987 the surplus on this part of the balance of payments, which represents purchases and sales of financial instruments, has probably been more than £10 billion. Second, banks have raised money from foreign sources and lent it to people and companies in this country. According to the Bank of England's statistics, these inflows via the banking system have exceeded £10 billion over the last year.

It is important to understand what is happening. When foreigners buy British financial instruments (such as shares on the London Stock Exchange), they are acquiring assets which they can sell at some future date, even if the original intention was to keep them for many years. The whole point of portfolio investment is that it can be unwound quickly and without fuss. Similarly, inflows via the banking system can rapidly become outflows. Foreigners who are happy to hold sterling one day may prefer deutschmarks or dollars the next.

Portfolio investment and inflows via the banking system are therefore quite unlike direct investment. Whereas investors in shares, government securities and bank deposits can redispose their holdings at a moment's notice, companies who have committed themselves to building new factories and warehouses usually have to stick to their decisions for several years; and, whereas the inflows into Britain in recent quarters could be reversed with little warning, most outflows would continue for many months even if British companies changed their minds about the ultimate value of the overseas investments.

The vulnerability of Britain's balance of payments, and the sterling exchange rate, to a change in international sentiment is obvious. If the estimate that portfolio inflows and inflows via the banking system have been over £20 billion in the last year is correct, these favourable short-term elements in the balance of payments have amounted to about 5 per cent of gross domestic product. The scale of recent capital movements, and the severity of the adjustment problem if the inflows were to stop, is without precedent in peacetime.

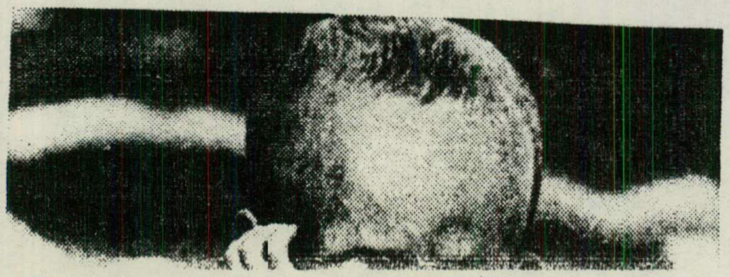
It is no exaggeration to say that Britain's economy has become dependent on continued inflows of hot money. The funds have been attracted here by high interest rates and the image of economic success associated with the Thatcher Government. The latest trade figures, suggesting that the current account deficit could approach 4 per cent of GDP have begun to tarnish that image. If yet higher interest rates prove necessary to keep hot money in Britain, the subsequent inevitable slowdown in the economy would raise further questions about the durability of the UK's "growth miracle".

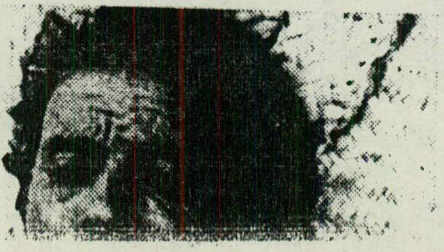
Of course, the Government could allow the exchange rate to fall if hot money inflows became hot money outflows. That might sustain economic growth for a time, but the result would be an acceleration in inflation which would be fair retribution for the credit and monetary excesses of the last three years.

Paul Vallely

Sudan's war harvest of famine

Suddenly we have another famine in Sudan. Tens of thousands of destitute people are on the move. Hundre[illegible]re dying every day. Aid wo[illegible]s report that migrants are literally crawling into refugee centres where the levels of malnutrition and percentage of those dying every week are the worst ever recorded





can mean six to eight weeks walking."

The agencies are finding it hard to cope. The natural obstacles are intimidating as are the problems caused by Sudan's collapsed economy – its national debt is $12 billion and the interest repayments alone are far

CONFIDENTIAL

FROM: J W GRICE

DATE: 5 September 1988

ECONOMIC SECRETARY

cc PS/Chancellor
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Sedgwick
Mr Peretz
Mrs Lomax
Miss O'Mara
Mr Bush
Mrs Ryding o/r
Mr Brooks
Mr Hurst

File: MAMC C1

M0 FIGURES : AUGUST DATA, CORRECTION

On Friday evening, we received full M0 data from the Bank for August. It revealed that there was a transmission error in the data upon which Mr Pike's minute to you of 1 September was based.

2. The effect is to raise the growth rate in the 12 months to August by 0.2 per cent on a seasonally adjusted basis to 7.6 per cent and by 0.3 per cent on an unadjusted basis to 7.8 per cent. This means, unfortunately, that the 12 month unadjusted growth rate given in the press notice will exceed the previous peak for June. The full revised figures are attached.

JWG

J W GRICE

TABLE 16

CONFIDENTIAL (Until Publication)

M0 : THE WIDE MONETARY BASE

Monthly data	Level £ million (Change in brackets)							Percentage change on previous month		6 month % growth annualised		Percentage change on previous year			
	Notes and Coin (nsa)	Notes and Coin (sa)		Bankers' Deposits	M0 (nsa)	M0 (sa)		Notes(sa) and Coin	M0 (sa)	Notes & Coin (sa)	M0 (sa)	Notes and Coin (nsa)	Notes and Coin (sa)	M0 (nsa)	M0 (sa)
December	16447	15661	(136)	186	16633	15846	(139)	0.9	0.9	7.9	8.5	4.7	4.8	4.2	4.3
1988 January	15458	15620	(-41)	181	15638	15801	(-45)	-0.3	-0.3	6.1	5.3	4.7	4.5	4.8	4.6
February	15353	15659	(39)	124	15477	15783	(-18)	0.2	-0.1	5.3	4.5	5.7	5.7	5.3	5.3
March	15588	15753	(94)	162	15750	15916	(133)	0.6	0.8	5.0	4.6	6.9	6.4	6.4	5.8
April	15797	15826	(73)	229	16026	16055	(139)	0.5	0.9	4.8	5.1	5.8	6.1	5.9	6.2
May	15870	15954	(128)	178	16048	16132	(77)	0.8	0.5	5.6	5.5	6.0	6.5	5.7	6.2
June	16073	16143	(189)	174	16247	16317	(185)	1.2	1.1	6.3	6.0	7.5	7.1	7.7	7.3
July	16411	16271	(128)	188	16599	16459	(142)	0.8	0.9	8.5	8.5	7.5	7.3	7.0	6.9
August (5/5)	16576	16461	(190)	156	16732	16617	(158)	1.2	1.0	10.5	10.8	8.1	7.9	7.8	7.6
Latest 4 weeks	16583	16482	(186)	141	16724	16623	(138)	1.1	0.8	10.6	10.6	7.7	7.7	7.3	7.2

Weekly data	Level £ million (Change in brackets)					Percentage change on previous week
	Notes(sa) and Coin		Bankers' Deposits	M0 (sa)		M0 (sa)
July						
6th	16276	(56)	212	16488	(26)	0.2
13th	16230	(-46)	169	16399	(-89)	-0.5
20th	16273	(43)	112	16385	(-14)	-0.1
27th	16303	(30)	259	16562	(177)	1.1
August						
3rd	16376	(73)	217	16593	(31)	0.2
10th	16415	(39)	187	16602	(9)	0.1
17th	16428	(13)	176	16604	(2)	0.0
24th	16487	(59)	78	16565	(-39)	-0.2
31st	16599	(112)	122	16721	(156)	0.9

chex.ps/mw/1 **UNCLASSIFIED**

FROM: MISS M P WALLACE
DATE: 5 September 1988

MR A RITCHIE

MP

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mrs Lomax
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Gieve
Mr Grice
Mr Ilett
Mr Pickford
Mr Hudson
Dr Kosmin
Mr Sharples

PERSONAL SECTOR DEBT TO INCOME RATIO

The Chancellor was grateful for your minute of 30 August, which he has noted.

MPW.

MOIRA WALLACE

pmp.

V05391

P/S Chancellor

Thanks.

cc Mr Flaxen)
Mr Kidgell)CSO
Miss Carter o/r)

Mr Mowl - Treasury

CSO BLUE BOOK 1988 EDITION

The Chancellor requested a pre-publication copy of the CSO Blue Book 1988 edition, as attached.

The Blue Book is due to be published at 00.30 hours on Friday 9 September; it is embargoed until that time.

F. Hackman

F HACKMAN
CSO Branch 2
Room 134A/1 (tel 270-6189)
6 September 1988

A, B, C, Cii, Po's

PPS
12/2

JAPAN TO MAINTAIN PRESENT MONETARY POLICY-SUMITA NRLC
TOKYO, SEPT 6, REUTER - BANK OF JAPAN GOVERNOR SATOSHI SUMITA SAID THE CENTRAL BANK WILL MAINTAIN ITS CURRENT MONETARY POLICY FOR THE PRESENT.
BUT THE BANK WILL KEEP A CAREFUL WATCH ON PRICES AND EXCHANGE RATE MOVEMENTS AND CONDUCT POLICIES IN AN APPROPRIATE AND FLEXIBLE MANNER WITHOUT ANY PREJUDGEMENT, SUMITA TOLD THE ANNUAL CONVENTION OF JAPAN'S NON-LIFE INSURANCE COMPANIES.
HE SAID JAPAN'S DOMESTIC PRICE STABILITY IS UNLIKELY TO BE UNDERMINED IN THE NEAR TERM, BUT CLOSE ATTENTION MUST BE PAID TO FUTURE PRICE TRENDS AS PRODUCTION CAPACITY AND LABOUR MARKETS ARE TIGHTENING AND MONEY SUPPLY GROWTH REMAINS HIGH.
06-SEP-0643. MON254 MONO

CONTINUED ON - NRLD

P

DEALING - SEE AADA 0939

JAPAN TO MAINTAIN PRESENT MONETARY POLICY-SUMITA -PART 2 NRLD
REFERRING TO RECENT INTEREST RATE RISES IN THE U.S. AND SOME EUROPEAN COUNTRIES, SUMITA SAID THOSE NATIONS ARE NOW FOCUSING THEIR POLICY ON SECURING PRICE STABILITY.
HE SAID MAJOR NATIONS REMAIN FIRMLY COMMITTED TO POLICY COORDINATION PRACTISED SINCE THEIR LOUVRE AGREEMENT.
IN FEBRUARY LAST YEAR, THE GROUP OF SEVEN INDUSTRIAL COUNTRIES AGREED AT A MEETING AT THE LOUVRE MUSEUM IN PARIS TO STABILIZE CURRENCIES AROUND THEN PREVAILING LEVELS AND ACHIEVE SUSTAINED, NON-INFLATIONARY ECONOMIC GROWTH.
SUMITA MADE SIMILAR COMMENTS TO THE ANNUAL CONVENTION OF JAPAN'S LIFE INSURANCE COMPANIES ON SEPTEMBER 2.
06-SEP-0650. MON262 MONO

CONTINUED FROM - NRLC

ENDS

P

DEALING - SEE AADA 0939

Pg

FROM: A C S ALLAN
DATE: 6 September 1988

MR M HURST

cc Sir P Middleton
Sir G Littler
Sir T Burns
Mr Scholar
Mr Peretz
Mr Sedgwick
Mr Hibberd
Mr O'Donnell
Mr Owen
Ms Turk

CONGDON ON FINANCING THE BALANCE OF PAYMENTS

The Chancellor was grateful for your note of 5 September. As you know, the reason for commissioning this was that the Prime Minister has asked for a note on the Congdon article.

2. The Chancellor was puzzled why your account omitted any reference to the balancing item. The current account deficit has been financed by the balancing item to a significant extent. Over the most recent four quarters (1987 Q2 to 1988 Q1) this was over £6 billion. Some of this may of course mean a lower current deficit: and of the capital inflow element we simply do not know how much has been "hot".

3. I should be grateful if you could amend your note to include a reference to the balancing item.

ACSA

A C S ALLAN

FROM: MARTIN HURST

DATE: 7 SEPTEMBER 1988

PPS ✓ 12/2

cc: Sir P Middleton
Sir G Littler
Sir T Burns
Mr Scholar
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Hibberd
Mr O'Donnell
Mr Owen
Ms Turk

Ch
OK?

CONGDON ON FINANCING THE BALANCE OF PAYMENTS

As requested, I attach an amended note on this for Number 10. The main revision has been to include a discussion of the balancing item, but the opportunity has also been taken to clarify the periods over which various assertions apply.

Martin Hurst

MARTIN HURST

CONGDON ON FINANCING THE BALANCE OF PAYMENTS

1. Congdon's thesis is that the balance of payments deficit has been financed not by increased overseas direct investment in the UK - which he regards as fairly long term, stable, finance - but by short term flows or 'hot money' which are inherently volatile.

2. Data on capital flows are available to 1988Q2 for banking flows and to 1988Q1 for portfolio flows and for direct investment. Congdon's analysis deals with the twelve months period prior to these dates and is seriously flawed for the following reasons:

(i) Congdon argues that the £10 billion net inflows to UK banks are hot money, but in fact they represent almost entirely UK banks' repatriating holdings of overseas equities in 1987Q4. Net inflows in the form of bank deposits and loans, the 'hottest' money, have been roughly nil over the last few quarters.

(ii) Gilts and equities held by foreigners have become more liquid in the last few years but many such inflows are acknowledged to be long term investments. (Hong Kong and Shanghai bank's investment in Midland is a good example.) Furthermore, almost all the increase in net portfolio inflows over the last twelve months is actually attributable to UK institutions repatriating considerable amounts of overseas assets in 1987Q4. This represents a running down of a small part of the substantial holdings of net overseas assets which have been built up over the last decade. Overseas portfolio inflows, which could arguably play the role of hot money, were very little changed from the levels of previous years.

(iii) Total direct investment continues to show a net outflow but most of this represents unremitted profits, ie earnings by overseas subsidiaries of UK companies which have been retained by the subsidiary. Net new direct investments have recently shown that investment from overseas in the UK exceeds overseas investment by UK firms.

3. Analysis of the relationship between the current account and particular types of capital flows is complicated by the existence of large variable balancing items over the past. The balancing item,

positive in all but one year since 1977, averaged £7½ billion per year between 1984 and 1987, with an abnormally large figure of £14½ billion in 1986, much of which is thought to relate to unrecorded investment from overseas associated with Big Bang. In 1987 it was £3½ billion, and 1988Q1 alone has seen a further £3½ billion. Congdon makes no mention of the balancing item, which (with positive sign) acts to 'finance' the recorded current account. Some of the balancing item may in fact represent unrecorded current account credits; and of that part which represents unrecorded capital inflows we cannot tell how much, if any, could be classified as 'hot'.

4. Abstracting from problems with the balancing item, inflows of what could perhaps be termed hot money were at most only slightly higher over the last twelve months for which data is available than in the past. But neither Congdon nor ourselves can say much about flows over the last five months and it is likely that the level of repatriations of overseas assets will decline from the unusually high level of 1987. Certainly figures for 1988Q1, and preliminary institutional data for Q2 do not show any evidence of further repatriations. But less money is likely to be required to finance exchange rate intervention. It is also probable that the United States' requirements for foreign capital will decline as their trade balance improves. The US current account is expected to improve by around $30 billion this year.

5. The current account deficit has to be seen against this reduced demand for mobile foreign capital, the current attractive level of UK interest rates and the healthy state of public finances.

C,

CST would be grateful for

comments today if possible.

AH

8.9.

Mr [illegible]

I have suggested a [illegible].

[illegible]

(I also agree with you, except where noted.)

[illegible]

PS/CHANCELLOR -2.

FROM: MISS C EVANS
DATE: 8 September 1988

cc: PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir Peter Middleton
Sir T Burns
Mr Scholar
Mr Odling-Smee
Mr Peretz
Mr Culpin
Mr Gieve
Miss Simpson
Mr Call
Mr Tyrie
Mr Cropper

BALANCE OF PAYMENTS

I attach a draft of the Chief Secretary's proposed speech on the economy. The speech is to be delivered on Saturday but released tomorrow. This has not yet been cleared with officials - could I ask for copy recipients' comments by close today please.

P Wallace

pp **MISS C EVANS**
Private Secretary

Miss Evans

Thank you. The simplest thing is ~~to~~ to let you have this text. Let me know if you can't read the Chancellor's amendments. He has said he agrees with my own suggestions, except where indicated.

AAH

89.

SPEAKING TODAY TO [ ] THE CHIEF SECRETARY TO THE TREASURY, THE RT HON JOHN MAJOR, MP, SAID:

To read some recent commentators one could believe we are facing economic catastrophe. Far from it. The foundations of our economy are sound and strong and British firms are doing extremely well.

2. Take manufacturing for example. Exports are up 7% over the last year, taking them to record levels. The CBI's surveys indicate that firms' are confident that they can do better still. Order books are strong. As a result, there is an investment boom under way as British industry equips itself with the best and most up-to-date equipment.

3. The astonishing transformation of the economy which has taken place since 1979 has spread new prosperity. Living standards are up at all multiples of average earnings. And unemployment has been falling steadily for over 2 years, month in, month out. In every single region of the country - without exception.

4. This healthy state of affairs is no accident. It has come about because we have set the right ~~the~~ policy framework and stuck to it consistently [over many] years. Nigel Lawson has pursued policies for the long term designed to liberate an economy that had [stagnated] during much of the 1970s. That is why he has

or 'for the best part of a decade'.

for many years

fallen further and further behind our competitors pursued policies of deregulation and tax reduction. And above all he has pursued policies which have tamed inflation. This clear framework has given industry the stability it needs to plan for the future with confidence. We have earned that confidence by holding to our principles, not pursuing the short term solutions that others urge upon us.

5. So, what is the fuss about? The recent current account deficit figures are certainly unwelcome. No-one doubts that. But ~~this~~ the increase in the deficit is not so much a problem in itself as a symptom of a different concern. Although much of the deficit is accounted for by the investment boom, there is no doubt that demand in the economy has been growing unsustainably fast. Faster than even our revitalised industry's ability to expand output. As a result imports are drawn in, and the mismatch between imports and exports has led to a current account deficit.

6. There is a fundamental difference between this state of affairs and the crises we were facing time and again in the 1960s and 1970s. Then, the trade deficit reflected profligate government spending ~~based on~~ financed by massive borrowing. The contrast with today could not be greater. The public finances are in better shape than for a generation. We have turned the Government from being the largest borrower in the economy to the largest repayer of debt. The Budget is in surplus. And for the last two years we have not only cut borrowing, but we have simultaneously cut tax rates and increased public spending.

7. The trade deficit we are now seeing is the result of private sector activity. This is because of strong growth in individual spending, and even stronger growth in industry's reinvestment programme.

8. I can understand that people may be puzzled when the Government asserts, with perfect truth, that the economy is doing excellently and yet interest rates rise and the balance of payments deficit widens. They ask, naturally, why is this happening? Why is demand growing so strongly? Why are companies and individuals spending more? Precisely because they are so confident about our future prospects. Industry is investing in order to produce higher output. Individuals are buying the goods which are the mark of a better quality of life and the tangible sign of a more prosperous Britain. Because they are confident they are tending to save less. They borrow, in the expectation of being able to put money aside in the future to pay back their debts. Or they spend out of savings. That confidence is welcome and justified. But the resulting borrowing must be responsible. And it must not lead to spending at a rate the economy cannot sustain. That is a recipe for inflation.

9. That is why the Government has responded. The Chancellor has taken timely and appropriate action by raising interest rates. Interest rates change the balance of attractiveness between saving and borrowing. And they are well directed at the housing market which ~~is~~ has been a particular source of concern.

10. This is the right response. It is consistent with our underlying philosophy. We are not going to introduce credit controls, as some are urging us to do. Credit controls would be unwise and unworkable. ~~What's more,~~ In today's more open and international economic scene they could be avoided all too easily. We believe that people are able to make their own realistic judgments about the level of repayments they can afford.

11. So there will be no panic response. No credit controls. And no Autumn Budget either. ~~The Chancellor made the right Budget judgment in March when he introduced~~ a crucial and far-reaching supply-side reform. ~~And~~ it will be seen ~~to have been a great~~ opportunity, The Chancellor had the courage to seize. ~~that opportunity and~~ the country will reap the economic benefits of those reforms well into the future.

12. My message is simple. There was a need to nip inflationary pressures in the bud. That is why the Chancellor raised interest rates. It will take ~~a little~~ time to work through. But ~~it is undoubtedly the right policy.~~

The economy remains in excellent shape, and the policies which have brought this about will remain in place.

mg2.jw.mofigs

CONFIDENTIAL

FROM: S BROOKS
DATE: 8 September 1988

1. MR GRICE JWG 8.9.88

2. ECONOMIC SECRETARY

cc PS/Chancellor
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Sedgwick
Mr Peretz
Mrs Lomax
Miss O'Mara
Mr Bush
Ms Ryding o/r
Mr Hurst

File: MAMC C9

What is the normal timing lag between changes in interest rates & deceleration in M0 growth?

M0 FIGURES

The latest weekly figures, covering the first week in September are attached. They show that the 12 month rate of growth of M0 in the latest 4 week period was 7.3 per cent (7.4 per cent not seasonally adjusted). The 12 month rate of increase of notes and coin over the same period was 7.8 per cent (7.9 per cent nsa).

2. The 6 month rate of change of notes and coin was 11.2 per cent in the latest 4 week period, higher than in August.

S Brooks

S BROOKS

TABLE 16 CONFIDENTIAL (Until Publication)

M0 : THE WIDE MONETARY BASE

Monthly data	Level £ million (Change in brackets)							Percentage change on previous month		6 month % growth annualised		Percentage change on previous year			
	Notes and Coin (nsa)	Notes and Coin (sa)		Bankers' Deposits	M0 (nsa)	M0 (sa)		Notes(sa) and Coin	M0 (sa)	Notes & Coin (sa)	M0 (sa)	Notes and Coin (nsa)	Notes and Coin (sa)	M0 (nsa)	M0 (sa)
1988 January	15458	15620	(-41)	181	15638	15801	(-45)	-0.3	-0.3	6.1	5.3	4.7	4.5	4.8	4.6
February	15353	15659	(39)	124	15477	15783	(-18)	0.2	-0.1	5.3	4.5	5.7	5.7	5.3	5.3
March	15588	15753	(94)	162	15750	15916	(133)	0.6	0.8	5.0	4.6	6.9	6.4	6.4	5.8
April	15797	15826	(73)	229	16026	16055	(139)	0.5	0.9	4.8	5.1	5.8	6.1	5.9	6.2
May	15870	15954	(128)	178	16048	16132	(77)	0.8	0.5	5.6	5.5	6.0	6.5	5.7	6.2
June	16073	16143	(189)	174	16247	16317	(185)	1.2	1.1	6.3	6.0	7.5	7.1	7.7	7.3
July	16411	16271	(128)	188	16599	16459	(142)	0.8	0.9	8.5	8.5	7.5	7.3	7.0	6.9
August	16576	16461	(190)	156	16732	16617	(158)	1.2	1.0	10.5	10.8	8.1	7.9	7.8	7.6
September(1/4) @	16644	16661	(200)	153	16797	16814	(197)	1.2	1.2	11.9	11.6	8.4	8.4	8.1	8.1
Latest 4 weeks @	16622	16544	(202)	132	16755	16676	(140)	1.2	0.8	11.2	10.8	7.9	7.8	7.4	7.3

Weekly data	Level £ million (Change in brackets)					Percentage change on previous week
	Notes(sa) and Coin		Bankers' Deposits	M0 (sa)		M0 (sa)
August						
3rd	16376	(73)	217	16593	(31)	0.2
10th	16415	(39)	187	16602	(9)	0.1
17th	16428	(13)	176	16604	(2)	0.0
24th	16487	(59)	78	16565	(-39)	-0.2
31st	16599	(112)	122	16721	(156)	0.9
September						
7th	16661	(62)	153	16814	(93)	0.6

@ Weekly data for the current month so far include estimates for the unbacked note issue. The latest week also includes an estimate for coin. The changes for the current month so far use as a base the previous full month and the full month a year ago.

mg2.cc/Brooks/91g.16.9.9

CONFIDENTIAL

FROM: S BROOKS

DATE: 9 September 1988

1. MR PERETZ 9/9

2. CHANCELLOR OF THE EXCHEQUER

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Sedgwick
Mr Peretz
Mrs Lomax
Miss O'Mara
Mr Grice
Mr Bush
Mr Hurst
Ms Ryding

MAMC: F1

Thanks

MO FIGURES

You asked (Miss Wallace's minute of 9 September 1988) about the normal time lag between interest rate rises and declines in MO growth.

2. Interest rates affect MO in two ways. There is a direct effect reflecting the fact that the interest rate is the cost of holding cash, and an indirect one from the change in economic activity induced by the change in interest rates.

3. Of the two effects we are more confident about our estimates of the direct impact. In the long run, according to the Treasury model, a one percentage point increase in interest rates reduces MO by about ¾ per cent. The profile of this effect is shown in the table below.

Effect of a one percentage point increase in interest rates on MO

Quarter	Effect (%)
1	- 0.1
2	- 0.3
3	- 0.5
4	- 0.6
Long run	- 0.8

4. It is much more difficult to be at all sure of the size and profile of the indirect effect. It works partly through consumers and firms taking into account the higher cost of borrowing and higher return to saving when making their expenditure decisions. But it also works partly by influencing consumers' and producers' confidence. Indeed, in the first few quarters, this is likely to be the most important mechanism at work. But the exact effects will depend on the circumstances and are notoriously difficult to capture in an econometric model. These confidence effects were discussed at Sir Peter Middleton's meeting on current monetary conditions on 7 September, reported in Mr Grice's submission to you of today.

S Brooks

S BROOKS
MG2 Division

CONFIDENTIAL

FROM: KEVIN DARLINGTON
DATE: 9 SEPTEMBER 1988

1. MR SEDGWICK p. N.S 9. ix

2. CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Paymaster General
Sir P Middleton
Sir T Burns
Mr Monck
Mr Scholar
Mr Odling-Smee
Mr Peretz
Mr Hibberd
Mr Gieve
Mr Grice
Mr O'Donnell
Mr Hurst
Mr O'Brien
Mr Cropper
Mr Tyrie
Mr Call

Ch
But are figs affected by v large balancing item between financial & national accounts?
AA

PSR pursue this -

THE COST TO INDUSTRY OF CHANGES IN SHORT TERM INTEREST RATES

Introduction & Summary

At your meeting on August 25 you asked for a note setting out what we thought would be the impact on the company sector of a 1 per cent increase in short term interest rates (copy of Mr Allan's record of the meeting attached to your top copy only). This note examines recent trends in ICC's holdings of liquid assets and liabilities and their implications for estimates of the net direct cost to industry of a one per cent rise in short term interest rates.

2. Our current estimate of the direct cost to industry in a full year of a 1 percentage point rise in UK bank base rates is £430 million. (This assumes no behavioural changes as a result of the change in interest rates.) This represents a significant upward revision to the previous estimate which for some time had been £300 million. The higher estimate implies that the ratio between the cost to industry of a 1 percentage point rise in wage settlements and the interest rate cost has fallen from 4 to 1 to 3 to 1.

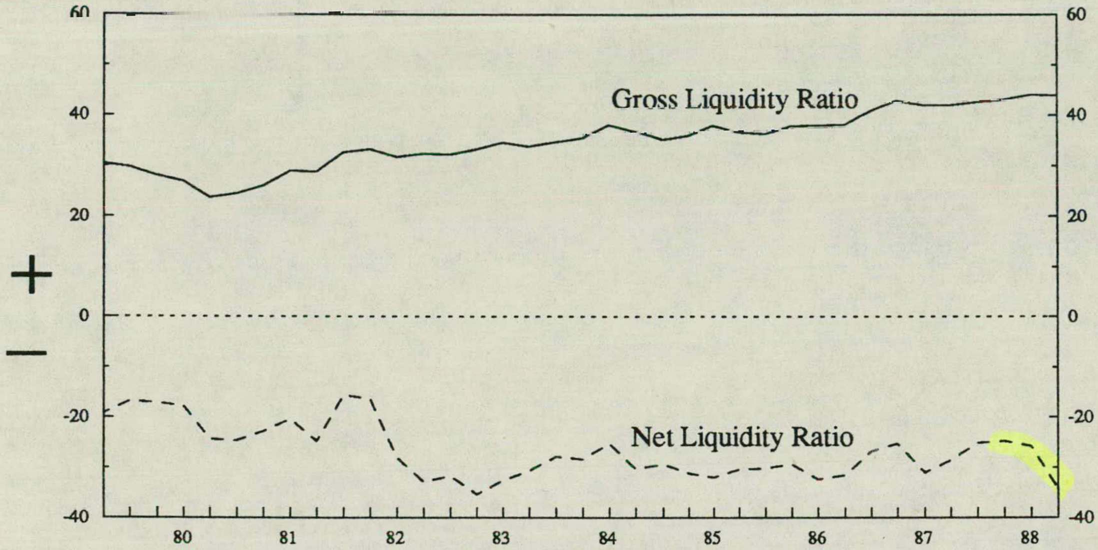
3. The higher estimate of the cost of an interest rate hike is the result of the surge of bank borrowing by ICCs that has taken place so far during 1988. This has not been matched by an increase in holdings of gross liquid assets, thus increasing net liabilities and, hence, the estimated interest rate cost. The rest of this note describes how recent developments in company sector finance have led to the revised estimate of the costs to industry of an interest rate hike.

ICCs' liquidity in the 1980s

4. A striking feature of ICCs' financial position in recent years has been the simultaneous build-up of short-term gross debt and gross

liquid financial assets. The chart shows trends in gross and net liquidity ratios. Whilst gross liquidity has risen fairly steadily

ICC LIQUIDITY RATIOS IN THE 1980s



both ratios expressed as a percentage of total final demand

throughout the 1980s, the build-up of short-term debt has kept net liquidity negative and, broadly, flatter. There has been a sharp fall in net liquidity over the most recent period, no doubt reflecting in part at least the strong rise in investment that we know has been occurring.

5. Table 1 compares ICCs' holdings of liquid assets and liabilities at various points during the 1980s. It shows the expansion on both sides of the balance sheet has come from bank deposits and borrowing.

Table 1 : ICCs' holdings of liquid assets and liabilities (£ billion)

	End 1980Q1	End 1984Q1	End 1987Q4	End 1988Q1
Liquid Assets				
Sterling deposits with monetary sector	10.1	21.3	46.5	47.0
Other deposits	3.7	11.0	9.2	9.3
Treasury bills	0.1	0.3	0.8	0.6
Tax instruments	0.4	1.7	2.2	2.0
British Govt. securities	1.4	2.1	1.0	0.8
Other	0.9	0.4	0.2	0.2
Total	16.6	36.8	59.9	59.9
Liquid liabilities				
Bank lending inc. Issue Dept. holdings of commercial bills	33.6	67.1	94.8	106.5
Net holdings	-17.0	-30.3	-34.9	-46.6

6. The simultaneous expansion of both sides of the balance sheet is the result of a number of factors. Positive real short-term interest rates in the 1980s have been a financial incentive to building gross liquidity. On the liabilities side, the abandonment of the corset in 1980, the distress borrowing of 1981, the advent of securitisation in 1985 (which has led to a narrowing of the gap between the rate of interest on borrowing and that from bank deposits) and, in the last 2 years, the increase in acquisition and merger activity have all played a part.

Developments so far in 1988

7. Bank borrowing surged by almost £12 billion in 1988Q1. This was not matched by any build-up of liquid assets. The effect on net holdings of liquid assets can be seen in Table 1 and is reflected in the fall in the net liquidity ratio in the chart.

8. The strength of bank borrowing reflected the drying up of equity issues post-crash as a source of finance, only £0.3 billion being raised through ordinary shares compared with a quarterly average of £3.2 billion in 1987. Increased dividend and tax payments made a greater claim on income whilst total expenditure on acquisitions and mergers peaked at £6.1 billion, 71 per cent of which was cash-financed.

9. Indicators suggest that the developments in the first quarter have continued in the second quarter. The latest DTI Company Liquidity Survey (of large companies only) shows that companies increased their bank borrowing in 1988Q2 whilst their sterling bank deposits fell. This picture is supported by evidence from the monthly monetary statistics.

Cost to industry of UK interest rate changes

10. For the purposes of estimating the cost to industry of a change in interest rates those assets and liabilities deemed to be sensitive to UK short term interest rates are selected. All identifiable fixed-rate assets and liabilities are excluded, as are those denominated in foreign currencies. This entails excluding some assets and liabilities from the measures of gross and net liquidity such as British Government securities and including others such as Building Society wholesale borrowing. Bank deposits and borrowing at variable rate are the major components of this selected balance sheet. As a consequence, the spurt in bank borrowing in 1988Q1 not only caused net liquidity to fall but also increased the interest rate sensitive net liabilities of ICCs. Table 2 shows the selected balance sheet and the rise in net liabilities of £11.4 billion in 1988Q1.

Table 2 : ICCs' Assets and Liabilities sensitive to UK short-term interest rates

£ billion

	End 1987 Q4	End 1988 Q1
Assets		
Sterling interest-bearing sight deposits with UK banks	13.3	11.4
Sterling interest-bearing time deposits (incl. CDs) with UK banks	28.6	29.4
Local Authority temporary deposits	0.1	0.1
Building Society shares and deposits	0.5	0.5 e
Building Society wholesale borrowing	2.1	2.1
Treasury Bills	0.8	0.6 e
Other	1.8	1.7
Total Assets	47.1	45.7
Liabilities		
Sterling bank lending	71.1	78.8
Issue Debt. holdings of ICCs bills	5.9	8.2
Other	2.8	2.8 e
Total liabilities	79.8	89.8
Net liabilities	32.7	44.1

e = estimate

11. Some of the selected assets and liabilities, such as commercial bills, are only affected by a change in short-term interest rates when they mature. This lagged effect is taken into account when making the cost estimate.

12. Most borrowing by firms as recorded on their balance sheets is short-term and variable rate. Increased use of swaps, however, probably means that the amount of effective long-term fixed rate debt of ICCs is understated. On the other hand, the selected balance sheet excludes finance leases which are affected by short-term interest rates but are not currently recognised as financial liabilities in the national accounts. Furthermore, commercial paper and floating-rate sterling eurobonds are excluded as no accurate data exist. The majority of short-to-medium term debt instruments issued post-securitisation have been at a fixed rate.

13. The estimate of the cost to industry of a 1 percentage point rise in UK bank base rates rose from £320 million to £430 million between the end of 1987 and the end of 1988Q1. Given the indicators of company finance in the second quarter the estimate is likely to remain at or above that level at the end of 1988Q2.

14. The cost to industry of a 1 percentage point rise in wage settlements can be compared to the interest cost in the form of a ratio. This has stood at 4 to 1 in the recent past. We have revised our estimate of the wage cost given the latest Blue Book data for ICCs' wage bill in 1987 and taking into account employment and earnings developments in 1988Q1. The wage cost is about £1.3 billion, implying a lower ratio of 3 to 1.

Kevin Darlington

KEVIN DARLINGTON

Extract of the meeting held in Chancellor's room HMT on 25 August.

National Savings

5. The Chancellor said he hoped it would be possible to announce new National Savings rates for income bonds, INVAC, and deposit bonds. The question was whether the increase should be $1\frac{1}{2}$ per cent or 2 per cent. He was concerned about the accusations of bad faith in failing to honour the prospectus commitment that rates would be kept competitive, and would be ready to make the increase 2 per cent if that was what was necessary to kill these stories, which he took very seriously indeed. Mr Peretz said he had not yet talked to DNS. As soon as the interest rate increase was announced he would do so and would press them to see if the announcement could be made tomorrow. His view was that an increase of $1\frac{1}{2}$ per cent was perfectly adequate to counter the criticisms, but he would discuss this further with DNS; it was unlikely that the building societies would increase rates to depositors very substantially, since they were flush with funds and there were signs that mortgage approvals were dropping off.

Briefing

6. Various points on the briefing were discussed:

(i) the Chancellor thought some amendment was needed to the line on the impact on industry: this should stress that industry was doing very well and would continue to do very well; and it should make the point that industry did not, in general, finance its investment by overdrafts. Mr George noted that there would be offsetting effects on companies' holdings of liquid assets, since the company sector was very liquid. The Chancellor thought this was an important point, and asked for a note in due course setting out what we thought the impact would be on the company sector of a 1 per cent increase in short-term interest rates;

(ii) there was some discussion about whether the line to take should impart a flavour of international collaboration or chex.ps/mw/20

CONFIDENTIAL

FROM: MISS M P WALLACE
DATE: 9 September 1988

MR S BROOKS

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Sedgwick
Mr Peretz
Mrs Lomax
Miss O'Mara
Mr Grice
Mr Bush
Ms Ryding
Mr Hurst

BF 16/9

M0 FIGURES

The Chancellor has seen your minute of 8 September to the Economic Secretary, attaching the latest M0 figures. He has asked what the normal time lag is between rises in interest rates and declines in M0 growth.

MPW.

MOIRA WALLACE

mg2.jw.docs.mma.midmin

COPY NO. 1 OF 37 COPIES

SECRET AND PERSONAL

FROM: J W GRICE

DATE: 9 September 1988

1. SIR PETER MIDDLETON

2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Sir T Burns
Sir G Littler
Mr Lankester
Mr Monck
Mr Scholar
Mr H P Evans
Mrs Lomax
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Gieve
Mr Hibberd
Miss O'Mara
Mr Riley
Mr Brooks
Mrs Ryding
Mr Cropper
Mr Tyrie
Mr Call

Mr Cassell - Washington

File: MAMC F1

MONTHLY MONETARY ASSESSMENT: AUGUST 1988

This note records the discussion at Sir Peter Middleton's monthly meeting on monetary conditions on 7 September. Attached is the usual Monthly Assessment.

Sir Peter Middleton's Meeting

2 Beginning the discussion, Mr Scholar said at the international level, there were signs of change - mainly for the better. Growth seemed to be moderating to more sustainable levels and this would be helped by the monetary tightening in August in most major countries other than Japan. There were no signs of

inflationary pressures: indeed, commodity prices had levelled off, though remaining much higher than a year ago.

3. Domestically, there was no evidence yet of a response to the progressive tightening of policy. Inflation was edging up but no more than anticipated in the June Forecast. Otherwise, the indicators looked threatening:

a) house prices had accelerated for 7 months consecutively with the Halifax index now showing 12 month growth in excess of 30 per cent, and the other indices just below. Some commentators saw signs of levelling off but their reasoning looked flimsy. Nationally, house prices could still have some way to go;

b) similarly, there were no signs in the statistics so far that M0 growth had peaked. At Budget time, we anticipated that it would re-enter its target range in August: now the Assessment doubted if the range would be re-gained this financial year. Growth in M4 had also clearly accelerated; a month earlier there had been reason to doubt this.

4. Virtually all of this data was available when base rates were increased to 12 per cent on August 25. This rise was ? likely to precipitate an increase in mortgage rates of 1-1¼ per cent on October 1st. These measures should have an impact on consumer confidence, especially if they succeeded in checking house price rises. But it could be some months before the effects showed up in the data. Mr Scholar concluded that on the current evidence it was right to leave interest rates at their present levels. But he recognised that market circumstances could make that objective difficult to achieve. !

5. <u>Mr Coleby</u> agreed with Mr Scholar's appraisal and with his policy conclusion. The supply side of the economy had performed remarkably well. There was little inflationary pressure - the current account had acted as an effective safety valve. But demand clearly remained uncurbed as yet. In the housing market, those commentators who saw price rises easing were probably over-

influenced by events in the South-East. There had been a change of gear there, perhaps because of the altered tax treatment of multiple mortgages. Overall, like Mr Scholar, he would want to wait for fresh evidence before moving interest rates again. But the foreign exchanges were a potential threat to this strategy. Events at the end of the previous week had demonstrated the current fragility of confidence, though there had been an improvement this week.

6. Sir Terence Burns felt that there had not been a great deal of evidence since the June Forecast but it had all pointed one way: in particular, the current balance and, most worryingly, the continued buoyancy of M0. He believed that we might have been passing through a short period of particularly strong demand over the last couple of months. Tax rebates, forestalling of the changed tax treatment of multiple mortgages and the new car registration year beginning in August had all boosted demand. Latterly, there was some indication of a change of tempo. Newspaper stories on consumer credit now concentrated on the dangers of debt rather than its cheapness and availability. It could be that consumers' moods were changing but there was no hard evidence of that yet.

7. Mr Flemming noted that evaluating the effect of the interest rate changes was complicated by the growing practice amongst mortgage lenders of changing monthly repayments only at infrequent intervals, regardless of intervening mortgage rate changes. Much of the effect of rate changes therefore depended upon the extent to which people adjusted current behaviour to anticipated future changes in their repayments.

8. Professor Griffiths said that the main impression of the current economy was of excess demand, manifested in the current account deficit and generated by a monetary/credit thrust. The M0 projections were now very different from their Budget time profile. It made it imperative to ask whether the house price rise was not just a shift in relative prices but a precursor to a more general inflation.

9. Taking up this point, Sir Peter Middleton initiated a general discussion. He noted: (i) all the money numbers looked bad; (ii) money GDP had accelerated; (iii) domestic demand volumes had grown considerably more quickly over the last year than domestic output. We needed to ask ourselves:

- when M0 growth would fall. Were the projections in the Assessment now realistic;

- why money GDP growth had exceeded expectations;

- if money GDP had accelerated in the past, were we right to think present levels of interest rates were sufficient to bring the economy on course?

10. During the discussion, the following points were made:

(i) M0 had continued to prove a reliable indicator. Its future behaviour largely depended upon what happened to money GDP;

(ii) the main factor underpinning the acceleration in money GDP had been the buoyancy of consumer spending. It was possible to cite the factors that might be involved - for example, rising real incomes and growing personal wealth, especially in housing. But past relationships between such factors and spending were incapable of explaining quantitatively what has happened this time;

(iii) what little rise in inflation had occurred was largely due to higher profit margins rather than cost pressures. Higher margins could give a helpful cushion against any future cost increases though higher profitability might also make firms less resistant to cost pressures;

(iv) in the past, considerations such as exchange market conditions and the fragility of confidence after the stock exchange crash had prevented us raising interest rates to the extent we would have liked. For the moment, such constraints were less pressing. The interest rate/exchange rate mix was now much better than had been obtainable in the past;

(v) an important aspect of the working of high interest rates, particularly in the short run, would be the effect on confidence, especially of consumers. The aim must be to counter over-ebullience on the part of consumers without causing a serious decline in confidence in industry or precipitating a damaging recession. This would not necessarily be easy.

11. Summing up, Sir Peter Middleton said that there had been a substantial rise in interest rates. The meeting was agreed in recommending a period of stability to see what the effects would be. But we could not be confident that rates were now at the right level. If market pressures required action, the recommendation was to err on the side of tightness.

JWG

J W GRICE

cc: Governor)
Deputy Governor)
Mr George) Bank of England
Mr Flemming)
Mr Coleby)
Mr Plenderleith)

Professor Griffiths - No 10

SECRET AND PERSONAL

MONTHLY MONETARY ASSESSMENT: AUGUST 1988

Summary Assessment

The critical factor in assessing monetary conditions over the next month or two will be to detect what impact higher interest rates are having. It is too early to be able to pick up signs of deceleration in activity and indeed the available data suggest a very buoyant economy. The fall-off in building society lending commitments in August is a straw in the wind to the contrary. But MO, another timely indicator, continues to grow strongly.

Main Points

MO's 12 month rate of growth rose to over 7½ per cent in August from just under 7 per cent in July. MO growth is expected to fall from now on but it is not expected now to regain its target range this financial year. (Paras 29-30, table 25, Chart VI, Annex)

Short term interest rates have risen by about 1½ per cent since the last assessment. Sterling's interest rate advantage has risen by less as rates abroad have also increased. (Paras 4, 41-42. Table 3).

Sterling's effective exchange rate has fallen 1¾ per cent since the last report (28 July). But lower oil prices will more than offset the inflationary impact: the oil adjusted ERI has risen by nearly 1½ per cent. (Paras 27-28).

M4 growth rose to 17½ per cent in July (June: 16¾ per cent) tending to confirm earlier evidence of an upward trend. Bank and building society lending growth was 23¾ per cent in July, a record. (Paras 31-36).

Money GDP growth Recent economic statistics indicate growth in first half of year was higher than expected last month. RPI inflation is now expected to be 6½-7 per cent at the end of the year (5-5½ per cent excluding mortgage interest payments). (Paras 17, 18, 23).

The PSDR, projected in the June forecast at £7.4 billion, could turn out even higher. (Paras 24-26).

House prices increased by 28 per cent in the year to July according to the Halifax index (June: 24 per cent.) But building society commitments in August so far have fallen off sharply. (Paras 21-22, 35).

ANNEX: THE BEHAVIOUR OF MO

MG2 Division

8 September 1988

SECRET AND PERSONAL

MONTHLY MONETARY ASSESSMENT: AUGUST 1988

Summary Assessment

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MG2 Division
8 September 1988

ANNEX : THE BEHAVIOUR OF MO

SECRET

Monetary developments since last month's report

Latest outturns available at time of:

	February Report	**July Report**	**August Report**
Monetary aggregates (12 month % growth)	**(Jan)**	**(June)**	**(July)**
M0 (sa)	4.6	7.3	6.9
M3	22.5	20.2	20.6
M4	16.6	16.8	17.4
M5	16.3	6.1	16.7
Bank lending	24.7	27.8	27.9
Bank & building society lending	20.1	23.0	23.6
Interest rates (%)	**1 March**	**28 July**	**7 September**
3 month interbank	9.3	10.8	12.1
20 year gilt-edged (par yield)	9.1	9.5	9.6
Yield gap	0.2	1.3	2.5
UK real 3 month interbank	5.1	5.3	6.2
Equity dividend yield (all share)	4.2	4.2	4.5
IG yield (2001) assuming 5% inflation	3.9	3.9	4.0
3 month UK interest differential with			
Germany	6.0	5.4	7.2
US	2.6	2.4	3.8
World basket	3.3	3.8	4.9(est)
Exchange rate			
$/£	1.78	1.73	1.70
Yen/£	228	228	228
DM/£	2.99	3.21	3.14
ERI	74.8	76.8	75.9
Oil adjusted ERI*	106.9	108.1	109.6
Asset prices			
FT-A Index (% pa)	-8.0	-20.4	-20.6
FT-A Level (July 1987 peak: 1239)	914	960	913
Halifax house index (% pa)**	16.9	24.1	28.0

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* The oil adjusted ERI shows whether the joint effect of oil price and exchange rate changes has been counter-inflationary or otherwise, relative to the base period Jan 1983-Nov 1985, on the assumption that the inflationary effect of a 4 per cent rise in oil prices is exactly offset by a 1 per cent rise in the exchange rate.

** 12 month growth rates shown are for January, June and July. August 30½ per cent.

SECRET AND PERSONAL

A. External Developments

1. After a spurt in the second half of 1987 and the first quarter of 1988, economic growth in the major countries may have moderated to a rate closer to potential in the second quarter. US GNP continued to grow at an annual rate of 3 per cent. German GNP was 3 per cent higher than a year earlier but slightly lower than in the first quarter which was erratically high. Industrial production in Japan was 10 per cent up on a year earlier but about the same as in the first quarter.

2. Prices of metals and agricultural raw materials fell back in July somewhat since early June, having increased very sharply earlier in the year. Food prices, however, were increased by the American drought. On 9 August, the Economist all-items commodity price index (in SDRs) was 8½ per cent lower than on 7 June, though still 27 per cent higher than a year before. By the end of August it was 3.7 per cent higher than a month earlier and 33 per cent higher than a year earlier. Dollar oil prices have fallen by about 15 per cent since the end of July.

3. The drought has started to affect producer and consumer prices in the US, but inflation overall in the major countries has remained almost unchanged, at 2½-3 per cent, so far this year

4. Short-term interest rates have risen in the US. Though growth in the targeted aggregates has remained well within their ranges, the continuing strength of the US economy and the rise in commodity prices has made the Fed more concerned about inflation. Further rises in US interest rates are possible. Germany and Japan have taken the opportunity offered by the appreciation of the dollar since June to increase their own interest rates (table 3).

5. The dollar moved up from DM1.8690 and Y 132.55 at the opening on 29 July to over DM1.92 and Y135 on 9/10 August (in characteristically thin August trading) as US interest rates firmed on concern about the inflationary implications of continued growth. The ¼ per cent rise in the Bundesbank repo rates to 4¼ per cent on 2 August had little effect on the foreign exchanges. Although the dollar benefited in previous months from

the strengthening of the US trade account, worse than expected June trade figures led to a sharp fall in the dollar but had no lasting effect. However periodic bouts of concerted intervention and comments from Stoltenberg and an unnamed US official that a further rise in the dollar would be unwelcome eventually took their toll and the dollar eased further to DM1.8580, following the increases in European interest rates (including a ½ per cent rise in the Bundesbank's discount rate to 3½ per cent) on 25 August. The dollar ended August firmer especially against the Yen (on rumours of a tax on Japanese stock market profits and an announcement that Japan would not raise its discount rate). But it slipped back as the view that an early rise in US interest rates was unlikely gained ground, to close at DM 1.8455 and Y 133.87 on 7 September. The Bundesbank sold around $2½ billion and the Fed $1½ billion over the period.

B. Activity and Inflation

6. Recent indicators of activity and inflation are summarised in table 6. All the evidence continues to point to very strong growth of domestic demand and output, at a rather faster rate than anticipated in the June forecast. Indicators confirm an upward drift in retail and producer price inflation, broadly as expected.

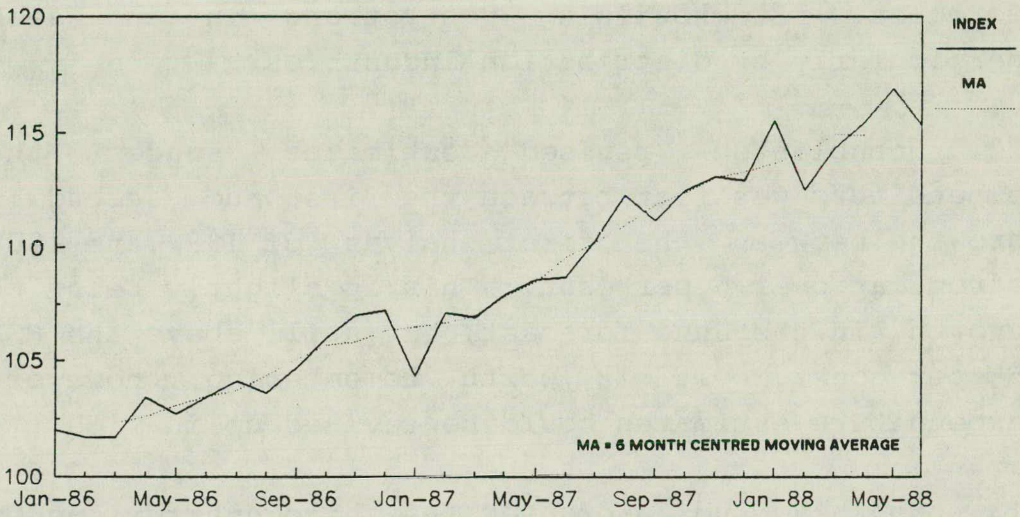
Activity and demand

7. The preliminary estimates of **GDP(O)** for the second quarter of 1988 showed a strong rise of nearly 1½ per cent between the first and second quarters, largely accounted for by growth in the manufacturing sector and in the banking, insurance and finance industries. The growth rate on a year earlier has now been stable at 5-5½ per cent since the third quarter of 1987, with the slight slowdown in the second quarter apparently only a temporary fluctuation from a steady upward trend.

8. Upward revisions to **manufacturing output** in the first quarter have virtually removed the slowdown in growth in this sector which were evident in earlier estimates. This confirms the view we took that the trend in manufacturing output remained upwards, and

suggests that growth - now put at 7 per cent in the year to 1988Q2 - is probably even stronger than we were expecting.

Chart : Index of manufacturing output



9. The August **CBI Monthly Trends enquiry** provides further confirmation of strong growth in manufacturing output and demand. The balances on the volume of output and total orders questions both rose in August, and, on a seasonally adjusted basis, are close to their highest levels since 1977. The balance of firms expecting to raise prices fell in August and remains close to the average level since early 1987.

10. In the year to the second quarter strong growth has also been recorded by service industries (up over 5 per cent) and, on the basis of CSO projections for the second quarter, by the **construction** industry, which is thought to have grown by nearly 14 per cent over this period. Private sector housing starts and completions fell back slightly in the second quarter from the exceptional first quarter levels, but they remain well up on 1987 levels. Growth in these sectors has been partly offset by small falls in agriculture, oil and gas extraction and other energy and water supply industries.

11. Provisional estimates of **investment** by manufacturing, construction, distribution and financial industries show growth of over 3½ per cent in the second quarter to a level around 11 per

cent higher than a year earlier. **Manufacturing investment** grew particularly strongly, with the growth between the first halves of 1987 and 1988 now put at 13 per cent. Both manufacturing and non-manufacturing investment appear to have grown more rapidly over the past year than we had thought at the time of the June forecast. **Stockbuilding** was strong in the second quarter, particularly by distribution industries.

12. Unpublished revised estimates suggest that **consumers' expenditure** was flat between the first and second quarters, but growth between the first halves of 1987 and 1988 remains very strong at over 6 per cent. This is slightly below the 7 per cent growth in the June forecast, but still above the FSBR forecast of 5½ per cent. It is worth remembering, however, that these expenditure estimates could be revised up in time.

13. Monthly indicators for the third quarter suggest there could have been a strong surge in consumption in July and early August. The volume of **retail sales** rose by nearly 2½ per cent in July following a period of little growth during the second quarter. And SMMT figures for **car registrations** in the first 10 days of August (not officially published but leaked in the FT) show a sharp rise in sales compared with the same period last year, with the import share up to 60 per cent compared with 55 per cent in the first half of August last year. Registrations for the period 1 January - 10 August 1988 were 12¾ per cent higher than a year earlier.

14. Seasonally adjusted adult **unemployment** fell by 59,000 in July, the largest fall since November 1987 and one of the largest falls recorded since the War. The average fall over the past six months is 40,000 a month. The large fall in July provides further confirmation of the very buoyant state of the economy so far in 1988.

15. The **July trade figures** showed a current account deficit of £2151 million, £1 billion higher than in June. (Only about £80 million of the deficit is attributable to Piper Alpha.) This increase reflected an ½ per cent deterioration in the terms of

trade, a 3½ per cent fall in export volumes and an 11 per cent increase in import volumes. The July deficit is the largest recorded both in nominal terms and, at 5½ per cent, as a percentage of GDP. The trend in non-oil export volumes appears to be upwards, and the underlying level is now higher than at the end of last year. Import volumes (less oil and erractics) have confirmed their upward trend, rising well above their previous highest figure in June.

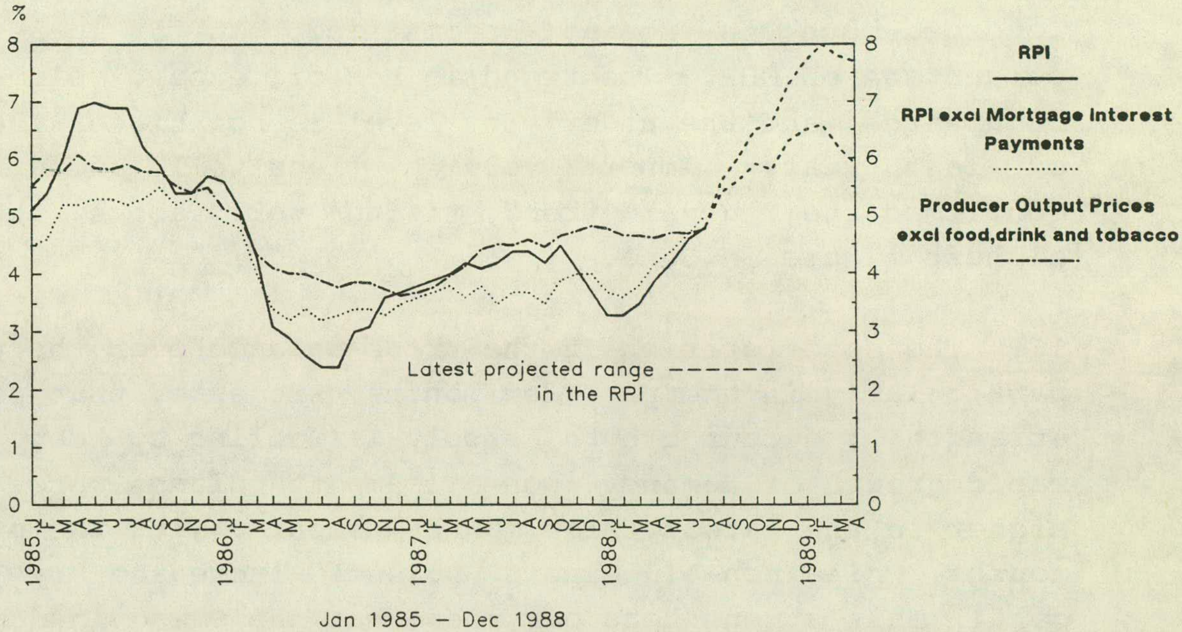
16. The deterioration in the trade balance over the past year and particularly in the past few months, suggests that, despite the strength of output growth, supply is failing to keep pace with the rapid growth of demand. Non-oil import volumes were 11 per cent higher in the latest three months compared with the previous three months, while non-oil export volumes increased by only 4½ per cent. This strengthens our view that the trend in demand has been strongly upward and that the recorded figures for consumers' expenditure in the second quarter may well understate the true position.

Inflation

17. **RPI inflation** has risen in every month since February and reached 4.8 per cent in July, broadly as expected in the June forecast. It now at its highest level since early 1986. The same is true for RPI inflation excluding mortgage interest payments (MIPs), which reached 5.0 per cent in July. A further increase in inflation is likely in August, mainly because of higher mortgage rates, though there does also seem to be an upward trend in the RPI less MIPs. RPI inflation now looks likely to reach about 6½-7 per cent at the end of the year (5-5½ per cent excluding MIPs).

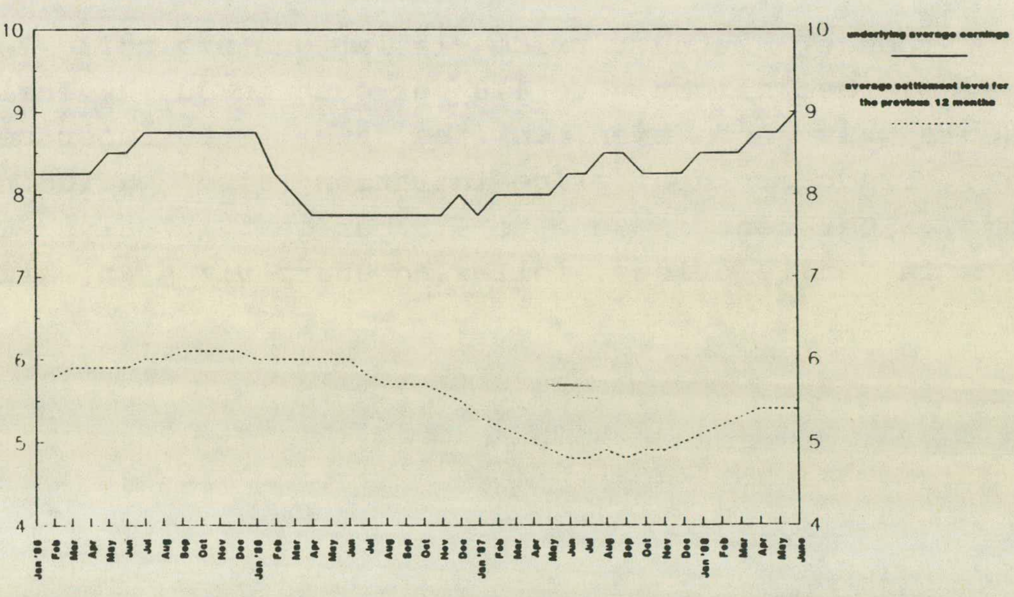
18. **Producer output price** inflation (excluding food, drink and tobacco) rose slightly to 4.8 per cent in July. Inflation on this measure has not been in the range 4½ to 5 per cent for over a year. **Producer input price** inflation (also excluding FDT) fell from 7.5 per cent in June to 4.6 per cent in July. This reflected falls in metals prices, following sharp rises in earlier months.

Chart : Retail and producer price inflation



19. In the private sector, **wage settlements** have risen this pay round. It now looks as if the average level of private sector settlements will be 5¾ per cent this year, up from 5¼ per cent in 1986/87. The rise in the manufacturing sector is likely to be slightly greater - up ¾ per cent to 5½ per cent. Underlying growth of **average earnings** remained unchanged at 8½ per cent for the seventh successive month in June, but underlying earnings growth in manufacturing drifted up a further ¼ point to 9 per cent. Part of the difference between growth of earnings and settlements can be put down to overtime payments, though these have been making a declining contribution in recent months.

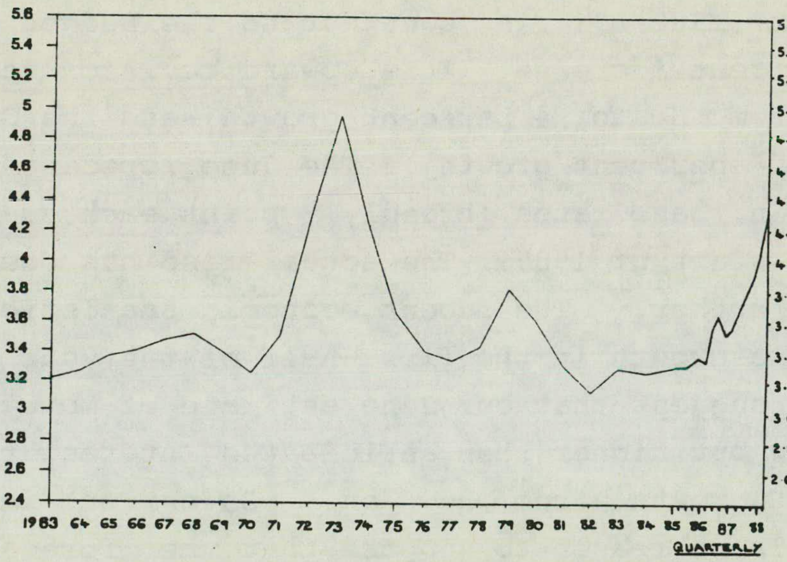
Chart : Settlements and earnings in manufacturing



20. Increases in manufacturing earnings are not having big effects on **unit wage costs** because of continued strong growth in productivity. In the second quarter of 1988 manufacturing productivity was 7.2 per cent higher than a year earlier.

21. **House prices** continue to grow rapidly. The Halifax index shows a rise in prices of 28 per cent over the year to July[1], with a rise of 10.8 per cent over the three months since April. This is the seventh month running in which house price inflation, as measured by the Halifax index, has risen. The rate in December stood at 15.8 per cent. Other available indices of house prices tell a similar story. The two DOE indices based on data on building societies advances - one for advances approved, the other for advances completed - both show house price inflation in July around 27 to 28 per cent.

HOUSE PRICE TO EARNINGS RATIO



22. So there is no evidence so far of any slow-down in the rapid growth in prices on a nationwide basis. Nevertheless, there is something of an emerging consensus among commentators that house price inflation may have now reached a peak. There is some evidence of slower growth in prices in London (from the latest RICS survey of estate agents, and to a lesser extent from recent regional figures from the Halifax and Nationwide Anglia). It is also clear that the 1 August deadline for multiple tax relief did have a significant effect in boosting demand over the months to July. Weekly figures for the largest 14 building societies show

(1) Latest figures show a rise of 30½ per cent in the year to August.

new lending commitments for the first four weeks in August down by nearly 30 per cent on July, although some of this fall may reflect seasonal factors. Mortgage rates increased by around 1¼ per cent on average on 1 August, with a further rise (probably of around 1¼ per cent) to come in October. But, although all these factors point to some slow-down of housing demand growth, the magnitude and timing of their impact on house prices is uncertain. Even if house prices in London - where the impact of multiple tax relief has probably been greatest - slow down markedly, prices in other regions could take some time to follow.

Projections of money GDP

23. The June internal forecast showed a 10 per cent rise in money GDP in 1988-89, in contrast to the Budget forecast which was a 7½ per cent increase. This upward revision was to both activity (up from 3 to 4 per cent growth) and the GDP deflator (up from 4½ to 5¾ per cent growth). The June forecast projected a gradual rise in base rates (broadly ½ point each quarter) to 10 per cent at the start of 1989. The actual rise has been more rapid and has gone further. The recent economic statistics, indicating faster economic growth in the first half of the year than we thought last month, suggest that our June estimate of money GDP growth could be too low but higher than anticipated interest rates should tend to reduce growth from now on. On current information therefore, there is no reason to suppose that the forecast of 10 per cent growth in money GDP is not central. But of course the Autumn Quarterly Forecast will look at this in detail.

C. Public Sector Finances and the Fiscal Stance

24. Table 5 gives the main indicators of the fiscal stance. The PSDR in July 1988 was £1.7 billion (privatisation proceeds were zero). In the first four months of 1988-89, the cumulative PSDR was £3.2 billion, compared to a PSDR of £0.3 billion in the Budget profile. The CGBR(0) was £2.8 billion below profile, the LABR £0.4 billion below profile and the PCBR £0.3 billion above profile. Excluding privatisation proceeds the PSDR in the first four months of the financial year was £0.4 billion, £2.9 billion

greater than the Budget profile and £4½ billion greater than in the same period as last year.

25. The PSDR in the first seven months of 1988-89 is now projected at £5.2 billion compared with projections at Budget time of £0.5 billion and borrowing of £0.9 billion in the same period last year. With greater than expected buoyancy of Government revenues in the year to date and the sale of British Steel in November of this year, the latest projections suggest that the June internal forecast of a PSDR of £7.4 billion for 1988-89 as a whole will be reached and could be exceeded.

26. As we noted last month the increase in the PSDR between the Budget time projection and the June forecast can be more than fully explained by higher privatisation proceeds and the higher June forecast of activity and inflation. On that basis we thought the money GDP adjusted fiscal stance was probably looser than envisaged at Budget time. But recent developments suggest an even higher PSDR than projected in June and accordingly cast doubt on that assessment of the fiscal stance.

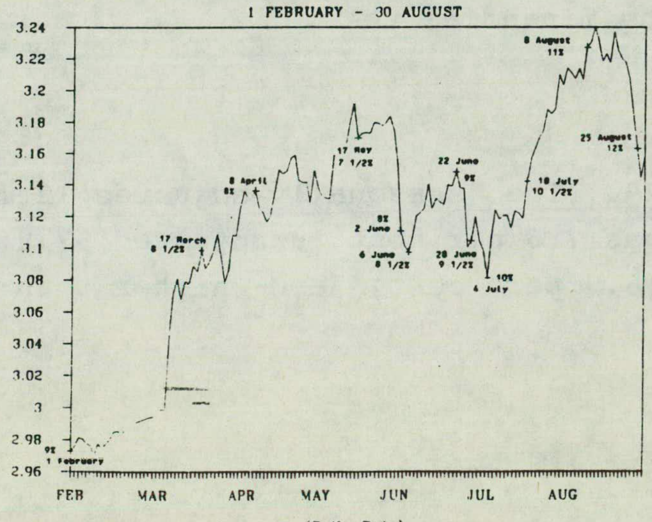
D. Exchange Rate

27. Sterling opened at ERI 77.1, $1.7260 and DM3.2259 on 29 July and traded quietly and narrowly as the markets focused on the dollar. The unexpected ½ per cent rise in base rates on 8 August had only a very modest immediate effect on exchange rates, but sterling moved up with the stronger dollar to DM3.24 on 10 August. However increased concern about the UK current account, particularly after publication of the revised 1987 figures in the

DM/£ & INTEREST RATES

1 FEBRUARY - 30 AUGUST

The DM/ rate has changed little since mid - May when base rates were 7 1/2 %



(Daily Data)

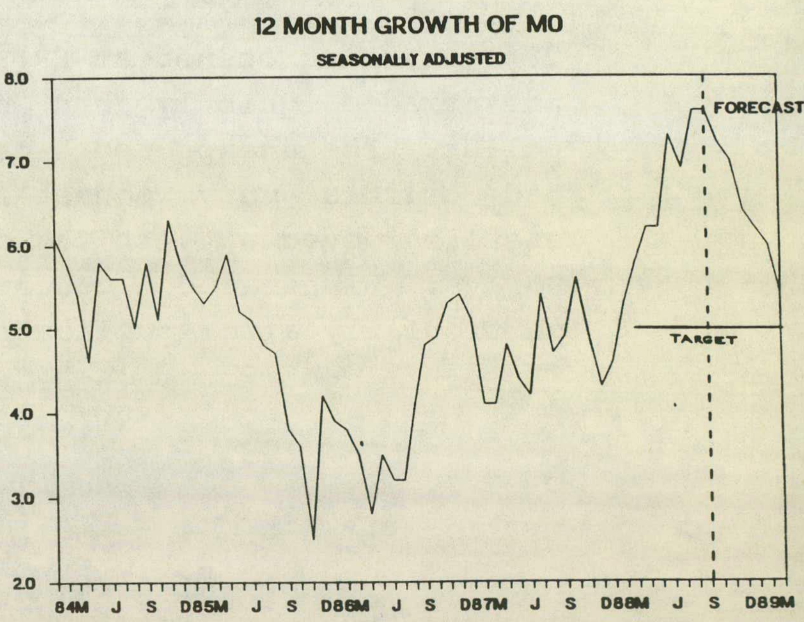
Pink Book, caused sterling to fall away quite sharply and, after the July trade figures were announced on 25 August, it dropped further to lows of $1.6725 and DM 3.135. The pound strengthened quickly when interest rates increased by 1 per cent after the announcement of the trade figures. After pressure very early in September sterling recovered a little and on 7 September sterling closed at ERI 75.9, 1.7030 and DM 3.1430. The Bank sold some $400 million (net) over the period as intervention cushioned the pressure on sterling from late August, offsetting earlier purchases.(The underlying increase in the reserves in August of $830 million reflects the dollar proceeds from the second call on BP shares and intervention at the very end of July for settlement in August.)

28. The fall in the sterling index of just over one per cent since the end of July has been accompanied by a fall in dollar oil prices of over 15 per cent. The combination of a lower exchange rate and lower oil prices may itself have left monetary conditions a little lighter the oil adjusted ERI has risen by just under 1½ per cent since the end of July.

E. Domestic Monetary and Financial Market Developments

Narrow Money

MO growth has been above its range so far in 1988-89, confirming other indicators of strong economic growth. Growth should slow as recent interest rate rises feed through, but is not likely to regain its range before the end of the financial year.



29. The seasonally-adjusted 12 month growth rate of MO in August was 7.6 per cent (unadjusted, 7.8 per cent), higher than in July (6.9 per cent) and higher than in any other month over the past

year. Bankers' operational balances, the more erratic of the components of MO, fell in August. The growth rate of notes and coin picked up from 7.3 per cent in July to 7.9 per cent.

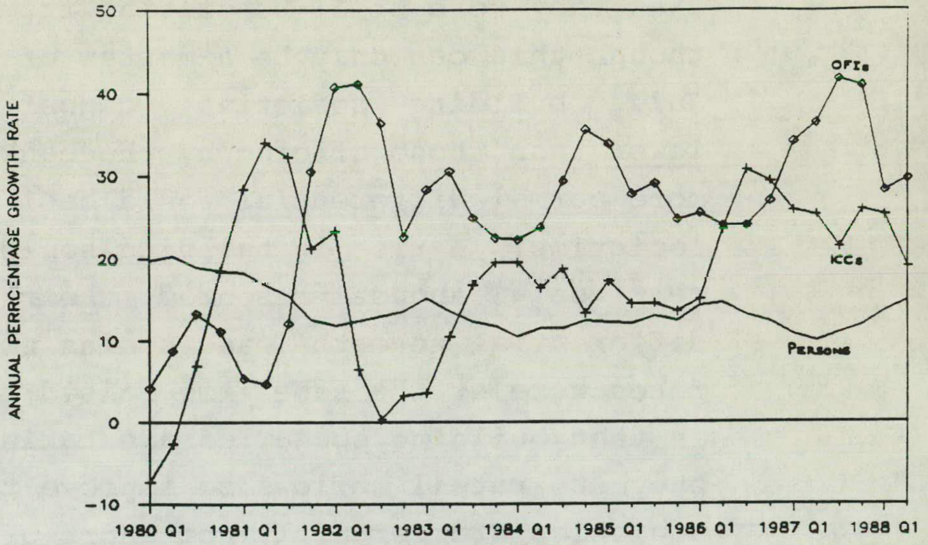
30. After August, MO growth is expected to slow down under the influence of higher interest rates (table 25), but to remain outside its target range for the rest of the financial year. In August MO growth was around 3¾ percentage points above the Budget profile (chart VI). At the end of the financial year, it is expected still to be about 3½ percentage points higher. An annex to this Report discusses the behaviour of MO in greater detail.

Broad Money

Persons' liquidity has accelerated post-crash; OFIs' liquidity growth has fallen back to more normal levels after a Big-Bang related surge in 1986-87.ICCs' liquidity growth has slowed in 1988Q2, reflecting the effects of the crash on corporate finace.

SECTORAL M4

ANNUAL GROWTH RATES



1980Q1 – 1988Q2

31. M4 was 17½ per cent higher in July than a year earlier, compared with an increase of 16¾ per cent in the year in June. Last month we thought that PAYE tax rebates might have been responsible for the high growth of M4, which would have been inflated if personal sector deposits increased by more than companies' deposits fell - especially if companies temporarily increased their borrowing. It now seems likely that we overstated the importance of this special effect. There is no sign in the July figures of firms unwinding temporary borrowing, and banks' retail deposits increased by 1¾ per cent in July - less than in June (2½ per cent) but well above the average increase of 1 per cent per month in the ten months to May (but see also paragraph 33). Although the redemption of 3 per cent Transport Stock, which was largely held by small investors, may have

inflated retail deposits somewhat, it now seems likely that there has been an increase in the underlying growth of M4 over the last couple of months.

32. **Building societies' net retail inflows** were £1.2 billion in July (£2.0 billion including interest credited), more or less the same as in June. This represents a continuation of the high inflows seen in October; net inflows have been in excess of £1 billion for every month from November onwards.

33. Given their deteriorating competitive position against the banks, this represents a good result for the societies. It may be that they were still benefiting from the tax rebates paid in June, though this can only be a matter of speculation. By the end of July, building societies' deposit rates were around ½ per cent lower than those offered by the banks on competing accounts. A more normal differential would be 1 per cent in favour of building societies. A rise in building societies deposit rates of 1.1 per cent on 1 August restored their competitive advantage, but the differential nevertheless remains smaller than usual. As mortgage rates were at the same time raised by 1¼ per cent, the implication is that building societies are taking the opportunity offered by buoyant retail inflows to improve their retail margins. Building societies are certainly not short of funds to lend. Despite very strong mortgage lending growth, the building societies' liquidity ratio stood at 15.9 per cent at end-July, the same as at the end of last December and about ¾ percentage point higher than the pre-crash levels of the first three quarters of 1987.

34. **Building societies' wholesale inflows** in July of £0.5 billion were less than half the very high June level, but still high by historical standards. Wholesale funding in July was mainly Eurobonds. Retail inflows are seasonally low in August, and relatively high wholesale funding may well continue if, as is likely, mortgage lending remains high in August.

35. **Building societies mortgage lending** continued to grow strongly. Net new lending in July was £2.7 billion, a little higher than in June. July was the fifth month running with

lending around or in excess of £2 billion. However, weekly figures for the largest 14 building societies show a fall in net new lending commitments of nearly 30 per cent in the first four weeks of August. Part of this fall is seasonal, reflecting a holiday season slow-down in business, but the magnitude of the fall suggests that the 1 August combination of the ending of multiple tax relief and a 1¾ per cent rise in mortgage rates is having an early effect. A fall in new mortgage commitments is likely to take a month or two to feed through into lower mortgage lending, but is nevertheless a sign that the very high levels of mortgage lending seen over the past few months may not continue through the autumn.

36. **Bank and building society lending** increased by £8.9 billion in July, taking the 12 month rate of increase to 23.6 per cent. The 12 month growth rate has now increased in every month since February. Although lending was lower than the (revised) increase of £10 billion for June, this decline probably represents mainly seasonal influences as the Bank's seasonally adjusted lending figures increased slightly in July compared with June. The sectoral composition of the lending is not straightforward.

(i) CLSB banks' share of new sterling advances was low (£2.6 billion out of a total of £4.9 billion) - this suggests strong borrowing by ICCs relative to borrowing by persons.

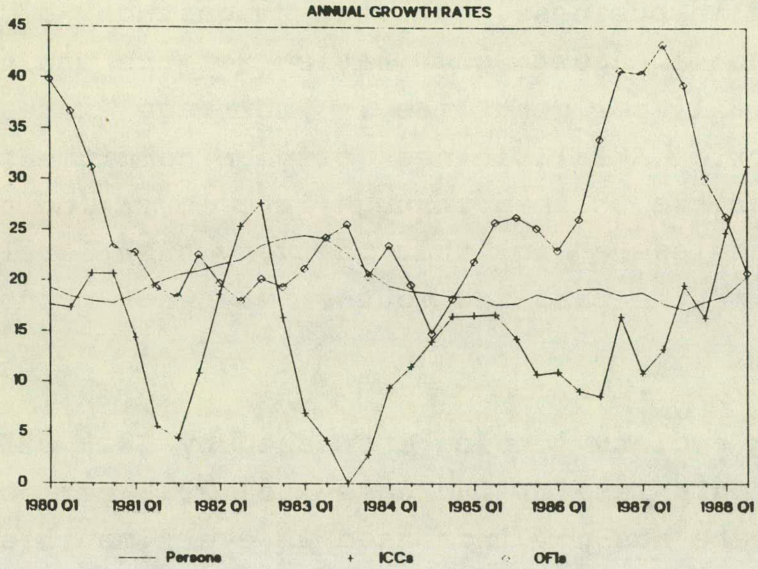
(ii) Personal sector lending accounted for an unusually large proportion of CLSB advances. Lending for house purchase increased by a record amount, presumably reflecting the 1 August deadline. Other lending (apart from credit card lending) also increased strongly.

(iii) Building society advances increased by 1¾ per cent, continuing the fast increases of recent months.

The high share of personal sector lending in total CLSB lending reflects the strength of mortgage lending in advance of 1 August. Companies probably borrowed relatively heavily from non-CLSB banks in July. Apart form the high share of non-CLSB banks in the increase in sterling advances, there was plenty of bill finance in July - CLSB banks report acceptances up by £800 million and holdings of bills over £400 million higher.

SECTORAL M4 LENDING COUNTERPART

ANNUAL GROWTH RATES



ICCs' borrowing has grown sharply post-crash; OFIs' borrowing (and deposits) have fallen back post Big Bang. Persons' borrowing, fairly stable in the 80s, has accelerated recently reflecting higher mortgage borrowing.

<u>Funding</u>

37. The PSBR was overfunded by less than £0.2 billion in July, taking the cumulative overfund in the financial year to date to £0.6 billion. With a PSDR of £1.7 billion, central government debt sales to the non-bank non-building society private sector were negative by around £1 billion - reflecting mainly the redemption of the 3 per cent Transport Stock. Other public sector debt sales were negative to the tune of £½ billion, while external finance of the public sector fell by £0.3 billion. Within external finance a large increase in official reserves of £½ billion was only partially offset by net purchases of gilts by non-residents of £0.3 billion.

38. The market's response to the auction of Treasury 8½ per cent 1994 on 10 August was encouraging, if a little disappointing in terms of price. The auction was a little over 3 times covered. Accepted prices fell in a narrow range from £92.12 to £92.20 (average £92.14), with no 'tail' as in the previous auction.

Life assurance and pension funds

39. **Institutional investment** data for the first quarter of 1988, and early estimates for life assurance and pension funds for Q2, show significant unwinding of the post-crash liquidity build-up. The temporary surge in institutional liquidity does not appear to have affected M4 growth, because it was partly in foreign currency deposits and because movements in securities dealers' liquidity were partially offsetting within M4. The institutions have not significantly reversed their heavy sales of overseas securities in the fourth quarter, investing instead in UK equities. Life assurance and pension funds appear to have made small gilt disposals in the second quarter, in sharp contrast to purchases of £2½ billion in the first quarter.

Broad Money Forecast

40. **The broad money forecast** for August shows increases in M3 and M4 in line with recent months. But a sharp rise in annual rates is projected because of moderate growth in August last year. The annual rate of growth of M4 is expected to rise by ½ per cent to a new record 18 per cent (and M3 by ¾ per cent to 21½ per cent). Bank and building society lending is expected to remain high, although some slackening of mortgage lending is projected and bank lending may be depressed by up to £500 million by repayments of borrowing by Rover Group. Nevertheless, annual lending growth rates should also rise sharply - bank and building society lending by 1 per cent to a further record 24½ per cent and bank lending by 1¼ per cent to 29 per cent. (Tables 26-28).

Money Markets and interest rates

41. **Money market rates** at the end of July ranged from 10.4 per cent at one month to 11 per cent at 12 months, with base rates at 10½ per cent. In **August** base rates increased by ½ per cent on the 8th and by a further 1 per cent on the 25th. Money market rates at the end of the month stood at 12.1 per cent (one month) and 12.4 per cent (12 months).

42. The stock of **money market assistance** fell to £8¼ billion at the end of July from £8¾ billion in June. It is estimated to have been £7½ billion at the end of August, and is expected to fall to about £6¼ billion in September and £5½ billion in October (Table 29).

Capital Markets

43. **Gilts** ended July with the index at 88.0 and 5, 10 and 20 year par yields at 9.9, 9.8 and 9.5 per cent respectively. Base rates were raised on 8 August but this had little effect on the market, which remained broadly steady until the index rose in the middle of the month to around 88.3. The index fell sharply on 25 August as base rate rose. The index currently stands at 86.5, with par yields at 10.5, 10.2 and 9.7 per cent. The yield curve is therefore markedly more strongly downward sloping than a month ago.

44. Real yields on **index-linked stock** began at 3.9 per cent for medium dated and 3.8 per cent for the longest dated stocks, and are currently at around these levels. **Break-even inflation rates** for index-linked Treasury 1990 and 2006 are currently 5.6 and 5.9 per cent, compared with 4.9 and 5.7 per cent at the beginning of the month. The evidence is therefore generally consistent with some increase in inflation expectations in the short term, but not particularly at the expense of the authorities' longer-term credibility. The **equity dividend yield** (based on the all-share index) now stands at 4.6, higher than at the end of July.

45. **Equity prices** in August fell especially after the interest rate rise on the 8th which was not anticipated by the markets. Prices fell faster following the news of the trade figures and the interest rate rise on the 25th. On 1 September the FT Actuaries All Share index was 6½ per cent lower than at the end of July.

46. **Unit trust** inflows in July at £111 million were lower than in June (£229 million), but close to the average monthly inflow since the stock market crash. There is thus no sign of any renewed enthusiasm for equities on the part of the personal sector.

47. **Sterling commercial paper** outstanding increased by £145 million in July - more or less in line with the average increase since December. At the end of July, the total amount outstanding was £3.4 billion. ICCs accounted for about half the rise, and their issues outstanding amounted to £2.7 billion at the end of July.

48. **Eurosterling fixed rate issues** in July were very small - only £0.1 billion for UK issuers and none at all for non-UK issuers - compared with a total of £0.7 billion in June. There have been no issues in August. But FRN issues, mainly by Building Societies, amounted to £535 million - in July in line with the average monthly issue in the first half of the year but well down on June's figure of £1.2 billion. A further £515 million of FRNs were issued in August, of which building societies accounted for £400 million. Bond issues on the domestic market amounted to £0.2 billion in July (with virtually nothing in August), about the same as in June.

49. ICC's foreign currency bond issues amounted to £300 million in July and are expected to have been around £175 million in August, taking the cumulative total for 1988 to date to £1.7 billion - already well above the total for the whole of 1987 (£0.9 billion). OFI's issues of foreign currency bonds were £70 million in July, with no issues in August. So far this year OFI's have raised £0.9 billion from foreign currency bonds with £0.5 billion raised in June alone.

MG2 Division
8 September 1988

ANNEX : THE BEHAVIOUR OF M0

One of the most striking features of monetary developments over the last few months has been the persistent strength of the growth in M0. At Budget time, we expected M0 to be above its target range in the early part of the year - the FSBR was explicit about this. But the excess has been greater than was then envisaged and has persisted for longer. Matching the greater activity now forecast for the rest of the financial year, the projected profile for M0 has steadily increased. Even with the recent rises in interest rates, it is now expected to be above its target range at the end of the current target period.

2. The Budget and Current Projections: Our latest projections, based on EA's most recent forecast compares with that made at Budget time as follows:

Growth in M0

% change on 1 year earlier seasonally adjusted

	Budget Projection	Current Projection	Difference
1988 April	5.0	6.2	1.2
May	4.8	6.2	1.4
June	5.1	7.3	2.2
July	4.1	6.9	2.8
August	3.8	7.6	3.8
September	2.9	7.6	4.7
October	2.1	7.2	5.1
November	1.9	7.0	5.1
December	1.4	6.4	5.0
1989 January	1.9	6.2	4.3
February	2.0	6.0	4.0
March	1.9	5.4	3.5

Growth in M0 in the 12 months to August has turned out to be some 3¾ per cent more than was expected. Whilst a steady decline is anticipated from now on under the influence of higher interest rates and less buoyant activity, M0 is nevertheless expected to remain above its Budget profile by about this same margin or by rather more.

3. Why the Projections have Changed: There are several possible explanations for the divergence to date:

a) recorded nominal activity in the economy to date has been higher than forecast in the Budget projections;

b) actual nominal activity may have been greater than shown by the recorded statistics;

c) the velocity of M0 may have grown less quickly than would be anticipated from the evidence of past behaviour. So faster than expected M0 growth would then be consistent with satisfactory monetary conditions overall.

These explanations are not mutually exclusive. But it is clearly a matter of considerable policy significance as to what relative weight can be placed on each of them.

4. Economic activity has been running at significantly higher levels in the financial year to date than was forecast at Budget time. Full money GDP data is still not available even for the second quarter. But EA's best guesses as to what has been happening are as here:

	Money GDP		**Non-durable Consumer Spending**	
	Budget Projection	**Latest Projection**	**Budget Projection**	**Latest Projection**
1988 Q2	9.5	10.9	7.4	9.4
Q3	6.7	9.1	5.7	10.4

Thus in the second quarter, money GDP was nearly 1 per cent above its expected level. Whilst some deceleration is projected over the third quarter, this is not now as sharp as that implicit in the Budget projections and the difference between the two forecasts accordingly widens. These same features are apparent in the path for non-durable consumer spending - the category of expenditure thought to be most closely related to M0 - but to a greater extent. Non-durable spending was probably some 2 per cent above where we expected it to be in the second quarter. We now anticipate that the 12 month growth rate will accelerate in the third quarter and not decline as in the Budget projection.

5. These buoyant paths for economic activity are clearly sufficient to explain a good deal of the excess growth in M0. But it is also necessary to examine the behaviour of velocity. Short term interest rates have been lower in the early part of the year than was anticipated at Budget time but not by enough on average to have a serious impact on velocity. For the third quarter of the year, rates now look as if they will be higher than the Budget projections allowed for:

3 Month Interbank Rates

Per Cent

	Budget Projection	**Current Projection**
1988 Q2	9.0	8.4
Q3	9.0	11.0*

* Assuming no further change in rates

6. Charts A1 and A2 show the conventional measure of velocity - the ratio of money GDP to M0 - and the narrower ratio of non-durable consumer spending to M0, respectively.

a) Chart A1 suggests that conventional velocity did little out of the ordinary in the second quarter. If anything, it rose at a rather faster rate than has been typical in recent periods; but

b) from Chart A2, a slightly different story emerges. The ratio of non-durable consumer spending to M0 almost certainly fell - at least using the recorded spending figures. Whilst the extent of the apparent decline was not great, it is nevertheless very unusual for this ratio to fall at all. But the significance of this phenomenon is not clear. Since there has been an unanticipated decline in this velocity ratio, one might argue that M0 is proving unnecessarily alarmist as an indicator - that it is indicating monetary conditions looser than they really are. On the other hand, the force of this point is weakened by the behaviour of full expenditure velocity as in Chart A1. Indeed, the divergence of the two charts calls into question the accuracy of the consumer spending figures. There must be a suspicion that they have been under-recorded, one which is all the stronger given past tendencies in these official statistics.

Conclusion

7. The fact that M0 has drifted so far above the path expected at Budget time must obviously be a matter for concern. The question is whether its behaviour has a significant message for the interpretation of monetary conditions or whether it has ceased to be a reliable indicator. On the evidence available, there is relatively little support for the latter position. M0 has been growing much as would be expected, given what looks to have been the behaviour of the economy overall. In fact, there must be a possibility that in reality consumer spending has been more buoyant than the statistics imply.

8. For the future, M0's growth will be slowed by the direct effects of the recent rises in interest rates which increase the opportunity cost of holding cash. But the most important factor will be in the extent to which they slow the growth in money demand. EA's present view is that the overall effect will be to reduce M0's 12 month growth rate over the rest of the financial year but not by quite enough to restore it to the target range. However, developments will obviously have to be monitored continuously.

CHART A1

SECRET

MO VELOCITY : RATIO OF MONEY GDP TO MO

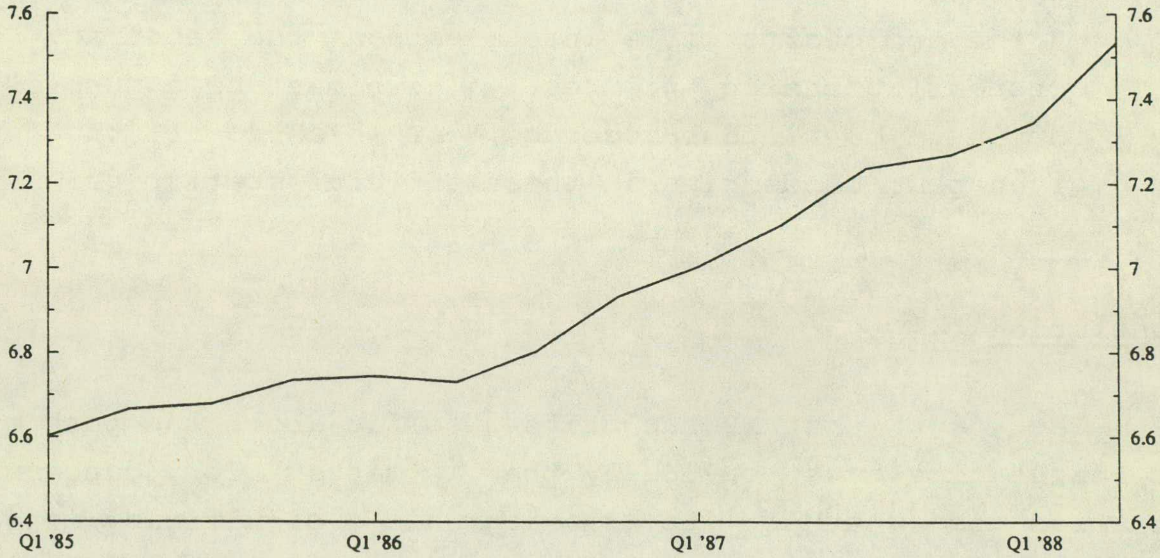
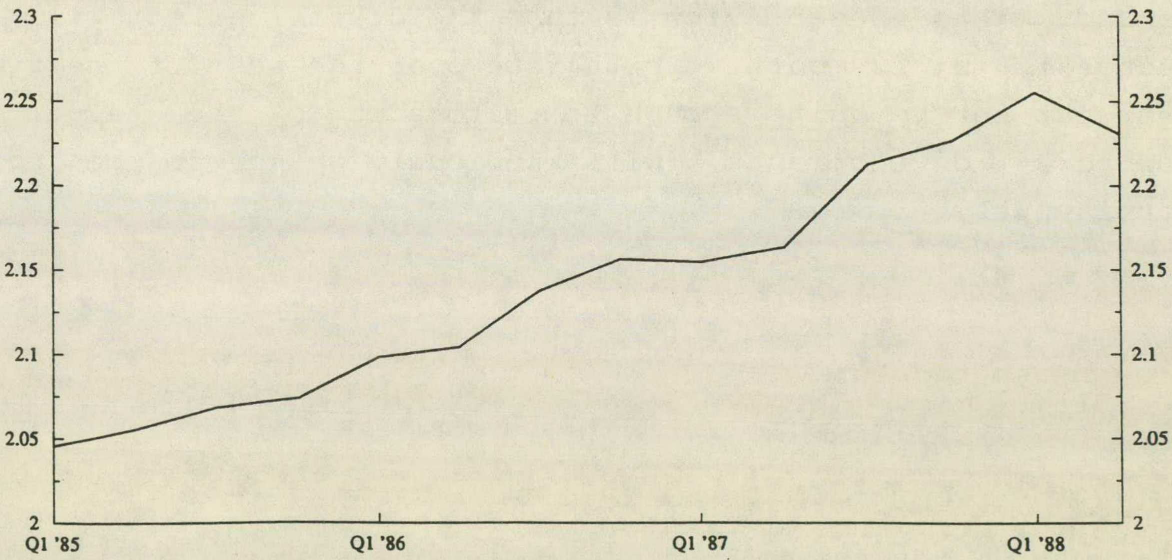


CHART A2

RATIO OF NON-DURABLE CONSUMER SPENDING TO MO



MONTHLY MONETARY REPORT : TABLES

Table 1: Developments in the G5 (including UK)*

	Activity			Money supply		Costs and prices		
	Nominal GNP	Real GNP	Industrial production	M1	M2/M3	Unit labour costs	Consumer prices	GNP deflator
1984	8.6	4.9	7.8	6.7	8.6	-0.6	4.1	3.6
1985	6.6	3.2	2.8	8.2	8.4	0.7	3.5	3.3
1986	5.7	2.7	1.0	11.0	8.3	1.0	1.5	2.9
1987	5.4	2.9	2.8	11.2	8.6	-1.0	2.5	2.4
1987 Q1	5.0	2.5	0.8	13.7	8.9	0.1	1.5	2.4
Q2	4.7	2.3	1.8	12.5	9.0	-0.7	2.5	2.4
Q3	5.6	3.2	3.4	10.1	8.3	-1.4	2.9	2.2
Q4	6.4	3.8	5.2	8.0	8.5	-2.1	3.0	2.4
1988 Q1	6.2	3.4	6.1	7.2+	8.5+		2.7	2.7
1987 Jul			2.8	10.9	8.5		2.6	
Aug			4.2	10.5	8.4		3.0	
Sep			4.0	9.6	8.1		2.9	
Oct			4.6	10.1	8.7		3.1	
Nov			5.3	8.4	8.5		3.0	
Dec			5.6	6.2	8.2		3.0	
1988 Jan			6.5	6.9	8.2		2.7	
Feb			5.9	7.3	8.5		2.7	
Mar			5.7	7.1	8.5		2.7	
Apr			5.8	6.9	8.4		2.6	
May			5.9	6.1+	8.5+		2.6	
Jun				6.8+	8.7+			

* Percentage changes on a year before.
\+ Partly estimated.

Table 2

GERMANY: KEY FIGURES

		INDUSTRIAL PRODUCTION*	index	CONSUMER PRICES*	TRADE SURPLUS** $bn		MONEY SUPPLY (M3)*
1984		3.4		2.4	1.7		3.3
1985		5.4		2.2	2.2		3.8
1986		2.1		- 0.2	4.5		4.2
1987		0.2		0.3	5.5		6.7
1987	J	- 1.9	104	- 0.8	4.8	(4.5)	6.7
	F	0.0	106	- 0.5	6.1	(4.7)	7.1
	M	- 0.9	106	- 0.2	4.8	(4.9)	6.6
	A	- 0.9	107	0.1	5.3	(5.0)	7.9
	M	2.9	108	0.2	6.0	(5.2)	8.5
	J	- 0.9	107	0.2	4.6	(5.1)	7.4
	J	- 2.8	106	0.7	5.6	(5.1)	6.7
	A	2.8	110	0.8	4.9	(5.1)	6.5
	S	0.9	108	0.4	5.8	(5.2)	5.8
	O	0.9	108	0.9	4.8	(5.2)	5.8
	N	0.9	108	1.0	6.1	(5.3)	5.5
	D	3.6	109	1.0	6.8	(5.5)	5.8
1988	J	4.9	108	0.7	6.5	(5.6)	5.8
	F	2.8	110	0.9	4.9	(5.4)	6.1
	M	1.8	110	1.0	4.3	(5.5)	6.1
	A	2.0	109	0.9	6.5	(5.5)	6.3
	M	1.6	109	1.1	5.7	(5.6)	6.3
	J	3.5	111	1.1			6.5
	J			1.0			

* Percentage changes on a year before.

** Yearly figures are monthly averages. Monthly figures in brackets are 12 month moving averages.

TABLE 3

THREE MONTH INTEREST RATES IN THE G5 COUNTRIES*

		United States	Japan	Germany	France	UK
1983		9.1	6.7	5.8	12.5	10.1
1984		10.1	6.5	6.0	11.7	9.9
1985		8.1	6.6	5.5	10.0	12.2
1986		6.5	5.1	4.6	7.8	11.0
1987		6.9	4.2	4.0	8.2	9.7
1987	Jan	5.8	4.3	4.6	8.4	11.0
	Feb	6.1	4.2	4.0	8.5	11.0
	Mar	6.2	4.2	4.0	8.0	10.0
	Apr	6.5	4.1	3.9	8.0	9.8
	May	7.0	3.8	3.8	8.2	8.8
	June	7.0	3.9	3.7	8.2	9.0
	July	6.7	4.0	3.9	7.9	9.2
	Aug	6.8	4.0	4.0	7.9	10.1
	Sept	7.4	4.2	4.0	7.9	10.1
	Oct	8.2	4.8	4.8	8.2	9.9
	Nov	7.4	4.3	3.9	8.6	9.0
	Dec	7.8	4.5	3.6	8.7	8.7
1988	Jan	7.0	4.4	3.4	8.3	8.9
	Feb	6.6	4.3	3.4	7.6	9.2
	March	6.7	4.4	3.4	8.0	8.8
	April	6.9	4.2	3.4	8.1	8.3
	May	7.3	4.3	3.6	7.9	8.0
	June	7.6	4.4	3.9	7.4	8.7
	July	7.9	4.8	5.0	7.3	10.5
	Aug	8.5	4.7	5.3	7.8	11.3
	Sept 1	8.4	5.1	4.9	7.9	12.3

* CD rate for US and Japan, Interbank rates for rest.

35/3 lb.20.18.7

TABLE 4

EFFECTIVE EXCHANGE RATE INDICES (1975 = 100)

	United States	Japan	Germany	France	UK	YEN/$	DM/$
1980	93.7	126.4	128.8	94.4	96.0	225.8	1.82
1981	105.6	142.9	119.2	84.3	94.8	219.5	2.25
1982	118.0	134.6	124.4	76.6	90.4	248.8	2.43
1983	124.8	148.4	127.1	70.0	83.2	237.4	2.55
1984	134.6	156.7	123.8	65.7	78.6	237.5	2.85
1985	140.7	160.5	123.6	66.3	78.2	238.4	2.94
1986	114.8	203.1	137.3	70.1	72.8	168.3	2.17
1987	101.2	219.6	147.6	71.8	72.7	144.7	1.80
1986 Q1	121.2	186.8	133.1	71.0	75.1	187.8	2.35
Q2	116.0	202.8	134.7	69.0	76.0	169.9	2.24
Q3	111.4	214.8	138.6	69.5	71.9	155.9	2.09
Q4	110.5	208.0	142.6	70.8	68.3	160.4	2.01
1987 Q1	104.2	210.1	147.7	71.9	70.2	155.2	1.84
Q2	101.1	222.9	146.9	71.6	72.7	142.6	1.81
Q3	102.5	218.0	146.4	71.4	72.7	147.0	1.84
Q4	97.0	227.4	149.4	72.3	75.2	134.0	1.71
1988 Q1	94.2	240.2	149.6	71.9	75.3	128.0	1.68
Q2	93.5	245.4	147.7	70.9	77.6	125.7	1.71
1987 Jan	105.5	209.4	147.5	71.8	68.9	154.6	1.86
Feb	103.9	209.3	148.4	72.3	69.0	153.4	1.82
Mar	103.3	211.7	147.1	71.8	71.9	157.5	1.84
Apr	101.0	222.7	146.6	71.6	72.3	142.9	1.81
May	100.4	225.3	147.2	71.7	73.3	140.6	1.79
June	101.8	220.8	146.8	71.5	72.6	144.4	1.82
July	103.3	213.7	146.6	71.6	72.8	150.2	1.85
Aug	103.3	218.2	146.0	71.1	72.3	147.6	1.86
Sept	100.8	222.1	146.7	71.4	73.0	143.1	1.81
Oct	100.6	221.4	147.1	71.5	73.6	143.3	1.80
Nov	96.5	228.4	150.9	72.3	75.4	135.3	1.68
Dec	93.9	232.4	150.2	73.1	76.6	123.4	1.65
1988 Jan	93.0	239.5	150.4	72.5	71.9	127.8	1.65
Feb	95.0	239.5	149.1	71.8	74.3	129.2	1.70
March	93.6	241.6	149.3	71.5	76.8	127.1	1.68
April	92.7	245.0	148.9	71.3	78.2	124.9	1.67
May	93.0	246.2	147.9	71.1	78.4	124.8	1.69
June	94.8	244.9	146.2	70.4	76.2	127.4	1.76
July	98.1	239.2	144.2	69.5	75.6	133.1	1.85
August	99.5	240.6	143.1	68.6	76.5	133.7	1.89
August 31	100.2	235.5	144.2	68.8	75.8	136.5	1.87
% Change since dollar peak (Feb 85)	- 36½	+ 50	+ 23	+ 11	+ 8	- 48	- 45½
% Change since Plaza (Sept 85)	- 28	+ 50½	+ 15	+ 2½	- 7½	- 43½	- 35½
% Change since Louvre Accord (Feb 87)	- 3½	+ 12½	- 3	- 4½	+ 9½	- 11	+ 2½
% Change since Stock market crash (16 Oct 1987)	0	+ 6	- 2	- 4	+ 3	- 4½	+ 4½

TABLE 5

ECONOMIST COMMODITY PRICE INDICES 1985=100

	All items indices				SDR indices		
Annual	SDR	Dollar	Sterling	Real*	Food	Nfa**	Metals
1980	104.4	133.7	74.0	115.6	96.7	106.2	118.6
1981	99.3	115.2	73.5	105.3	93.7	104.7	106.2
1982	91.8	99.9	73.4	94.3	89.3	96.0	93.8
1983	107.2	112.7	95.7	110.4	102.0	116.6	110.1
1984	110.3	111.5	107.2	113.1	112.3	111.6	106.2
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	89.8	103.7	90.6	86.4	92.4	89.9	85.4
1987	87.4	111.5	87.1	82.2	73.0	103.3	100.6
Quarterly							
1986 Q3	84.6	100.2	86.2	81.8	85.1	85.5	83.1
Q4	84.2	100.1	89.5	80.2	82.2	91.0	82.8
1987 Q1	81.0	100.8	83.5	76.5	73.2	95.2	84.3
Q2	84.9	108.2	84.4	80.0	73.2	102.6	92.1
Q3	90.2	113.4	90.0	83.8	70.7	111.9	108.0
Q4	93.4	123.7	90.3	88.4	74.7	103.3	117.9
1988 Q1	99.8	134.6	95.9	94.6	77.6	105.5	133.4
Q2	115.5	155.7	108.8	107.6	84.0	115.1	169.1
Monthly							
July	89.3	111.5	88.9		71.9	109.4	104.4
August	91.4	114.2	91.8		69.6	115.0	111.7
September	90.1	114.5	89.3		70.7	111.4	107.9
October	93.5	119.3	92.3		74.2	106.8	117.0
November	91.3	121.3	88.1		74.2	101.4	113.3
December	94.8	129.1	90.5		75.6	102.1	122.4
January	97.4	132.2	94.1		78.1	102.7	126.6
February	98.2	131.2	95.6		78.0	106.5	126.7
March	103.8	140.3	98.0		76.8	107.3	157.0
April	106.4	144.9	99.1		77.3	110.5	152.8
May	113.4	153.8	105.7		80.9	114.1	168.2
June	126.7	168.4	121.6		93.9	120.8	186.4
July	119.1	152.9	115.1		96.9	117.7	157.6
August(prov)	116.9	148.9	116.5		91.0	113.6	163.1
Weekly							
July 5	122.2	157.4	118.2		99.7	121.6	160.9
12	118.4	152.5	115.1		97.4	117.9	154.3
19	118.3	150.9	114.2		98.5	116.2	153.2
26	117.3	150.9	112.9		92.1	115.1	161.8
August 2	113.6	145.7	109.2		89.9	114.8	153.0
9	117.4	149.4	113.5		92.8	114.9	160.9
16	117.2	149.5	111.5		91.4	115.0	162.4
23	118.4	149.8	114.4		90.2	111.6	171.0
30(prov)	117.9	150.1	133.8		90.8	111.8	168.1
% ch. on one yr	+33.0	+33.0	+29.0		+30.4	-2.4	+64.2

* In relation to prices of manufactured exports. Recent figures are estimated.
** Non-food agriculturals.

TABLE: 6

RECENT INDICATORS OF ACTIVITY AND INFLATION
(per cent changes on year earlier)

	MONEY GDP		OUTPUT AND ACTIVITY: GDP(O)	MANUFACTURING OUTPUT	RETAIL SALES	PRICES AND UNIT LABOUR COSTS: RPI	RPI EXCL. MORTGAGE PAYMENTS	PRODUCER PRICES*** OUTPUT	PRODUCER PRICES*** INPUT	UNIT WAGE COSTS MANUFACTURING	UNIT WAGE COSTS WHOLE ECONOMY
1985-86	9.7	1986	2.9	0.2	5.3	3.4	3.6	4.3	-10.8	5.2	5.3
1986-87	6.9	1987	4.7	5.4	5.9	4.1	3.7	4.5	5.2	1.1	4.3
1987-88	9.8										
1986 Q1	8.1		2.1	-1.9	4.4	3.6	4.6	5.0	-11.9	8.9	6.3
1986 Q2	6.4		2.2	-1.4	4.7	2.5	3.3	4.3	-12.4	7.1	6.3
1986 Q3	6.5		3.4	0.6	5.4	2.8	3.3	4.0	-13.1	3.7	4.2
1986 Q4	6.9		3.8	3.6	7.3	3.7	3.4	3.9	-5.6	1.6	4.7
1987 Q1	7.5		4.3	4.2	5.1	4.1	3.7	4.1	-1.7	0.9	3.8
1987 Q2	8.9		4.2	5.0	5.8	4.2	3.7	4.5	4.6	0.8	4.5
1987 Q3	10.7		5.2	6.9	6.6	4.2	3.6	4.6	12.9	0.8	4.2
1987 Q4	10.1		5.4	5.7	5.6	4.1	4.0	4.9	5.8	1.9	4.8
1988 Q1	9.5		5.2	7.5	7.8	3.4	3.7	4.8	4.8	0.5	5.9
1988 Q2			5.2	6.9	6.3	4.3	4.4	4.8	7.3	1.4	
1988-1989*	10.0										
		1987 MAY		5.7	5.0	4.2	3.8	4.5	3.4	0.5	
		JUNE		5.1	5.0	4.4	3.5	4.5	7.2	1.0	
		JULY		6.0	7.0	4.4	3.7	4.5	12.4	1.5	
		AUGUST		8.4	6.8	4.4	3.5	4.6	11.5	0.9	
		SEPTEMBER		6.2	5.9	4.2	3.5	4.5	8.5	0.7	
		OCTOBER		6.1	6.4	4.5	3.8	4.7	7.1	0.7	
		NOVEMBER		5.7	5.1	4.1	4.0	4.8	4.6	1.6	
		DECEMBER		5.3	5.4	3.7	4.0	4.8	3.6	1.9	
		1988 JANUARY ^		10.7	9.1	3.3	3.7	4.8	2.8	0.5	
		FEBRUARY		5.0	6.7	3.3	3.6	4.7	3.8	0.7	
		MARCH		6.9	7.5	3.5	3.8	4.7	4.1	0.5	
		APRIL		7.0	5.0	3.9	4.2	4.6	4.8	1.9	
		MAY		7.6	8.3	4.2	4.4	4.7	6.6	1.6	
		JUNE		6.1	5.8	4.6	4.7	4.7	7.5	1.4	
		JULY			6.5	4.8	5.0	4.8	4.6		

* 1988 June forecasts

** Wage figures show averages for three months ending in month indicated

*** Excluding food drink and tobacco

^ Output and sales growth figures boosted by 2.5-3 per cent on account of lower economic activity during exceptionally cold January of 1987

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TABLE:7 UNDERLYING PRICE INFLATION

%-Change on a year earlier

		RPI	RPI exc Mortgages	RPI exc both Mortgages and Petrol
1984	Q1	5.2	4.5	4.4
	Q2	5.2	4.9	5.0
	Q3	4.7	4.2	4.4
	Q4	4.8	4.1	4.1
1985	Q1	5.5	4.8	4.6
	Q2	7.0	5.3	4.9
	Q3	6.3	5.4	5.2
	Q4	5.5	5.2	5.3
1986	Q1	4.9	4.6	5.2
	Q2	2.8	3.3	4.8
	Q3	2.6	3.3	4.8
	Q4	3.4	3.4	4.5
1987	Q1	3.9	3.7	4.3
	Q2	4.2	3.6	3.6
	Q3	4.3	3.6	3.5
	Q4	4.1	4.0	4.1
1987	July	4.4	3.7	3.6
	Aug	4.4	3.7	3.5
	Sept	4.2	3.5	3.6
	Oct	4.5	3.9	4.0
	Nov	4.1	4.0	4.2
	Dec	3.7	4.0	4.1
1988	Jan	3.3	3.7	3.9
	Feb	3.3	3.6	3.9
	Mar	3.5	3.8	4.1
	Apr	3.9	4.2	4.4
	May	4.2	4.4	4.7
	June	4.6	4.7	4.9
	July	4.8	5.0	5.2

TABLE 8 :INDICATORS OF FISCAL STANCE

	PSBR		PSBR EXCLUDING PRIVATISATION PROCEEDS		PSFD (1)	
	Cash £ billion	Ratio to GDP (per cent)	Cash £ billion	Ratio to GDP (per cent)	Cash £ billion	Ratio to GDP (per cent)
1970-71	0.8	1.5	0.8	1.5	-0.2	-0.4
1971-72	1.0	1.6	1.0	1.6	0.7	1.1
1972-73	2.4	3.6	2.4	3.6	2.0	3.0
1973-74	4.3	5.8	4.3	5.8	3.5	4.6
1974-75	8.0	9.0	8.0	9.0	6.0	6.7
1975-76	10.3	9.3	10.3	9.3	8.1	7.3
1976-77	8.3	6.4	8.3	6.4	7.5	5.7
1977-78	5.4	3.6	5.9	3.9	6.6	4.4
1978-79	9.2	5.3	9.2	5.3	8.3	4.8
1979-80	9.9	4.8	10.3	5.0	8.0	3.9
1980-81	12.5	5.3	12.9	5.5	11.7	5.0
1981-82	8.6	3.3	9.1	3.5	5.2	2.0
1982-83	8.9	3.1	9.4	3.3	8.3	2.9
1983-84	9.7	3.2	10.9	3.5	11.4	3.7
1984-85*	10.1	3.1	12.2	3.7	13.1	4.0
1985-86*	5.7	1.6	8.4	2.3	8.2	2.3
1986-87	3.4	0.9	7.9	2.0	9.5	2.5
1987-88	-3.5	-0.8	1.6	0.4	2.2	0.5
Budget forecast						
1988-89	-3.2	-3/4	1.8	1/2	1.4	1/2

*If adjusted for coal strike, PSBR and PSFD ratios to GDP roughly 0.9 per cent lower in 1984-85 and 0.2 per cent lower in 1985-86.

(b) Quarterly Data

£ billion		PSBR		PSBR excluding privatisation		PSFD	
		sa*	ua	sa*	ua	sa+	ua
1985	Q2	1.2	2.6	2.5	3.9	2.9	4.6
	Q3	1.9	2.9	2.4	3.4	1.5	1.9
	Q4	1.5	2.1	2.1	2.6	2.1	0.7
1986	Q1	1.1	-1.9	1.5	-1.5	2.0	1.0
	Q2	2.1	2.2	3.2	3.3	2.2	3.6
	Q3	2.1	3.6	2.1	3.6	3.0	4.2
	Q4	-1.3	-1.6	0.9	0.5	1.5	0.0
1987	Q1	0.4	-0.8	1.6	0.4	2.5	1.5
	Q2	0.4	1.4	2.8	3.8	1.5	3.2
	Q3	0.0	0.5	1.6	2.1	0.8	1.8
	Q4	-2.3	-2.4	-1.1	-1.3	-0.2	-1.7
1988	Q1	-1.6	-3.0	1.1	-0.2	-0.2	1.3

*financial year - constrained
+calendar year - constrained

Table 9 :CGBR(O) April to July: Differences from Budget profile

	£ billion	percentage
Receipts		
Inland Revenue	+0.4	+2.1
Customs and Excise	+0.3	+2.1
NICs	+0.1	+1.3
Interest and dividends	+0.3	+10.6
Other receipts	-0.2	-23.0
Total receipts	**+1.0**	**+2.0**
Expenditure		
Privatisation proceeds	+0.1	+2.0
Interest payments	+0.1	+1.5
Departmental expenditure [1]	-2.0	-4.4
Total expenditure	**-1.8**	**-3.8**
Net effect on CGBR(O)	**-2.8**	

[1] on a cash basis, net of certain receipts and on-lending

wpu.sr1.5

TABLE 10

EXCHANGE RATES

		Exchange Rate Index*	Real Exchange Rate @	ERI/(Oil Price Adjusted ERI)†	Dollar: Sterling exchange rate	D-Mark: Sterling exchange rate	Index against EMS currencies*	US-UK Interest rate differential	Brent spot price ($/bl)
1985	(1)	72.1	80.1	0.908	1.12	3.63	95.2	+4.1	27.7
	(2)	78.9	88.9	1.001	1.26	3.88	102.3	+4.4	27.0
	(3)	82.1	93.3	1.040	1.38	3.92	103.8	+3.6	27.4
	(4)	79.8	91.6	1.001	1.44	3.71	98.7	+3.5	28.3
1986	(1)	75.1	88.3	1.037	1.44	3.38	90.9	+4.5	17.8
	(2)	76.1	91.9	1.101	1.51	3.39	91.4	+3.2	12.8
	(3)	71.9	88.0	1.049	1.50	3.10	84.9	+3.8	12.4
	(4)	68.3	84.0	0.970	1.43	2.87	79.0	+5.1	14.8
1987	(1)	69.9	86.6	0.967	1.54	2.83	78.8	+4.3	17.9
	(2)	72.8	90.6	0.996	1.64	2.96	82.6	+2.1	18.6
	(3)	72.7	90.2	0.992	1.62	2.97	83.0	+2.8	19.0
	(4)	74.9	93.4	1.030	1.76	2.99	83.8	+1.2	18.1
1988	(1)	75.2	94.8	1.057	1.78	3.01	84.5	+2.2	15.7
	(2)	77.7	98.0	1.088	1.84	4.14	88.3	+1.0	16.2
1987	July	72.8	90.4	0.985	1.61	2.97	82.9	+2.6	19.8
	August	72.3	89.5	0.988	1.60	2.97	82.8	+3.2	18.9
	September	73.1	90.7	1.004	1.65	2.98	83.2	+2.6	18.3
	October	73.6	91.5	1.006	1.66	2.99	83.5	+1.7	18.8
	November	75.4	94.0	1.040	1.78	2.99	83.9	+1.0	17.8
	December	75.7	94.7	1.045	1.83	2.98	84.0	+0.9	17.7
1988	January	74.8	94.1	1.038	1.78	2.98	83.5	+1.8	16.7
	February	74.3	93.4	1.047	1.75	2.98	83.7	+2.6	15.6
	March	76.5	96.8	1.087	1.82	3.06	86.4	+2.1	14.8
	April	78.4	98.9	1.097	1.88	3.14	88.3	+1.2	16.4
	May	78.3	99.0	1.094	1.87	3.17	89.0	+0.5	16.5
	June	76.3	96.2	1.073	1.78	3.12	87.7	+1.3	15.8
	July	75.5	95.4	1.071	1.70	3.14	88.2	+2.4	15.0
	August	76.4	na	1.085	1.70	3.20	90.1	+2.8	14.8
	September 1st	75.5	na	1.077	1.67	3.14	88.6	+3.7	14.4

† Oil price adjusted ERI of 1.0 has roughly the same inflation implications as does an ERI of 80 given an oil price of $29 (their average values for January 1983 - November 1985). The ratio shown therefore indicates whether movements in the ERI are inflationary or otherwise, relative to the period Jan-1983 - Nov 1985, having allowed for oil prices.

* 1975=100

@ Figures for latest months are tentative forecasts based on extrapolated producer price indices wpu.sr1.4

UNCLASSIFIED

TABLE 11: NOMINAL AND REAL INTEREST RATES

		NOMINAL RATES				REAL RATES				
		Three month interbank	Three month Eurodollar	Base Rate	Long Rate (20 year Gilts)	Expected inflation over 12 months*	Real 3-month interbank rate	Yield on Index-Linked Gilts** 1990	2001	2011
1985	(1)	13.0	8.9	12.9	10.9	5.7	6.9	4.4	3.5	3.2
	(2)	12.6	8.2	12.6	10.8	5.6	6.6	4.3	3.8	3.4
	(3)	11.7	8.1	11.7	10.4	5.3	6.1	4.3	3.8	3.5
	(4)	11.6	8.1	11.5	10.3	4.2	7.1	4.1	3.9	3.6
1986	(1)	12.4	7.9	12.3	10.2	3.9	8.2	4.3	4.2	3.8
	(2)	10.2	7.0	10.4	9.0	3.6	6.5	3.6	3.6	3.4
	(3)	10.0	6.2	10.0	9.7	3.4	6.5	3.7	3.9	3.5
	(4)	11.2	6.1	11.0	10.7	4.1	6.8	3.7	4.1	3.8
1987	(1)	10.6	6.3	10.8	9.6	4.3	6.0	3.0	3.7	3.5
	(2)	9.2	7.1	9.4	9.0	3.8	5.2	2.4	3.8	3.6
	(3)	9.9	7.1	9.7	9.8	3.7	6.0	2.6	4.2	3.9
	(4)	9.2	7.8	9.0	9.5	4.0	4.7	2.4	4.1	3.8
1988	(1)	9.0	6.9	8.7	9.4	4.1	4.8	2.2	4.0	4.0
	(2)	8.4	7.4	8.0	9.2	4.0	4.5	2.0	3.8	3.8
1987	August	10.2	7.0	10.0	10.0	3.9	6.1	2.6	4.3	4.0
	September	10.1	7.5	10.0	10.0	4.0	5.9	3.1	4.2	4.0
	October	10.0	8.3	9.5	9.8	4.2	5.6	3.1	4.5	4.3
	November	8.9	7.4	9.0	9.2	3.8	4.9	1.9	4.0	3.3
	December	8.7	7.8	8.5	9.5	3.9	4.6	2.3	3.9	3.9
1988	January	8.9	7.1	8.5	9.6	4.1	4.6	2.3	4.2	4.1
	February	9.3	6.7	9.0	9.4	4.2	4.9	2.2	4.0	3.9
	March	8.9	6.8	8.5	9.1	3.9	4.8	2.2	3.9	3.9
	April	8.4	7.2	8.0	9.1	3.9	4.3	1.7	3.8	3.8
	May	7.9	7.4	7.5	9.3	3.9	4.5	2.0	3.7	3.8
	June	9.0	7.7	8.5	9.3	4.2	4.6	2.3	3.8	3.9
	July	10.6	8.2	10.1	9.5	5.2	5.3	2.5	3.9	4.0
	August	11.4	8.6	11.1	9.4	5.6	5.5	2.9	3.9	3.9
	September 1st	12.3	8.6	12.0	9.7	5.6	6.3	3.3	4.0	4.0

* Unweighted average of forecasts by Phillips and Drew, National Institute, LBS, James Capel, Oxford Economic Forecasting and Goldman Sachs; the expected rate of inflation for a given month is the change in the price level between six months earlier and six months ahead. This is assumed to approximate roughly to average inflation expectations over the three months immediately ahead.

** Average of yields calculated for each Friday of month and quarterly for last Friday in each month. Assumes inflation averages 5 per cent per annum to redemption.

TABLE 12 CURRENT ACCOUNT

percentage change on previous year

		Export Volume less oil and erratics	Import Volume less oil and erratics	Terms* of Trade (AVI) 1980=100	Current balance £mn
1982		0.8	8.9	0.0	4685
1983		-0.6	10.1	-0.6	3832
1984		8.6	10.8	-1.1	2022
1985		6.8	4.0	+1.6	3337
1986		2.3	6.0	-1.9	-199
1987		6.7	8.6	+1.0	-2504
1987					
	Q2	5.5	8.8	+0.7	-354
	Q3	8.7	11.5	+1.4	-1103
	Q4	3.7	10.0	+3.1	-1893
1988	Q1	0.5	13.7	+3.1	-2888
	Q2	5.7	14.0	+1.7	-2933
1988					
	Feb	-8.3	11.6	+1.6	-1181
	March	5.1	11.8	+2.6	-669
	April	6.1	17.9	+3.4	-703**
	May	5.3	8.7	+1.1	-1184**
	June	5.7	16.0	+0.9	-1041**
	July	6.0	24.4	+3.0	-2151**

* Excluding oil and erratics.
**Includes invisibles projection from April 1988.

TABLE 13

CONFIDENTIAL

KEY MONETARY INDICATORS

1987	July	Aug	Sept	Oct	Nov	Dec	Jan88	Feb	Mar	Apr	May	June	July
MONETARY AGGREGATES 12-month % change (u/a)													
M0	5.3	4.5	5.2	5.5	4.9	4.2	4.8	5.3	6.4	5.9	5.7	7.7	7.0
M3	21.0	22.2	19.7	22.5	21.5	22.9	22.5	20.6	20.9	19.4	18.6	20.2	20.6
M4	15.0	15.6	15.0	15.8	15.3	16.3	16.6	16.1	16.8	16.0	16.1	16.8	17.4
M5	14.4	15.0	14.4	15.3	14.7	15.9	16.3	15.7	16.6	15.7	15.5	16.1	16.7
STERLING LENDING 12-month % change (u/a)													
Banks	22.3	21.6	23.6	22.9	22.5	22.8	24.7	24.3	25.2	26.9	27.0	27.8	27.9
Banks & Building Societies	19.5	18.8	20.0	19.3	19.0	18.8	20.1	19.9	20.8	21.9	22.3	23.0	23.6
OVER(-)/UNDER(+) FUNDING Financial year to date: mn	1954	2202	2037	3881	1248	2476	-4086	-5584	1	-1556	-1346	-467	-883
MONEY MARKET ASSISTANCE Level Outstanding: mn	7078	6114	5421	5403	7073	7221	12507	13425	9673	10074	9572	8877	8141
INTEREST RATES													
3-Month Interbank	9.3	10.2	10.1	10.0	8.9	8.7	8.9	9.3	8.9	8.4	7.9	9.0	10.6
20-Year Par Yield	9.3	10.0	10.0	9.8	9.2	9.5	9.6	9.4	9.1	9.1	9.3	9.3	9.5
EFFECTIVE EXCHANGE RATE	73.3	72.7	72.8	72.3	73.1	73.6	75.4	75.7	74.8	74.3	76.5	78.4	75.5

TABLE 14

GROWTH RATES OF MONETARY AGGREGATES

S E C R E T (Until Publication)

£ million

			1987 AUG	SEP	OCT	NOV	DEC	1988 JAN	FEB	MAR	APR	MAY	JUNE	JULY
MO -	Monthly change	sa	39	120	99	49	139	-46	-18	133	139	77	185	141
	Monthly % change	nsa	0.1	0.1	-0.2	0.3	7.0	-6.0	-1.0	1.8	1.7	0.1	1.2	2.2
	Monthly % change	sa	0.3	0.8	0.6	0.3	0.9	-0.3	-0.1	0.8	0.9	0.5	1.1	0.9
	6-month annualised % change	sa	6.2	7.0	7.3	7.0	8.5	5.3	4.5	4.6	0.0	0.0	0.0	0.0
	Annual % change	sa	4.7	4.9	5.6	4.9	4.3	4.6	5.3	5.8	6.2	6.2	7.3	6.9
M3 -	Monthly change	nsa	2147	1657	5797	1206	2581	-2033	684	8627	1440	2577	5076	5714
	Monthly % change	nsa	1.2	0.9	3.3	0.7	1.4	-1.1	0.4	4.7	0.7	1.3	2.6	2.8
	Monthly % change	sa	1.3	1.4	3.7	-0.1	1.4	0.6	0.5	3.0	1.6	0.6	2.4	2.7
	6-month annualised % change	sa	25.2	22.0	25.6	21.9	21.8	17.9	15.9	19.6	14.8	16.4	18.7	23.8
	Annual % change	nsa	22.2	19.7	22.5	21.5	22.9	22.5	20.6	20.9	19.4	18.6	20.2	20.6
M4 -	Monthly change	nsa	2606	2979	5474	1527	4900	428	1371	9662	2012	4243	6781	8000
	Monthly % change	nsa	0.9	1.0	1.9	0.5	1.6	0.1	0.5	3.2	0.6	1.3	2.1	2.4
	Monthly % change	sa	1.3	1.2	2.3	0.3	1.3	0.3	1.0	2.2	1.1	0.9	1.9	2.1
	6-month annualised % change	sa	18.4	17.2	18.9	17.3	16.9	14.0	13.3	15.5	13.0	14.4	15.8	20.1
	Annual % change	nsa	15.6	15.0	15.8	15.3	16.3	16.6	16.1	16.8	16.0	16.1	16.8	17.4
M5 -	Monthly change	nsa	2720	3042	5607	1481	5210	108	1096	10601	1528	4181	6620	8155
	Monthly % change	nsa	0.9	1.0	1.8	0.5	1.7	0.0	0.3	3.3	0.5	1.3	2.0	2.4
	Monthly % change	sa	1.3	1.2	2.2	0.3	1.3	0.3	0.9	2.2	0.8	0.9	1.8	2.0
	6-month annualised % change	sa	17.9	17.0	18.9	16.8	16.3	13.8	12.9	15.4	12.3	13.8	14.9	18.8
	Annual % change	nsa	15.0	14.4	15.3	14.7	15.9	16.3	15.7	16.6	15.7	15.5	16.1	16.7
NIBM1 -	Monthly change	nsa	-132	337	288	440	390	-1388	857	2149	1	1148	502	97
	Monthly % change	nsa	-0.3	0.8	0.7	1.0	0.9	-3.1	2.0	4.8	0.0	2.5	1.0	0.2
	Monthly % change	sa	0.2	0.6	3.7	-2.4	-0.2	3.7	1.4	1.2	-0.1	1.2	-0.1	0.8
	6-month annualised % change	sa	9.7	13.5	24.7	14.0	4.2	11.4	14.1	15.4	7.2	15.2	15.4	9.1
	Annual % change	nsa	11.8	5.5	11.6	10.2	10.2	11.8	12.5	15.2	13.8	13.4	10.7	10.7
M1 -	Monthly change	nsa	1030	1567	2969	456	-258	-972	-268	5155	1080	2448	1538	563
	Monthly % change	nsa	1.2	1.8	3.3	0.5	-0.3	-1.1	-0.3	5.7	1.1	2.5	1.5	0.6
	Monthly % change	sa	1.5	1.6	5.0	-1.1	-1.0	2.3	-0.4	3.6	1.2	2.0	0.8	0.9
	6-month annualised % change	sa	28.2	23.2	36.4	24.9	15.6	17.9	13.4	17.9	9.5	16.4	20.8	17.5
	Annual % change	nsa	23.8	20.5	24.9	21.9	23.0	21.9	20.9	20.9	21.2	19.8	18.6	17.8
WIDER £	Monthly change	nsa	1373	1781	7801	-41	3514	643	314	8310	3883	3122	6135	5007
AGGREGATE	Monthly % change	nsa	0.7	0.9	3.8	0.0	1.7	0.3	0.1	3.9	1.7	1.4	2.7	2.1
	Monthly % change	sa	0.7	1.3	4.2	-0.6	1.6	1.7	0.2	2.4	2.5	0.8	2.5	2.0
	6-month annualised % change	sa	21.9	20.3	25.1	18.2	20.9	19.4	18.2	20.8	16.9	20.2	22.3	22.9
	Annual % change	nsa		18.6	22.4	20.5	21.6	21.7	20.1	20.6	20.3	18.8	21.6	20.9

TABLE 15

REAL PERCENTAGE GROWTH RATES OF MONETARY AGGREGATES

	RPI less Mortgage Element	Weekly Averaged M0	M3	M4	M5
FINANCIAL YEARS (12 month % changes to calendar March)					
1981-82	9.8	-6.5	4.2	3.7	3.0
1982-83	5.9	-0.6	5.4	7.9	8.0
1983-84	4.6	0.8	3.3	6.8	6.1
1984-85	5.2	0.3	6.0	8.2	8.2
1985-86	4.0	-0.5	12.2	10.1	9.1
1986-87	3.8	0.3	14.8	9.9	9.4
1987-88	3.8	1.9	16.5	12.5	12.3
12 MONTH % CHANGES (ua except M0)					
1987 JULY	3.7	1.6	16.7	10.9	10.3
AUGUST	3.7	1.0	17.8	11.5	10.9
SEPTEMBER	3.5	1.4	15.7	11.1	10.5
OCTOBER	3.9	1.6	17.9	11.5	11.0
NOVEMBER	4.0	0.9	16.8	10.9	10.3
DECEMBER	4.0	0.3	18.2	11.8	11.4
1988 JANUARY	3.7	0.9	18.1	12.4	12.2
FEBRUARY	3.6	1.6	16.4	12.1	11.7
MARCH	3.8	1.9	16.5	12.5	12.3
APRIL	4.2	1.9	14.6	11.3	11.0
MAY	4.4	1.7	13.6	11.2	10.6
JUNE	4.7	2.5	14.8	11.6	10.9
JULY	5.0	1.8	14.9	11.8	11.1

TABLE 16

CONFIDENTIAL (Until Publication)

MO : THE WIDE MONETARY BASE

Monthly data	Level £ million (Change in brackets): Notes and Coin (nsa)	Notes and Coin (sa)	(change)	Bankers' Deposits	MO (nsa)	MO (sa)	(change)	Percentage change on previous month: Notes(sa) and Coin	MO (sa)	6 month % growth annualised: Notes & Coin (sa)	MO (sa)	Percentage change on previous year: Notes and Coin (nsa)	Notes and Coin (sa)	MO (nsa)	MO (sa)
December	16447	15661	(136)	186	16633	15846	(139)	0.9	0.9	7.9	8.5	4.7	4.8	4.2	4.3
1988 January	15458	15620	(-41)	181	15638	15801	(-45)	-0.3	-0.3	6.1	5.3	4.7	4.5	4.8	4.6
February	15353	15659	(39)	124	15477	15783	(-18)	0.2	-0.1	5.3	4.5	5.7	5.7	5.3	5.3
March	15588	15753	(94)	162	15750	15916	(133)	0.6	0.8	5.0	4.6	6.9	6.4	6.4	5.8
April	15797	15826	(73)	229	16026	16055	(139)	0.5	0.9	4.8	5.1	5.8	6.1	5.9	6.2
May	15870	15954	(128)	178	16048	16132	(77)	0.8	0.5	5.6	5.5	6.0	6.5	5.7	6.2
June	16073	16143	(189)	174	16247	16317	(185)	1.2	1.1	6.3	6.0	7.5	7.1	7.7	7.3
July	16411	16271	(128)	188	16599	16459	(142)	0.8	0.9	8.5	8.5	7.5	7.3	7.0	6.9
August (5/5)	16576	16461	(190)	156	16732	16617	(158)	1.2	1.0	10.5	10.8	8.1	7.9	7.8	7.6
Latest 4 weeks	16583	16482	(186)	141	16724	16623	(138)	1.1	0.8	10.6	10.6	7.7	7.7	7.3	7.2

Weekly data	Level £ million (Change in brackets): Notes(sa) and Coin	(change)	Bankers' Deposits	MO (sa)	(change)	Percentage change on previous week: MO (sa)
July						
6th	16276	(56)	212	16488	(26)	0.2
13th	16230	(-46)	169	16399	(-89)	-0.5
20th	16273	(43)	112	16385	(-14)	-0.1
27th	16303	(30)	259	16562	(177)	1.1
August						
3rd	16376	(73)	217	16593	(31)	0.2
10th	16415	(39)	187	16602	(9)	0.1
17th	16428	(13)	176	16604	(2)	0.0
24th	16487	(59)	78	16565	(-39)	-0.2
31st	16599	(112)	122	16721	(156)	0.9

TABLE 17

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BUILDING SOCIETY BALANCE SHEET FLOWS

Unadjusted # million

	Total Flow	ASSETS: Net Mortgage Advances & Unsecured Lending	Liquid Assets	Fixed Assets	LIABILITIES: Retail principal	Interest credited	Wholesale funds	Other (eg reserves)
1985 *	1497	1226	244 (18.0)	27	621	497	205	174
1986 *	1626	1628	-25 (16.4)	23	549	508	524	45
1987 *	1650	1268	339 (16.9)	43	630	570	194	256
1986 Q2*	1629	1685	-79 (16.6)	23	474	521	332	302
Q3*	1788	1930	-163 (15.7)	21	54	402	1144	188
Q4*	2097	1594	480 (16.4)	23	933	647	448	69
1987 Q1*	1406	1170	158 (16.1)	78	458	523	111	314
Q2*	1592	1282	290 (16.2)	20	615	457	108	412
Q3*	1547	1288	215 (16.1)	44	409	516	337	285
Q4*	2063	1390	692 (16.9)	-19	1038	785	222	18
1988 Q1*	1870	1686	10 (16.5)	174	1027	626	113	104
Q2*	3176	2205	925 (17.0)	46	1349	415	697	715
June	3364	2533	891 (17.0)	-60	1179	796	1091	298
July	2986	2716	88 (16.7)	182	1241	734	549	462
Forecast								
1988 August	2627	2409	154 (16.2)	64	806	136	700	985

* Monthly averages
Figures in ( ) are end period liquidity ratio, unadjusted

TABLE 18

THE COMPONENTS OF M3

	NOTES AND COINS	BANK DEPOSITS RETAIL NIB	IB	WHOLESALE	M3
% CHANGES					
Financial years[1] (ua)					
1984-85	5.2	6.5	7.7	19.1	11.5
1985-86	3.7	4.5	16.8	26.1	16.7
1986-87	2.2	16.9	17.5	25.8	19.1
1987-88	13.7	15.6	12.4	29.2	20.9
Over 12 months (ua)					
1987 AUGUST	4.3	15.7	15.6	33.0	22.2
SEPTEMBER	5.6	5.5	14.7	32.1	19.7
OCTOBER	5.3	14.7	12.9	35.3	22.5
NOVEMBER	1.6	14.3	13.5	33.5	21.5
DECEMBER	6.1	11.9	10.7	38.5	22.9
1988 JANUARY	6.0	14.5	11.1	35.8	22.5
FEBRUARY	3.3	16.9	10.9	31.1	20.6
MARCH	14.9	15.3	12.4	29.0	20.9
APRIL	9.4	15.7	12.3	26.5	19.4
MAY	5.5	16.9	11.9	25.2	18.6
JUNE	10.7	10.7	15.6	28.3	20.2
JULY	8.8	11.6	17.1	27.8	20.6
Over 6 months (sa)					
1988 FEBRUARY	8.6	16.4	7.2	22.0	15.9
MARCH	14.0	16.0	11.0	26.7	19.6
APRIL	6.4	7.5	11.7	20.4	14.8
MAY	7.7	18.4	9.5	20.8	16.4
JUNE	5.6	19.7	22.5	18.4	18.7
JULY	8.0	9.6	24.7	30.9	23.8
CHANGES MILLION					
Monthly average[1] (sa)					
1984-85	42	56	238	683	1017
1985-86	17	90	161	556	1565
1986-87	4	359	538	1255	2157
1987-88					
Over 1 month (sa)					
1988 JANUARY	217	1384	940	-1499	1042
FEBRUARY	-86	736	91	140	881
MARCH	278	256	1335	3708	5577
APRIL	-88	51	351	2794	3108
MAY	-48	608	131	528	1219
JUNE	93	-154	2251	2532	4722
JULY	378	4	1515	3519	5416

1March on March

TABLE 19

THE COMPONENTS OF M4 AND M5

	M3	BUILDING SOCIETIES RETAIL[1]	BUILDING SOCIETIES WHOLESALE	BUILDING SOCIETIES HOLDINGS OF M3	M4	MONEY MARKET INSTRUMENTS	M5
% CHANGES							
Financial years[3] (ua)							
1984-85	11.5	15.1				13.8	13.8
1985-86	16.7	15.3		94	0.1	13.5	14.5
1986-87	19.1	10.8		50	-15.6	13.5	12.9
1987-88	20.9	13.6		39.5	16.8	12.6	16.6
Over 12 months (ua)							
1987 AUGUST	22.2	15.6	26.5	63.2	15.6	4.1	15.0
SEPTEMBER	19.7	10.8	46.8	58.1	15.0	5.0	14.4
OCTOBER	22.5	13.6	29.7	58.3	15.8	5.8	15.3
NOVEMBER	21.5	13.9	7.8	66.0	15.3	5.3	14.7
DECEMBER	22.9	11.2	17.8	63.2	16.3	8.1	15.9
1988 JANUARY	22.5	12.4	30.5	57.0	16.6	11.1	16.3
FEBRUARY	20.6	13.2	33.5	47.8	16.1	7.8	15.7
MARCH	20.9	13.6	41.5	39.5	16.8	12.6	16.6
APRIL	19.4	13.6	34.7	41.2	16.0	9.0	15.7
MAY	18.6	13.9	37.8	34.6	16.1	4.0	15.5
JUNE	20.2	13.6	46.4	45.5	16.8	2.3	16.1
JULY	20.6	14.9	31.7	40.3	17.4	2.5	16.7
Over 6 months (sa)							
1988 FEBRUARY	15.9	11.4	0.2	31.9	13.3	6.0	12.9
MARCH	19.6	13.9	0.5	43.2	15.5	12.0	15.4
APRIL	14.8	15.4	0.5	47.8	13.0	0.0	12.3
MAY	16.4	14.5	0.3	39.1	14.4	2.0	13.8
JUNE	18.7	15.5	0.4	43.3	15.8	-1.7	14.9
JULY	23.8	16.1	0.3	26.4	20.1	-4.3	18.8
CHANGES MILLION							
Monthly average3 (sa)							
1984-85	984	1034	42	-28	139	2221	2090
1985-86	1565	1207	50	-362	-118	2480	2557
1986-87	2157	938	17	-372	51	2791	2975
1987-88							
Over 1 month (sa)							
1988 FEBRUARY	881	1557	-13	596	3021	-183	2838
MARCH	5577	1805	-9	-630	6743	510	7253
APRIL	3108	1615	-91	-1161	3471	-801	2670
MAY	1219	1731	205	-238	2917	179	3096
JUNE	4722	1914	65	-673	6028	-30	5998
JULY	5416	1585	58	-39	7020	-14	7006

[1] Net in flow including Term sharesand SAYE.
[2] Treasury bills, bank bills, LA temporary debt, CID's and some national savings accounts.
[3] March on March.

TABLE 20

RETAIL DEPOSITS

	BANKS	BUILDING[1] SOCIETIES	NATIONAL SAVINGS[2]	TOTAL
% CHANGES				
Financial years[3] (ua)				
1984-85	7.1	15.1	11.9	12.0
1985-86	11.6	15.3	7.5	12.9
1986-87	17.2	10.8	10.8	12.7
1987-88	13.6	13.0	6.1	11.2
Over 12 months (ua)				
1987 AUGUST	15.6	10.4	9.7	11.9
SEPTEMBER	10.8	11.4	9.3	10.7
OCTOBER	13.6	10.2	8.2	10.9
NOVEMBER	13.9	11.1	7.4	11.3
DECEMBER	11.2	11.6	7.2	10.5
1988 JANUARY	12.4	12.1	6.8	10.9
FEBRUARY	13.2	12.6	6.4	11.1
MARCH	13.6	13.0	6.1	11.2
APRIL	13.6	13.6	5.9	11.4
MAY	13.9	14.2	5.5	11.7
JUNE	13.6	14.4	5.1	11.6
JULY	14.9	15.0	5.0	12.2
Over 6 months (sa)				
1988 FEBRUARY	10.8	11.4	4.5	9.3
MARCH	13	13.9	5	11.1
APRIL	10	15.4	6.1	12
MAY	12.9	14.5	6.3	12.5
JUNE	21.4	15.5	6.1	14.9
JULY	18.6	16.1	5.3	16.2
CHANGES MILLION				
Monthly average[3] (sa)				
1984-85	42	1034	683	1759
1985-86	255	1207	1093	2555
1986-87	871	938	266	2075
1987-88				
Over 1 month (sa)				
1988 FEBRUARY	827	1557	240	2624
MARCH	1591	1805	214	3610
APRIL	402	1615	165	2182
MAY	739	1731	67	2537
JUNE	2097	1914	161	4172
JULY	1519	1585	175	3279

NOTES

1 Total retail funds, including terms shares and SAYE.
2 Total inflows.
3 March on March.

TABLE 21

BREAKDOWN OF BANK LENDING BY INSTRUMENT

		ADVANCES	COMMERCIAL BILLS	MEMO ITEM: BILL LEAK	INVESTMENTS[1]	OTHER[2]	TOTAL (u/a)	TOTAL (s/a)
Monthly Average[3]								
1983/84		979	n/a	n/a	n/a	n/a	1075	1075
1984/85		1150	n/a	n/a	n/a	n/a	1378	1378
1985/86		1490	n/a	n/a	n/a	n/a	1747	1747
1986/87		2045	n/a	n/a	n/a	n/a	2537	2537
1987/88		3145	-129	(36)	130	75	3221	3195
Monthly Changes								
1987	July	2783	1627	(18)	-57	246	4599	4486
	August	2791	-1544	(115)	119	-232	1134	2633
	September	5378	12	(-150)	-19	148	5519	4329
	October	2734	-489	(278)	139	581	2965	2924
	November	2578	819	(-497)	235	-327	3305	3278
	December	3433	1544	(-149)	120	371	5468	5000
1988	January	2597	2484	(-312)	-195	215	5101	5598
	February	2323	396	(-98)	-35	-225	2459	2554
	March	5764	-509	(445)	287	351	5893	4778
	April	4962	-277	(-366)	-45	-133	4507	6216
	May	2904	130	(493)	-37	127	3124	3141
	June	8119	-1278	(168)	377	302	7520	6440
	July	5441	846	(5)	265	-509	6043	6271

[1] Investment by banks in private sector.
[2] Market loans, shipbuilding repos, CD's and time deposits of building societies and commercial paper.

TABLE 22

SECRET

FUNDING : FINANCIAL YEAR 1988/89 19/8/88

£ million

	FORECAST Financial Year 88/89	OUTTURN April - July 88	RESIDUAL Aug 88 - Mar 89	
PSBR AND FUNDING TARGET				
1 PSBR excl asset sales	-2400	-445	-1955	
2 Asset sales (sales-)	-5000	-2757	-2243	
3 PSBR	-7400	-3202	-4198	
FINANCED BY:				
4 OPS debt sales to M4ps (sales-)	1000	493	507	
5 National Savings (sales-)	-1500	-527	-973	* -122
6 CTDs sales to M4ps (sales-)	750	91	659	
7 Treasury bills etc M4ps (sales-)	0	59	-59	
8 Intervention (reserves inc+)	2100	1180	920	
9 Public sector externals excl intervention and gilts (inc-)	0	77	-77	
10 NET GILT SALES TO M4PS & OVERSEAS NEEDED FOR FULL FUND (sales+)	-5050	-1829		
11 Adjustment for 1987/88 underfund	400			
12 OVER(-)/UNDER(+)FUNDING	-400	-627	227	
GILT SALES:				
13 Net purchases by M4ps and overseas (purchases+)	-4650	-1202	-3448	
14 Net purchases by banks/b socs & other public sector (purchases+)	-1500	-1415	-85	
15 Maturities	8300	3550	4750	
16 GROSS OFFICIAL SALES	2150	933	1217	
17 Monthly average gross gilt sales	179	233	152	

* average per month

Relationship between lines:

3 = 1 + 2
10 = 3+4+5+6+7+8+9
12 = 10 + 11 - 13
16 = 13 + 14 + 15

Table 23:- BORROWING BY PRIVATE SECTOR EXCLUDING BUILDING SOCIETIES (million)

		BANK/BUILDING SOC. STERLING BORROWING			OTHER STERLING BORROWING					ALL BORROWING		
		Banks	B Socs	TOTAL	Sterling Commercial Paper(*)	Ordinary Shares (*)	Pref & Bonds (*)	Euro-Sterling (**)	TOTAL	Sterling	Foreign Currency	TOTAL
Change in Quarter												
1984	Q1	5141	3007	8148		163	44	117	324	8472	1102	9574
	Q2	2781	4076	6857		429	75	30	534	7391	808	8199
	Q3	3285	4087	7372		288	59	298	645	8017	1047	9064
	Q4	4535	3402	7937		249	73	410	732	8669	1948	10617
1985	Q1	7093	3189	10282		924	170	235	1329	11611	3225	14836
	Q2	4158	3748	7906		1092	327	230	1649	9555	1382	10937
	Q3	4148	3561	7709		873	274	193	1340	9049	-806	8243
	Q4	4294	4235	8529		525	89	445	1059	9588	939	10527
1986	Q1	7157	3967	11124	0	471	209	750	1430	12554	2362	14916
	Q2	5189	5220	10409	0	1369	344	605	2318	12727	1575	14302
	Q3	4877	5738	10615	23	1431	290	448	2192	12807	3688	16495
	Q4	10138	4782	14920	68	2338	-52	281	2635	17555	623	18178
1987	Q1	7147	3619	10738	416	1553	-782	1546	2733	13471	7142	20260
	Q2	8692	4240	12932	597	2259	352	990	4252	17184	4733	21917
	Q3	10855	3889	14744	259	5950	732	931	7872	22616	-1152	21464
	Q4	10906	3926	14832	-167	3735	423	591	4582	19414	-178	19236
1988	Q1	13196	4980	18176	892	370	-115	1600	2747	20923	1912	22835
	Q2	14698	7462	22160	527	996	331	1950	3804	25964	1558	27470
Average per quarter												
1984		3936	3643	7579	0	282	63	214	559	8137	1226	9364
1985		4923	3683	8607	0	854	215	276	1344	9951	1185	11136
1986		6840	4927	11767	23	1402	198	521	2144	13911	2062	15973
1987		9400	3919	13312	276	3374	181	1015	4846	18171	2636	20719
1988		13947	6221	20168	710	683	108	1775	3276	23444	1709	25153
Change in Month												
1987	JULY	4403	1302	5705	93	1840	182	360	2475	8180	-2215	5965
	AUGUST	1023	1269	2292	8	2090	390	261	2749	5041	1028	6069
	SEPT	5429	1318	6747	158	2020	160	310	2648	9395	35	9430
	OCTOBER	2521	1510	4031	122	2535	195	256	3108	7139	3421	10560
	NOVEMBER	3213	1441	4654	-43	975	55	335	1322	5976	-1530	4446
	DECEMBER	5172	975	6147	-246	225	173	0	152	6299	-2069	4230
1988	JANUARY	4993	1473	6466	379	48	41	625	1093	7559	728	8287
	FEBRUARY	2506	1396	3902	339	219	123	590	1271	5173	-969	4204
	MARCH	5697	2111	7808	174	103	-279	385	383	8191	2153	10344
	APRIL	4604	2050	6654	140	235	13	450	838	7492	-2519	4973
	MAY	2977	2495	5472	396	528	150	780	1854	7326	1439	8765
	JUNE	7117	2917	10034	-9	233	168	720	1112	11146	2638	13784
	JULY	6155	2739	8894	0	262	188	183	633	9527	-157	9370

* UK ICC's only
** Announced issues by UK ICCs and OFIs
** Gross issues announced by UK ICC's and OFI's

Table 24:- FINANCE OF U.K. INDUSTRIAL AND COMMERCIAL COMPANIES AND BUILDING SOCIETIES (million)

	BANK BORROWING				OTHER BORROWING						ALL BORROWING	
	Sterling ICC's	Sterling BSOC's	Foreign Currency	TOTAL	Sterling Commercial Paper	Ordinary Shares	Pref & Bonds	Euro-Sterling(*) ICC's	Euro-Sterling(*) BSOC's	TOTAL	TOTAL	(o/w ICCs)
Change in Quarter												
1984												
Q1	2905	-86	-895	1924		163	44	25	0	232	2156	2242
Q2	559	-56	-193	310		429	75	0	0	504	814	870
Q3	1219	533	-74	1678		288	59	100	0	447	2125	1592
Q4	2312	408	1433	4153		249	73	210	0	532	4685	4277
1985												
Q1	3386	6	-352	3040		924	170	235	0	1329	4369	4363
Q2	747	248	207	1202		1092	327	230	0	1649	2851	2603
Q3	229	161	1371	1761		873	274	130	600	1877	3638	2877
Q4	874	860	1377	3111		525	89	200	475	1289	4400	3065
1986												
Q1	3807	363	108	4278	0	471	209	350	935	1965	6243	4945
Q2	-356	461	108	213	0	1369	344	325	1075	3113	3326	1790
Q3	29	1856	1128	3013	23	1431	290	231	1575	3550	6563	3132
Q4	5248	404	-21	5631	68	2338	-52	281	2632	5267	10898	7862
1987												
Q1	1189	355	2008	2306	416	1553	-782	1231	290	2660	4966	4321
Q2	710	-516	762	113	597	2259	352	655	50	3913	4026	4492
Q3	3746	397	-81	4771	259	5950	732	570	100	7611	12382	11885
Q4	4391	832	628	5223	-167	3735	423	105	0	4096	9319	8487
1988												
Q1	6897	257	2084	7154	892	370	-115	915	625	2687	9841	8959
Q2	4968	440	1822	5408	527	996	331	1000	1030	3884	9292	7822
Average per quarter												
1984	1749	200	68	2016	0	282	63	84	0	429	2445	2245
1985	1309	319	651	2279	0	854	215	199	269	1536	3815	3227
1986	2182	771	331	3284	23	1402	198	297	1554	3474	6758	4432
1987	2509	267	829	3605	276	3374	181	640	147	4619	8224	7810
1988	5933	349	1953	6281	710	683	108	958	828	3286	9567	8391

Change in Month

		Sterling Commercial Paper	Ordinary Shares	Pref & Bonds	Euro-Sterling ICC's	Euro-Sterling BSOC's	TOTAL
1987	JULY	93	1840	182	210	0	2325
	AUGUST	8	2090	390	150	0	2638
	SEPTEMBER	158	2020	160	210	100	2648
	OCTOBER	122	2535	195	45	0	2897
	NOVEMBER	-43	975	55	60	0	1047
	DECEMBER	-246	225	173	0	0	152
1988	JANUARY	379	48	41	450	50	968
	FEBRUARY	339	219	123	355	150	1186
	MARCH	174	103	-279	110	425	533
	APRIL	140	235	13	150	150	688
	MAY	396	528	150	530	275	1879
	JUNE	-9	233	168	320	605	1317
	JULY	145	262	188	48	360	1003

* Gross Issues announced by U.K. ICC's and Building Societies

NOTE: Bank borrowing figures include monetary sector holdings of 'Other Borrowing' instruments, giving rise to some double counting in the 'All Borrowing' figures.

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TABLE 25

MO FORECAST, 1988-89

Note: Forecast assumes unchanged base rates from current levels (12 per cent)

	not seasonally adjusted		seasonally adjusted	
	Notes & Coin	MO	Notes & Coin	MO
Actual				
1987-88 *	5.0	5.0	5.0	4.9
1988-89				
April	5.8	5.9	6.1	6.2
May	6.0	5.7	6.5	6.2
June	7.5	7.7	7.1	7.3
July	7.5	7.0	7.3	6.9
August	8.1	7.8	7.9	7.6
Forecast				
September	7.3	7.3	7.6	7.6
October	7.4	7.2	7.3	7.2
November	7.3	7.2	7.1	7.0
December	7.2	7.1	6.4	6.4
January	9.6	9.6	6.2	6.2
February	5.5	5.9	5.6	6.0
March	5.1	5.2	5.3	5.4
1988-89 *	7.0	7.0	6.7	6.7

* average of 12 months

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TABLE 26 : BROAD AGGREGATES COUNTERPARTS AND FORECAST £ million

OUTTURN: JULY 1988

	M3	M4
PSBR	-1699	-1699
LA and PC debt sales to NBPS (-)	241	252
CG debt sales to NBPS (-)		
o/w Gilts	994	1215
Treasury bills etc.	-20	-1
National Savings	-165	-164
CTD's	-89	-89
Public sector external & fc finance	322	322
OVER(-)/UNDER(+) FUNDING	-416	-164
Sterling lending to NBPS : nsa	6043	8894
(sa)	(6271	9008)
Banks'/B Socs' externals	858	833
Banks'/B Socs' £NNDLs	-771	-1563
TOTAL M3/M4	5714	8000
Monthly % growth nsa	2.8	2.4
sa	2.7	2.1
Annual % growth nsa	20.6	17.4
sa	20.8	17.0

FORECAST: AUGUST 1988

	M3	M4
PSBR	-825	-825
LA and PC debt sales to NBPS (-)	100	50
CG debt sales to NBPS (-)		
o/w Gilts	0	100
Treasury bills etc.	0	0
National Savings	-175	-175
CTD's	75	75
Public sector external & fc finance	150	150
OVER(-)/UNDER(+) FUNDING	-675	-625
Sterling lending to NBPS : nsa	3700	5900
(sa)	(5200	7300)
Banks'/B Socs' externals & £NNDLs	975	-375
TOTAL M3/M4	4000	4900
Monthly % growth nsa	1.9	1.5
sa	2.0	1.9
Annual % growth nsa	20.1	16.6
sa	21.7	17.7

BUILDING SOCIETIES: Retail inflows	950
Wholesale inflows from NBPS	100
Holdings of M3 (-)	-150

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Table 27

Broad Money forecast

		OUTTURN 1988 JULY		FORECAST AUGUST	
		M3	M4	M3	M4
(i)	Underlying increase	5514	7825	4000	4900
(ii)	Estimated Special Factors	200	175	-	-
	Unwinding of tax rebate held on deposit	-50	-125	-	-
	Gilt redemption	250	300	-	-
(iii)	Total Increase	5714	8000	4000	4900
	Monthly % change	2.8	2.4	1.9	1.5
	Annual % change	20.6	17.4	21.4	18.1
	Annual % change expected at 1988 Budget time	20.2	16.4	20.1	16.6

Line (iii)=(i)+(ii)

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Table 28

Lending forecasts

		OUTTURN 1988 JULY			FORECAST AUGUST		
		Bank lending	B Soc lending	M4 Counterpart	Bank lending	B Soc lending	M4 Counterpart
(i)	Underlying increase (sa)	6046	2225	8383	5850	2050	7650
(ii)	Estimated Special factors	225	400	625	- 650	300	- 350
	PSBR offset	625	-	625	-	-	-
	Rover repayment of bank borrowing	-	-	-	- 500	-	- 500
	Company borrowing to finance tax rebate	- 300	-	- 300	-	-	-
	Bank/building society competition	- 150	150	-	- 150	150	-
	Budget measures affecting mortgage lending	50	250	300	-	150	150
(iii)	Lending increase (sa)	6271	2625	9008	5200	2350	7300
	Lending increase (nsa)	6043	2739	8894	3700	2450	5900
	Annual % change (nsa)	27.9	17.2	23.6	29.1	17.9	24.6
	Annual % change expected at Budget time	23.7	13.7	19.6	24.7	13.9	20.3

Line (iii)=(i)+(ii)

SECRET

TABLE 29: MONEY MARKET ASSISTANCE £ million

	Outturn	Forecast		
	1988 JUL	AUG	SEP	OCT
A. Money market influences				
(i) CGBR (+) excl bank deposits (+)	-1399	-425	875	-2175
(ii) Reserves etc (+)	553	500	-25	625
(iii) Notes and coin (-)	-677	325	-200	475
(iv) National Savings (-)	-204	-175	-125	-175
(v) CTDs (-)	-3	75	150	200
(vi) Gilts (-)	1236	225	700	1800
(vii) Other Exchequer items etc	1041	0	0	0
A. TOTAL MONEY MARKET INFLUENCES (Market surplus + / shortage -)	547	525	1375	750
B. Money market operations				
(i) Commercial bills (purchase +):				
Issue Department - outright	23			
- repos	0			
Banking Department	-1243			
(ii) LA bills (purchase +)				
Issue Department	182			
Banking Department	-76			
(iii) Treasury bills (purchase +)	75	0	0	0
(iv) Market advances	378			
(v) Treasury bill Repos	0			
(vi) Export Credit/Shipbuilding Repo	0			
(vii) Gilt Repos	0			
B. TOTAL MONEY MARKET OPERATIONS	-661	-525	-1375	-750
C. Change in bankers balances = A + B	-114			
D. TOTAL ASSISTANCE OUTSTANDING	8141	7625	6250	5500
of which commercial bills	7306			

SECRET

TABLE 30

GOVERNMENT SHARE SALES TIMING

1988/89

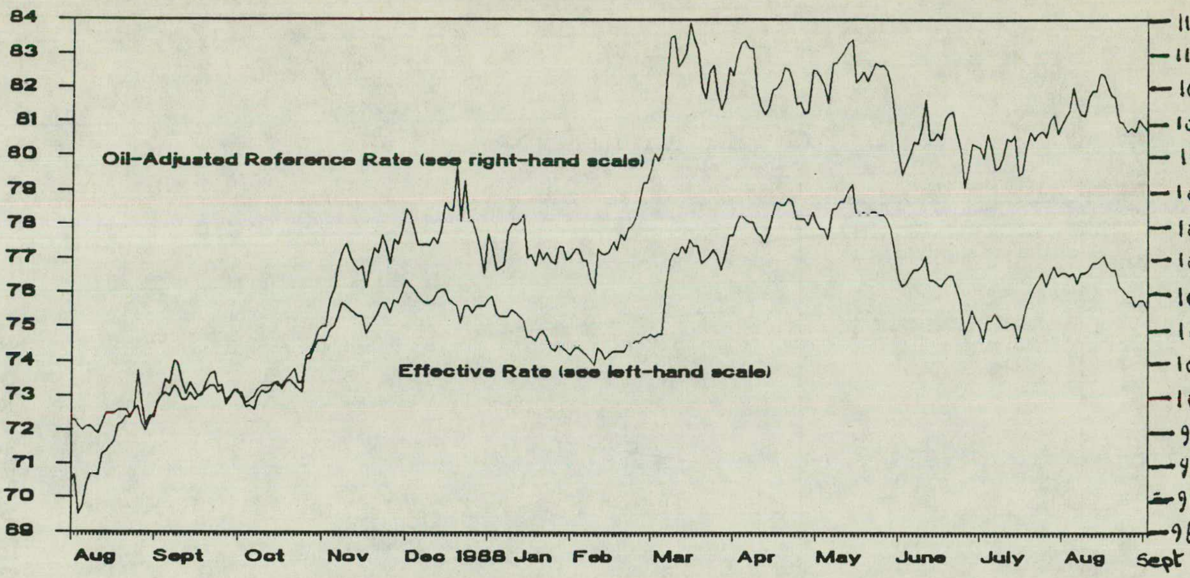
BP II	30 August
BSC I	30 November or 1 December

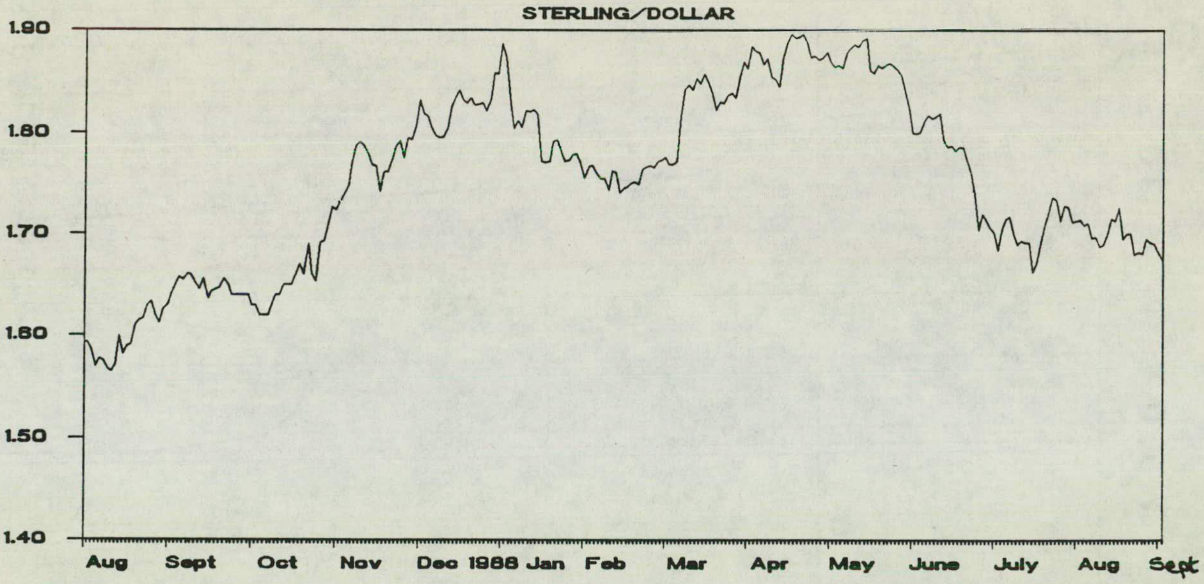
1989/90

BP III	27 April
BSC II	Undecided

MONTHLY MONETARY REPORT : CHARTS

CHART 1:EXCHANGE RATE





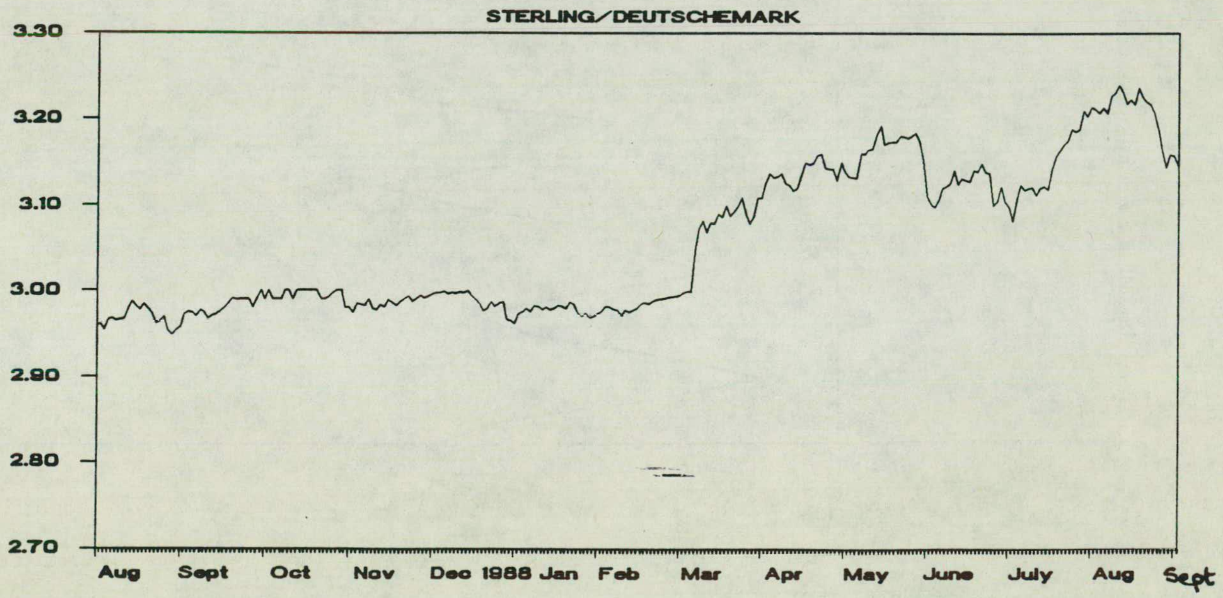


CHART II: UK/US INTEREST RATE DIFFERENCE

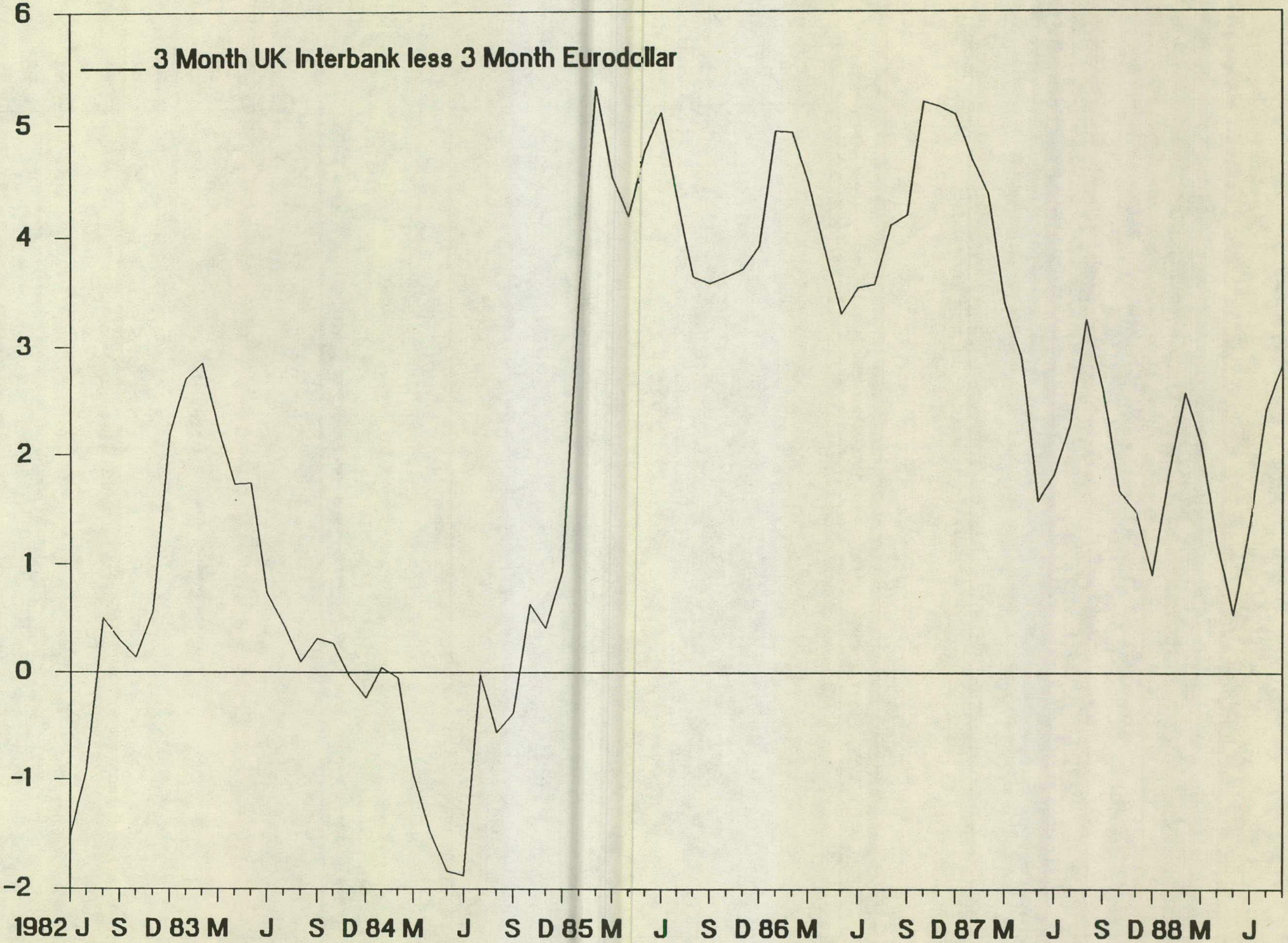


CHART III NARROW MONEY

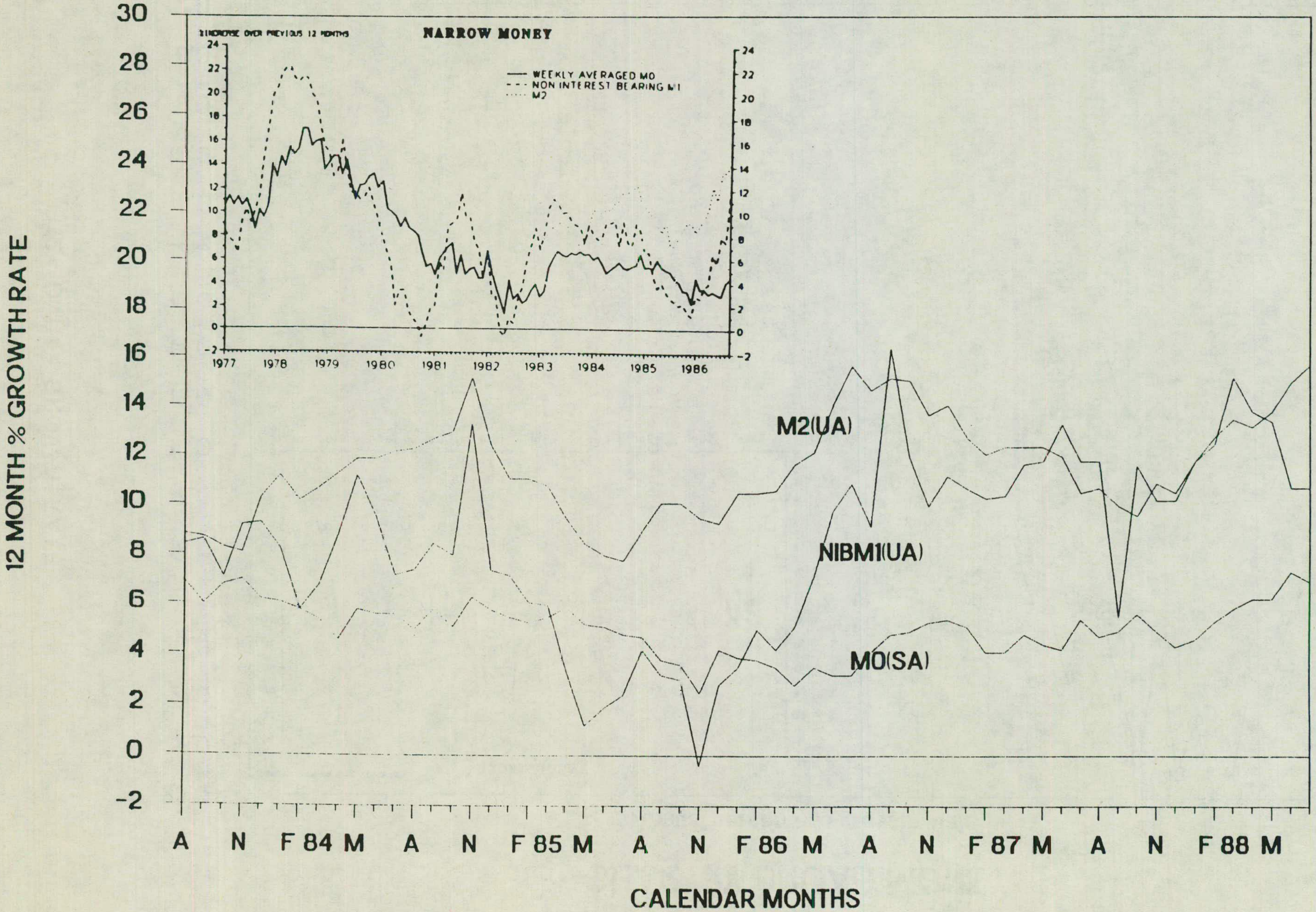


CHART IV BROAD MONEY

Annual percentage growth (ua)

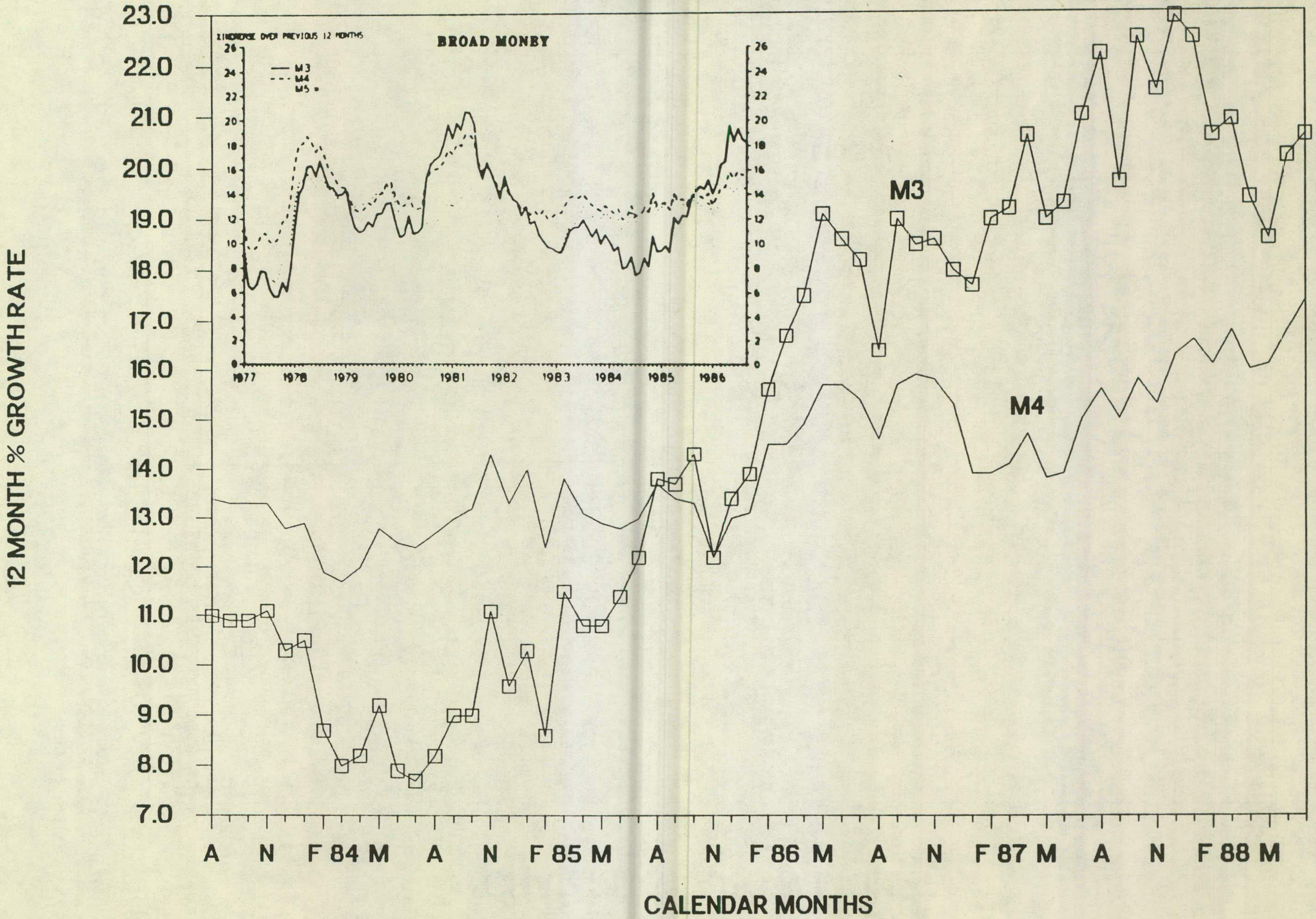


CHART V REAL MO

Annual percentage growth (sa)

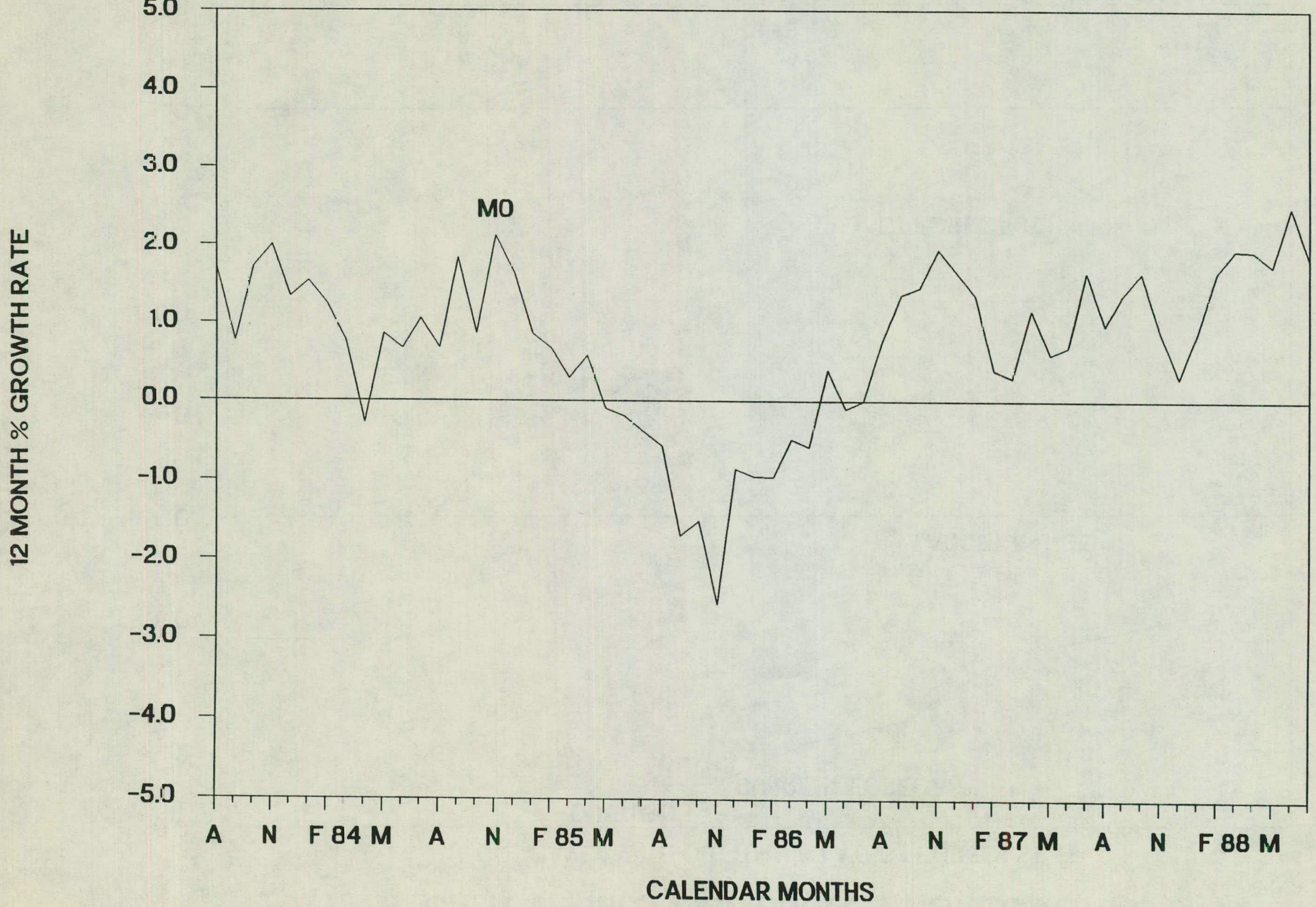


Chart VI M0 : 1988 BUDGET FORECAST

COMPARED WITH OUTTURN & LATEST FORECAST

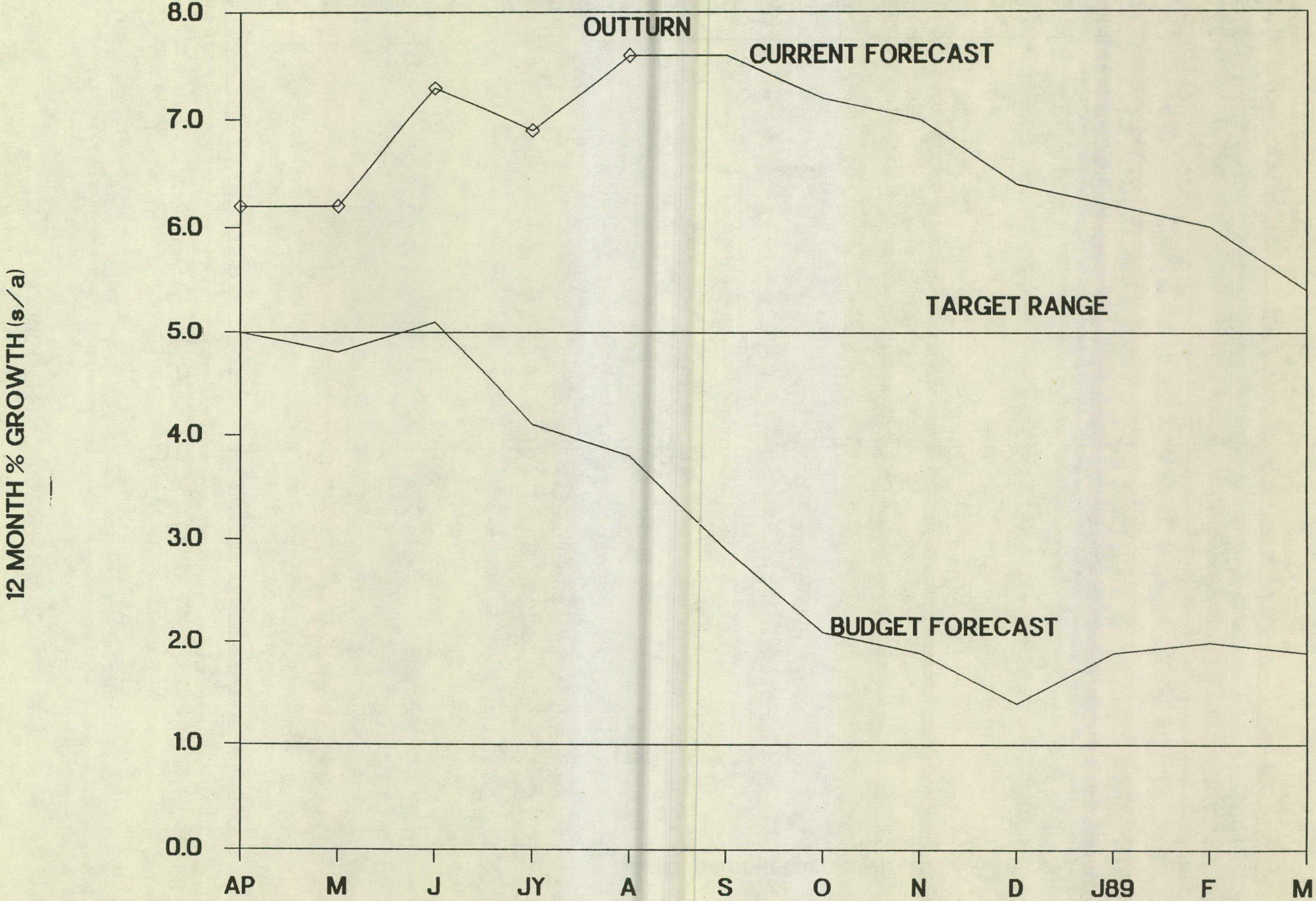
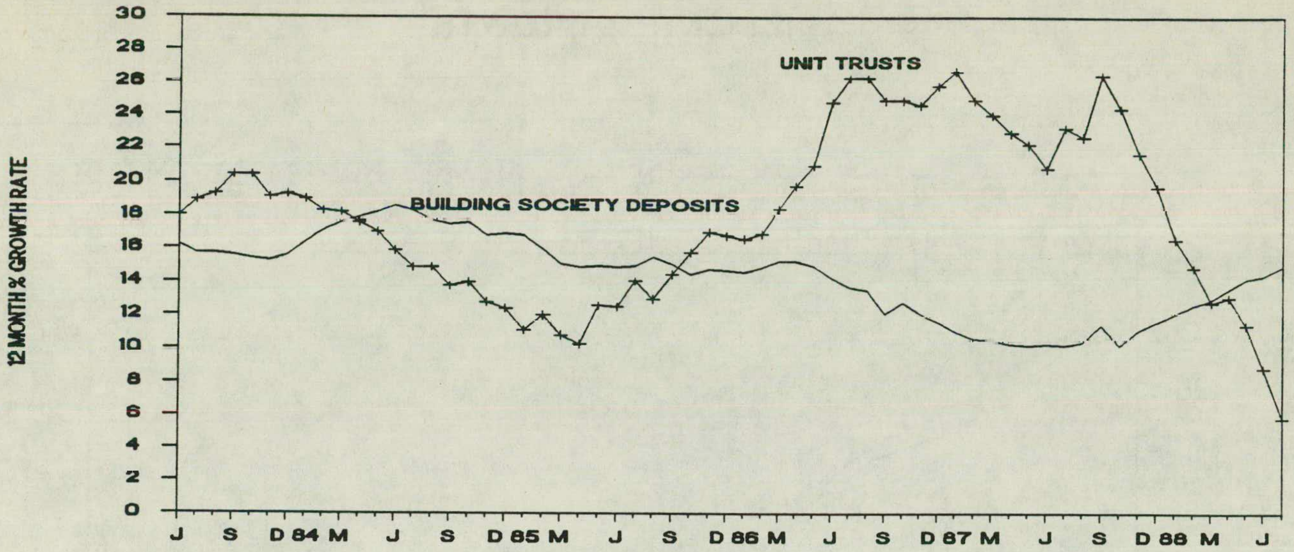
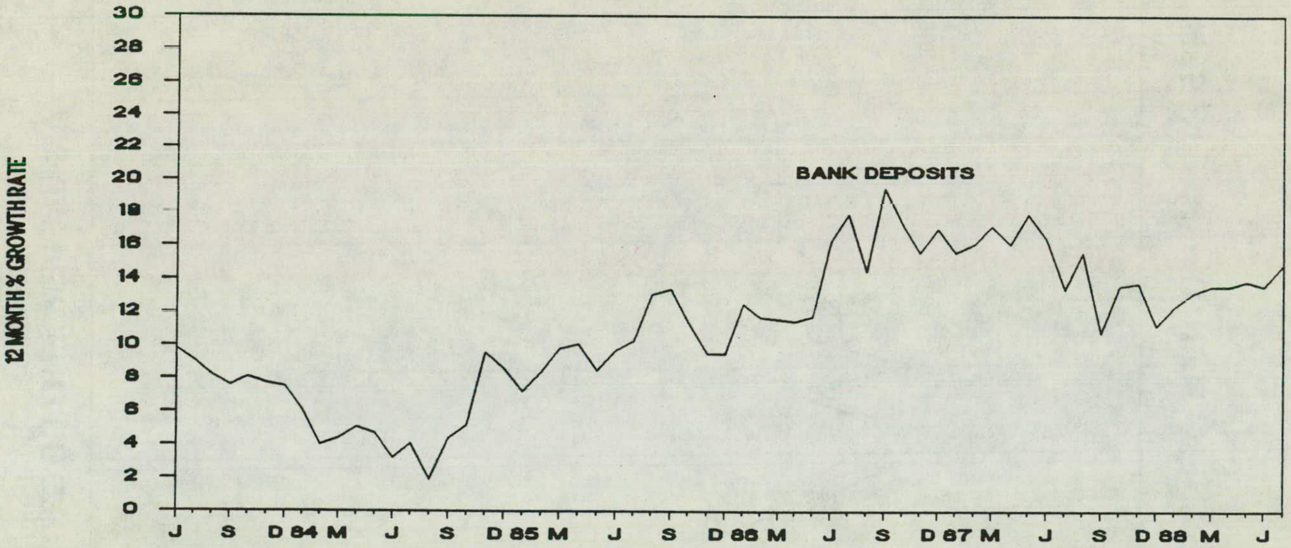


CHART VIII RETAIL DEPOSITS





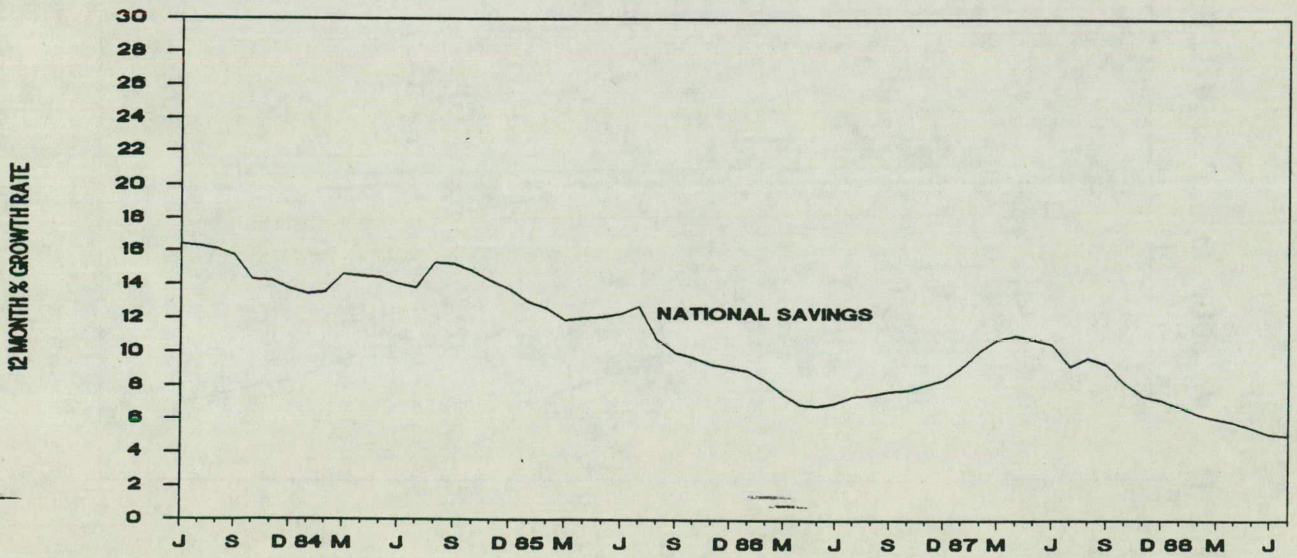


CHART IX :

BANK AND BUILDING SOCIETY LENDING

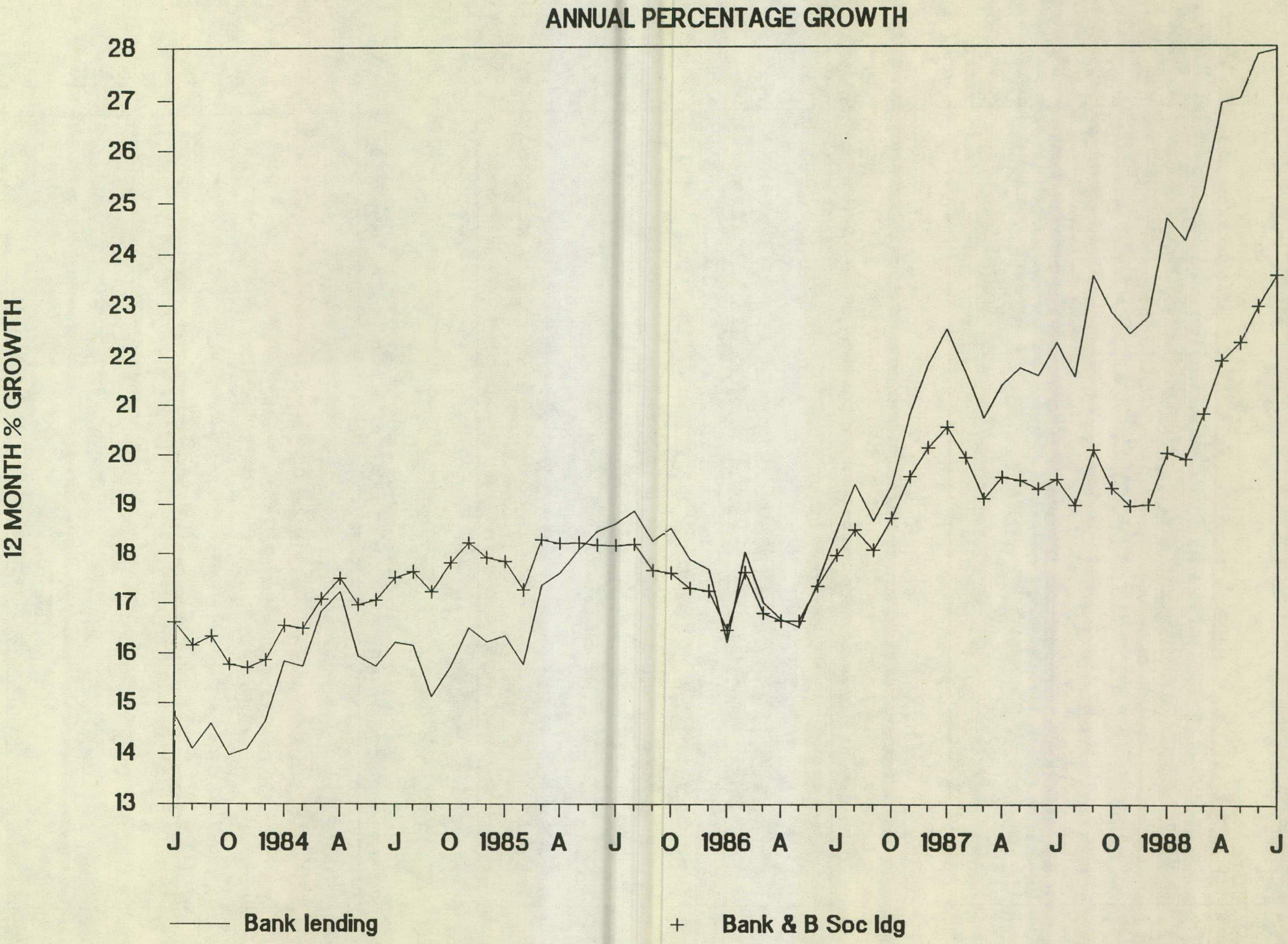


CHART X : STERLING BOND ISSUES

(Domestic and Euro Markets)

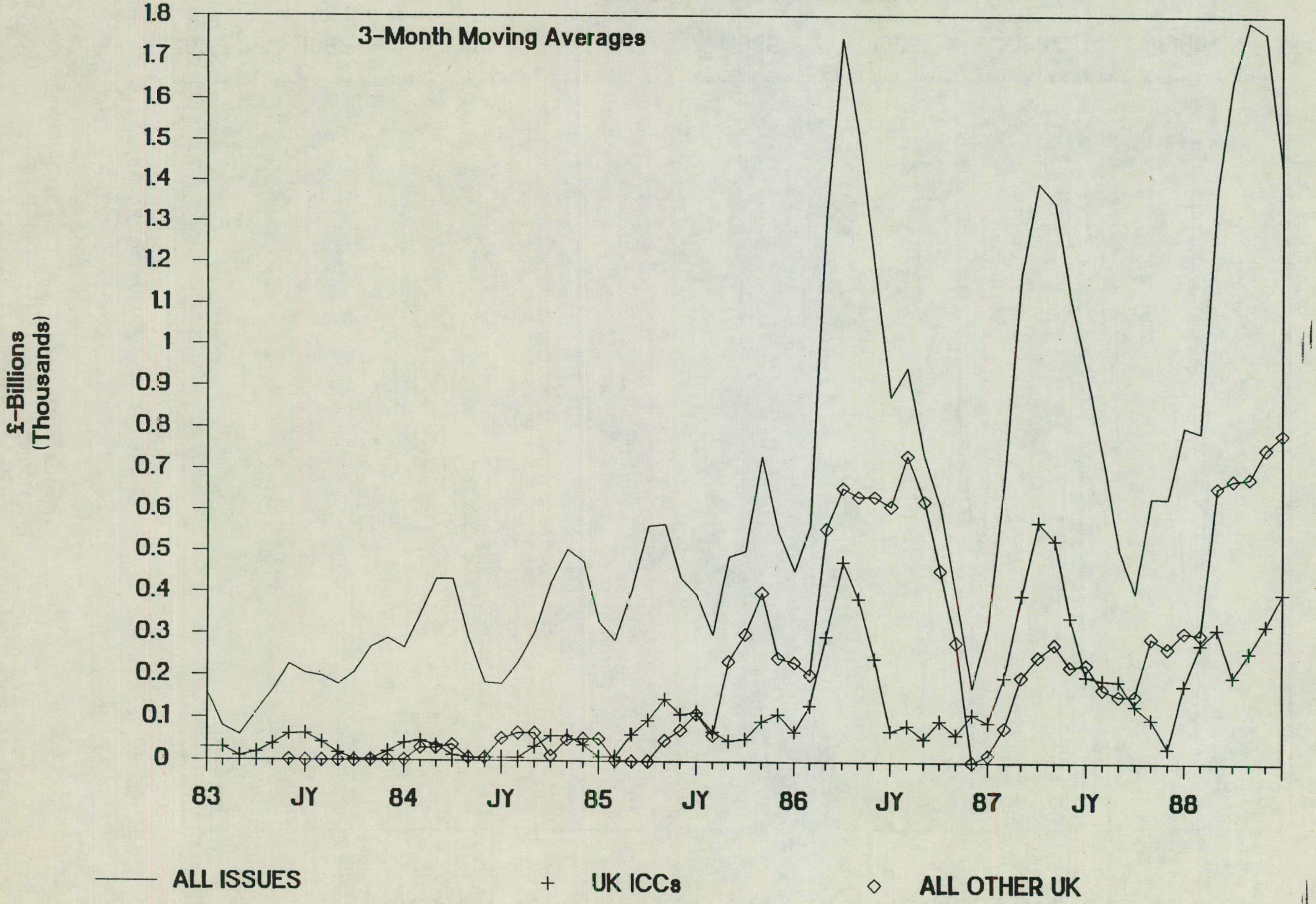


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CHART XI - MONEY MARKET ASSISTANCE

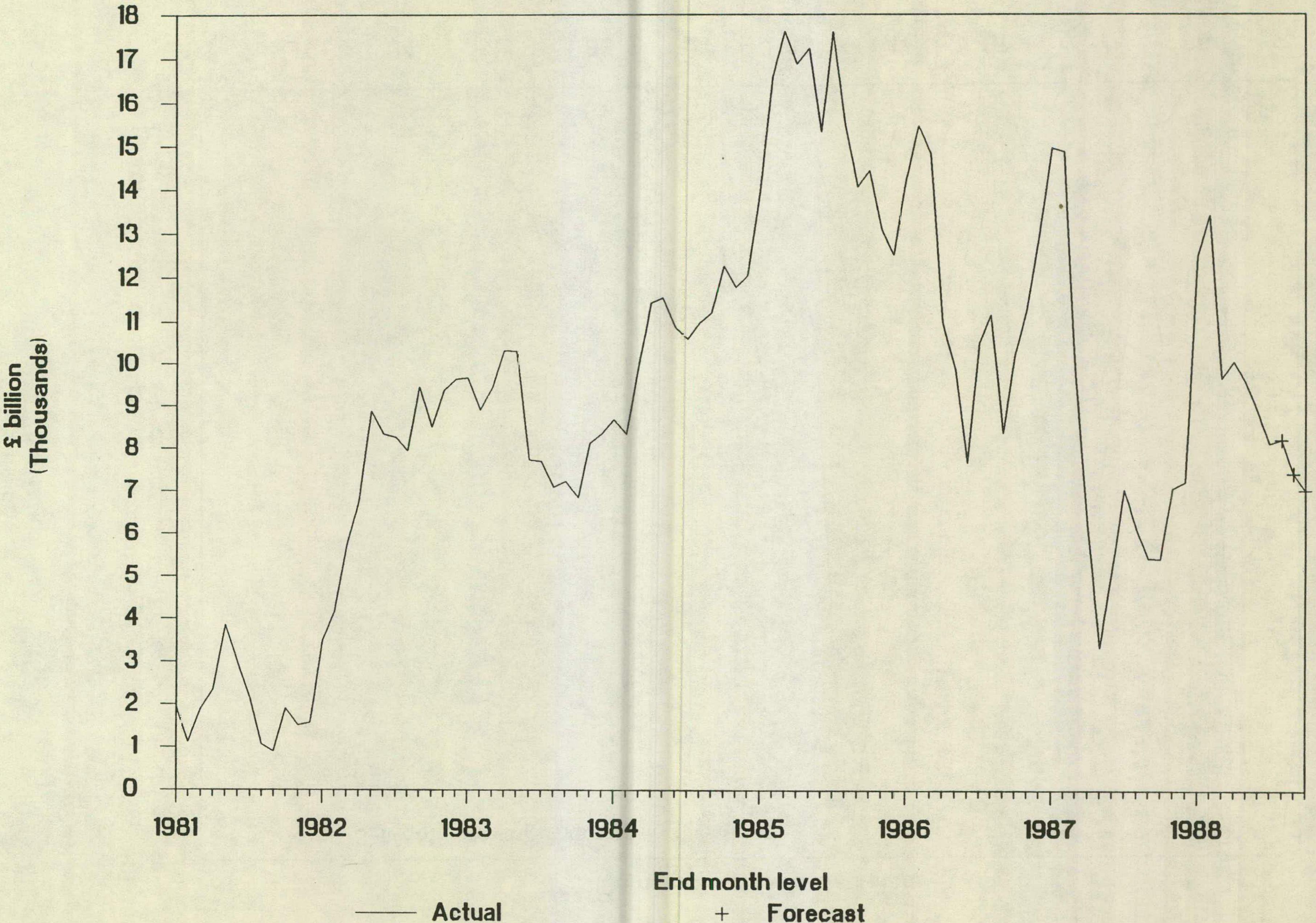


CHART XII :NOMINAL INTEREST RATES

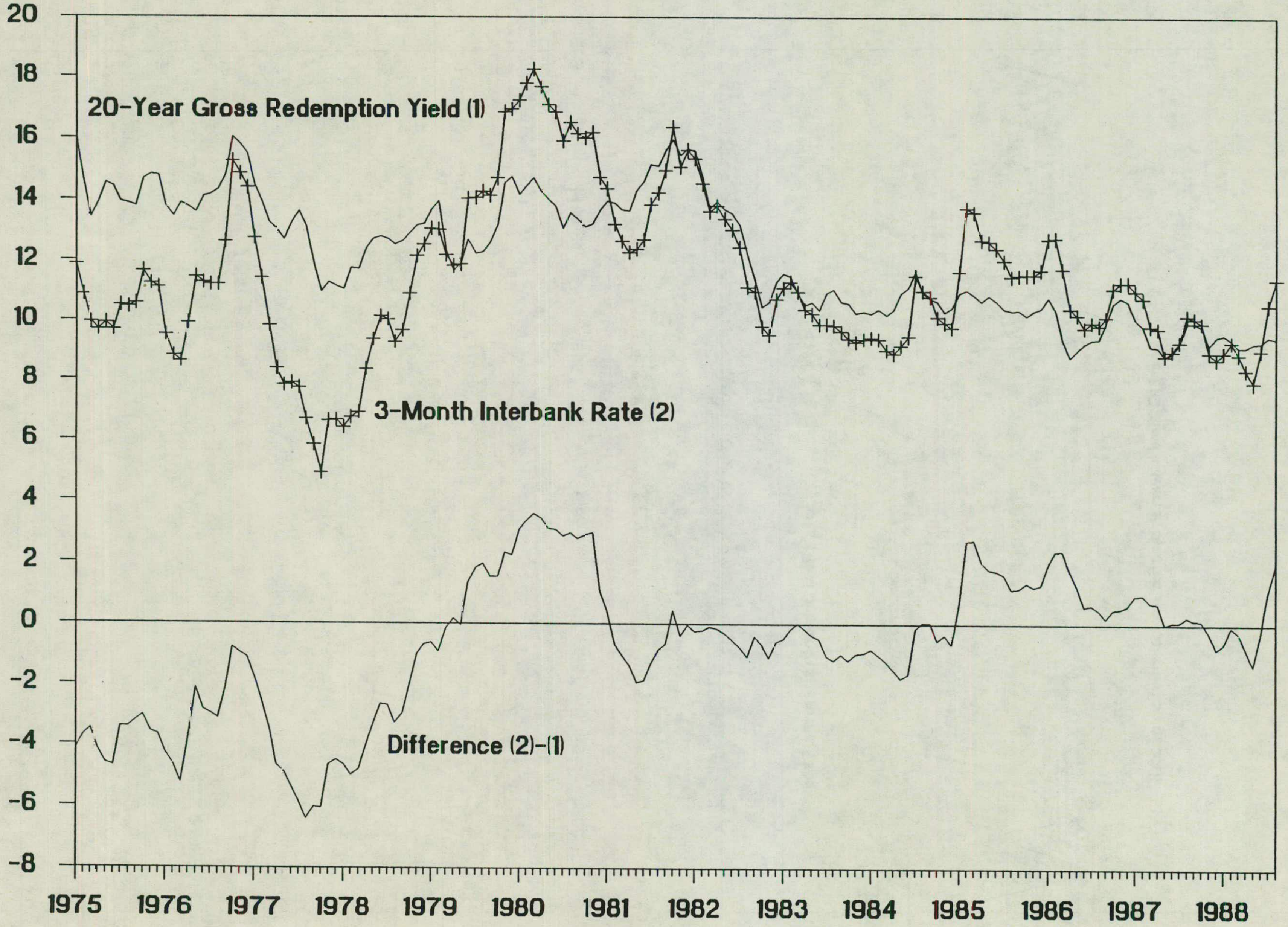
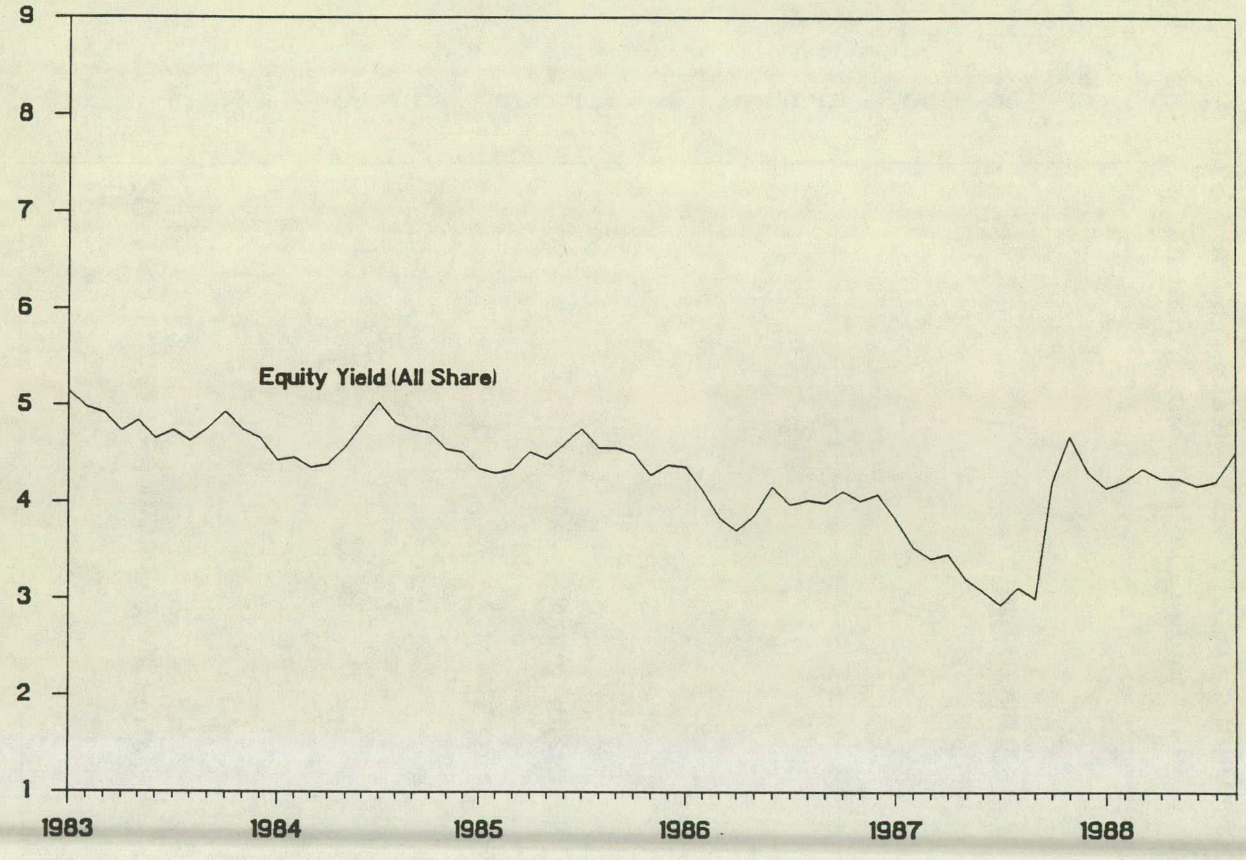


CHART XIV : REAL YIELDS



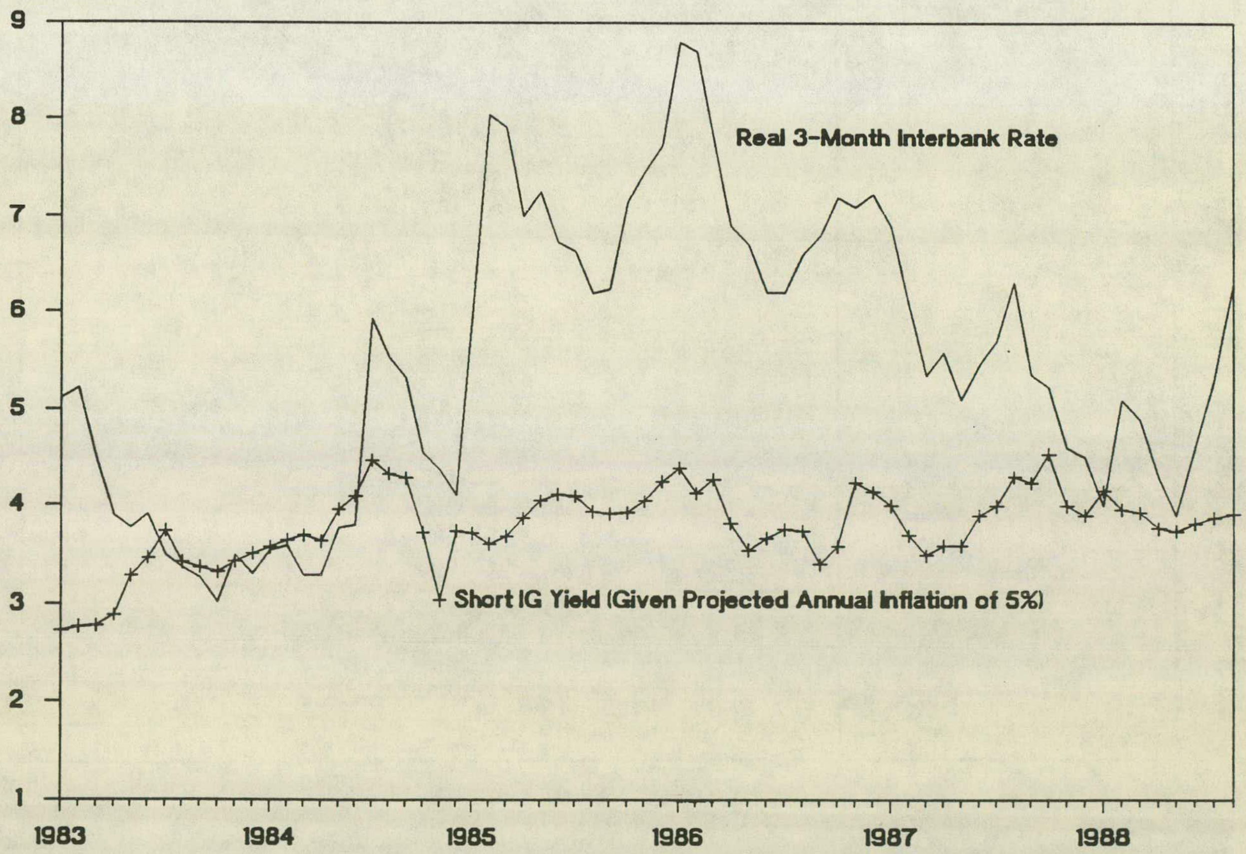
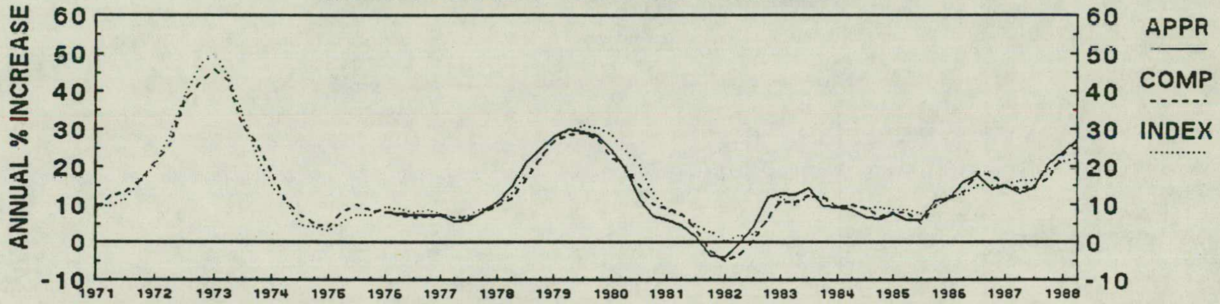


CHART XV : HOUSE PRICES

QUARTERLY HOUSE PRICES

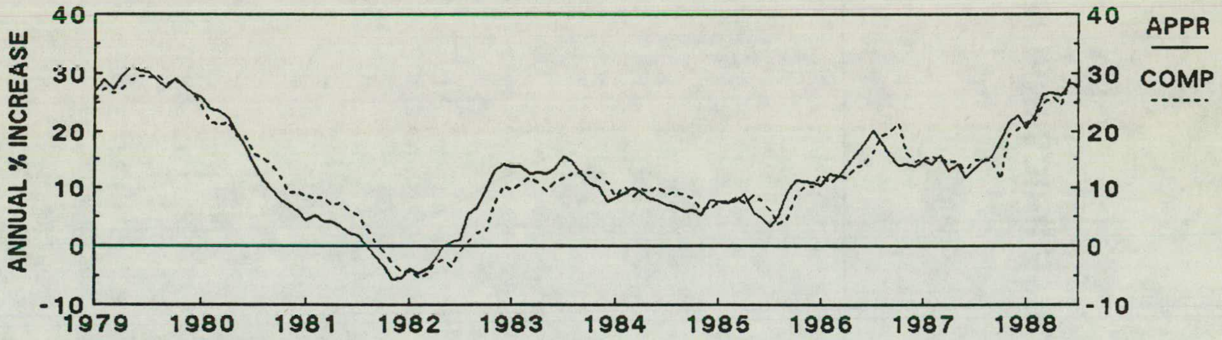


APPR = AVERAGE B. SOC. MORTGAGE AT APPROVAL

COMP = AVERAGE B. SOC. MORTGAGE AT COMPLETION

INDEX = MIX-ADJUSTED HOUSE PRICE INDEX

MONTHLY HOUSE PRICES

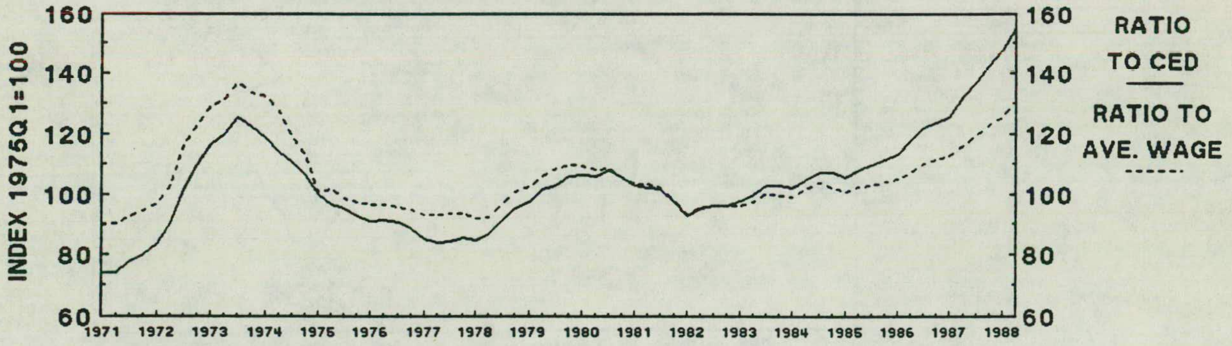


APPR = MORTGAGE APPROVAL STAGE

COMP = MORTGAGE COMPLETION STAGE ALL HOUSES

INDICES OF RELATIVE HOUSE PRICES

BASED ON DOE MIX ADJUSTED HOUSE PRICE INDEX

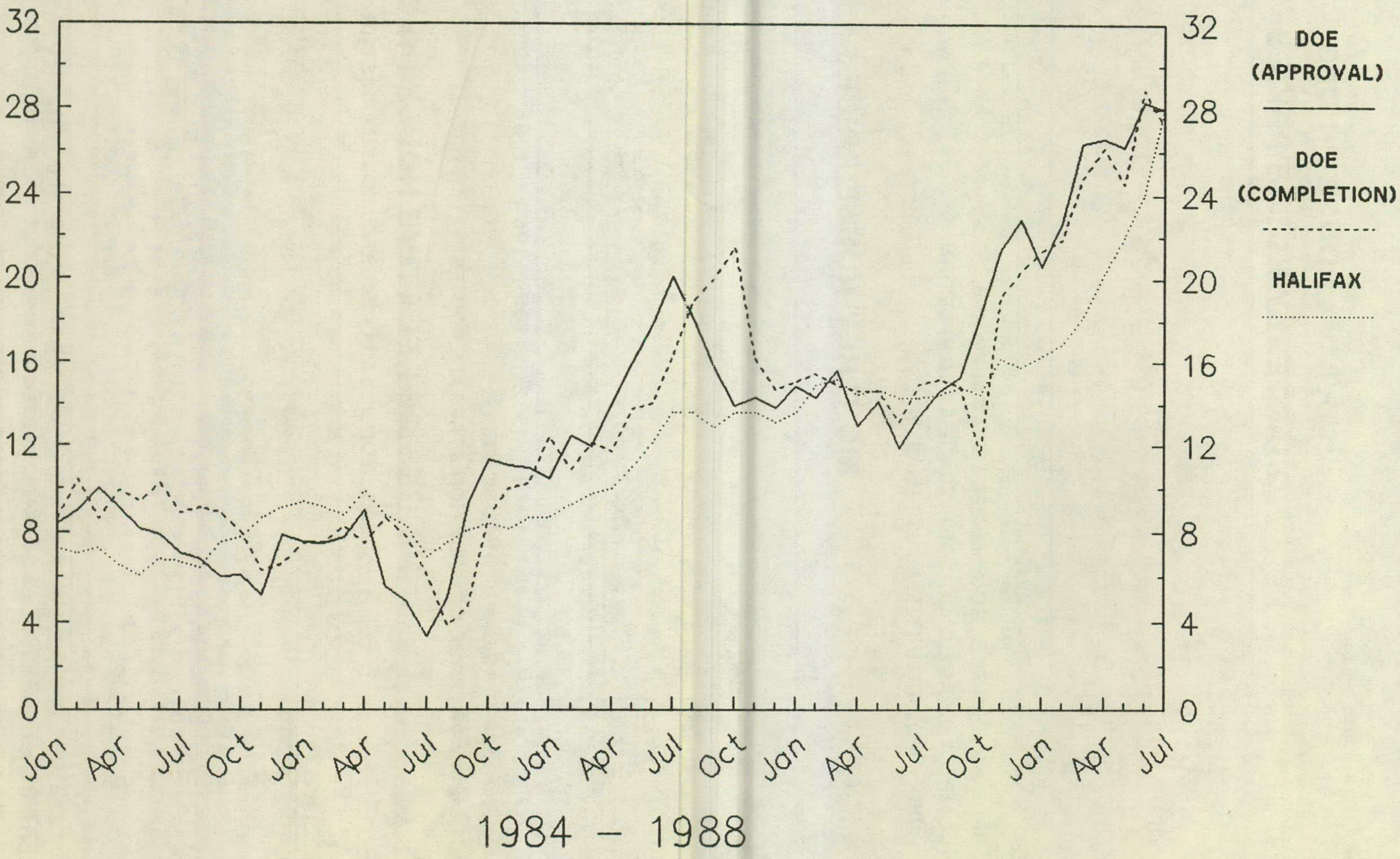


RATIO OF HOUSE PRICES TO THE CE DEFLATOR

RATIO OF HOUSE PRICES TO AVERAGE WAGES AND SALARIES

ANNUAL HOUSE PRICE INFLATION : 2

CHART XVI



NH/3/16

CONFIDENTIAL

BF 19/7

FROM: A C S ALLAN

DATE: 12 September 1988

MR DARLINGTON

cc Sir T Burns
Mr Sedgwick
Mr Hibberd
Mr Gieve

THE COST TO INDUSTRY OF CHANGES IN SHORT TERM INTEREST RATES

The Chancellor was grateful for your minute of 9 September. But he wondered to what extent the figures are affected by the " hole" in the national accounts - the June forecast showed ICCs NAFA of + £12 billion in 1987 in the national accounts and - £5 billion in the financial accounts.

ACSA

A C S ALLAN

NH/3/17

CONFIDENTIAL

FROM: A C S ALLAN
DATE: 12 September 1988

MR GRICE

cc Sir P Middleton

MONTHLY MONETARY ASSESSMENT: AUGUST 1988

The Chancellor was grateful for your minute of 9 September, recording the discussion at Sir P Middleton's monthly monetary meeting.

ACSA

A C S ALLAN

UNCLASSIFIED

FROM: MISS M P WALLACE

DATE: 12 September 1988

MR BROOKS

cc Mr Peretz

MP

MO FIGURES

The Chancellor was most grateful for your minute of 9 September.

MPW.

MOIRA WALLACE

Brief from Sedgwick BF

PCSM
2/late –

cc PEN [redacted]
TB

in particular about
priorities for review.

Giles?

C/ Mrs Jennifer Radice has rung to see if you will agree to see for half an hour the Group undertaking the Scrutiny of Government Economic Statistics, towards the end of next week or the beginning of the week 19 Sept.

As you know Stephen Pickford heads the group & the others are Mrs Radice, Robin Lynch Graham White & John Cunningham.

Content to see them?

If so I will try & find a suitable time.

Julie
5/9.

19/9

FROM: MRS J THORPE
DATE: 12 SEPTEMBER 1988

MR SEDGWICK

cc Sir P Middleton
Sir T Burns
Mr Odling-Smee
Mr Pickford
Mr Hibberd

SCRUTINY OF GOVERNMENT ECONOMIC STATISTICS

As you know, the Chancellor has agreed to see the group undertaking the Scrutiny of Government Economic Statistics, at No.11, at 11.30 am, on Monday, 19 September.

2. The Chancellor has suggested that you, Mr Odling-Smee and Mr Hibberd attend the meeting as well. Please can you let me know if you are free.

3. Please can you provide briefing, particularly about the priorities for the Review, by close of play on Thursday, 15 September.

Julie Thorpe

MRS JULIE THORPE
Diary Secretary

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

13 September 1988

Dear Alex,

TIM CONGDON'S ARTICLE ON THE BALANCE OF PAYMENTS

The Prime Minister was grateful for the note on Tim Congdon's article attached to your recent letter.

Yours,
Paul

Paul Gray

Alex Allan, Esq.,
H.M. Treasury.

mg2.cc/Brooks/91g.3.12.9

SECRET AND PERSONAL

1. Ales
2. MP

FROM: S BROOKS
DATE: 13 September 1988

1. MR GRICE
2. ECONOMIC SECRETARY

cc Chancellor
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Peretz
Ms O'Mara
Ms Ryding
Mr Wheatley
Mr Gray - No 10

MAMC A1

The lending figures are encouraging. We shall need to investigate further the Bank's hypothesis that unwinding of arbitrage positions may be depressing the figures, as more information becomes available. But, at first sight, it is hard to give it much credence. JWG 13.9.88

MONEY SUPPLY IN AUGUST: "FIRST GUESS" FOR M3 AND OUTTURN FOR MO
(All figures are unadjusted unless specified otherwise)

Table 1 shows the Bank's 'first guess' at the M3 figures for August - which are still subject to significant revision - and the outturn figures for MO, previously circulated on 8 September.

Table 1

Growth of Monetary Aggregates in August

per cent

	MO	**M3****
Annual Growth Rate*	7.8 (7.6)	18.8 - 20.0
Change in Month*	0.8 (1.0)	- 0.4 - +0.8 (- 0.3 - + 0.9)
Target Range	1-5	

* Figures in brackets are seasonally adjusted
** The outturn has been in the range forecast on this basis in each of the last 12 months

2. The estimated twelve month growth rate for August of 19½ per cent is one percentage point lower than the July outturn. Bank lending is thought to have increased by £3.2 billion (1.3 per

cent) on a seasonally adjusted basis which would be modest by the standards of the last two months, in each of which bank lending increased by more than £6 billion. Bank lending was probably (?) increased by further mortgage borrowing and, perhaps, to finance high sales of new cars. But Rover may have repaid borrowing with their 0.5 billion CG grant. Also the Bank report that the interest rate rises in July may have led to the unwinding of positions generated by £/$ arbitrage, rumoured to have occurred in the first half of the year.

3. On a seasonally adjusted basis M3 was overfunded by nearly £¾ billion (£0.1 billion, not seasonally adjusted).

4. We have no figures for M4 as yet, but building societies retail inflows remained high in August, and lending may still have been boosted by commitments entered into before the ending of multiple tax relief. M4 may turn out to have grown faster than M3 in August.

5. M3 Components and Counterparts

Tables 2 and 3 compare the changes in M3 components and counterparts with their average monthly changes over the last year.

6. Postal Strike

It is not thought that the partial postal strike on 31 August materially affected the figures.

7. Timetable

We expect to receive provisional figures for M3 on Wednesday 14 September, with figures for M4 and M5 available on the following day. The provisional estimates will be published at 11.30 am on Tuesday 20 September, the full figures will be published at 11.30 am on Thursday 29 September.

S BROOKS

TABLE 2: M3 COMPONENTS - AUGUST 1988

"First Guess" compared with average monthly change in the previous year.

£ millions

	First Guess	Average monthly change in previous 12 months
Notes and coins in circulation	-431	97
Non-interest bearing sight	455	294
Interest bearing sight	-358	885
Time deposits (including CDs)	465	1680
Grossing up to full population	318	-
Change in M3	449	2956

TABLE 3 : M3 COUNTERPARTS - AUGUST 1988

"First guess compared with average monthly change in the previous year

£ millions

		First Guess		Average change in previous 12 month
CGBR (O) (ex bank deposits)		-1292		-646
Other public sector:				
LABR)				
PCBR)		546		81
OPS debt sales)				
		------		------
Modified PSBR*		-746		-565
CG debt: Gilts	540		-117	
Treasury bills	19		9	
National Savings	-161		-148	
CTD's etc.	57		29	
		------		------
Total CG debt sales (-)		455		-227
External and fc finance of public sector (-)		203		555
		------		------
Wide over(-)/under(+)funding		-88		-237
		------		------
Sterling lending to nbps (incl Issue Dept commercial bills)		1706 #		4420
Net private externals		1420		-673
Residual (includes NNDLS and reporting differences)		-2589		-554
		------		------
Change in M3		449		2956
		------		------
(Monthly percentage change)		(0.2%)		(1.6%)
(12 month percentage change)		(19.4%)		(21.2%)

---

* Modified PSBR equals PSBR less OPS debt sales

\# £3209 million after seasonal adjustment.

CONFIDENTIAL

FROM: P N SEDGWICK
DATE: 14 SEPTEMBER 1988

CHANCELLOR

Many thanks. X is particularly bizarre. I note it.

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Peretz
Mr Gieve
Mr Hibberd
Mr O'Donnell
Mr Owen
Ms Turk
Mr Davis

THE BALANCE OF PAYMENTS AND GDP IN 1988Q2

While the Blue and Pink Books went some way to reducing a few of the major inconsistencies in the macroeconomic statistics for 1987 and earlier years, the problems with the current year have if anything got worse. I thought it would be helpful if I gave you advance warning of the balance of payments and national accounts figures for 1988Q2.

<u>The balance of payments in 1988Q2</u> (to be published at 11.30, Thursday, September 15)

2. Mr Davis will today be sending you our assessment of the figures and suggested press briefing. One of the notable features of the figures is the £5b (positive) balancing item in 1988Q2. The balancing item in the first half of 1988 is greater than the current account deficit. Since the first half of 1987 the rise in the balancing item is greater than the deterioration in the current account.

3. I am sure that it would be wrong, and probably counterproductive, for us to adopt a press line that suggested that the deterioration in the current account was grossly exaggerated. It would be better for the numbers to speak for themselves. It is perfectly in order, however, to emphasise the difficulties in making sense of the balance of payments statistics as a whole (including the capital account flows).

Y

The national accounts in 1988Q2 (to be published at 11.30, Wednesday September 21)

4. We do not have anything like final numbers for the 1988Q2 national accounts, but the difficulties in interpretation could very well be considerable even after the CSO have completed the exhaustive checking that we are urging on them. The main features that look like emerging are

(i) X a slight fall in the expenditure measure of real GDP in 1988Q2, with growth on a year earlier of about 2½-3 per cent; with GDP(E) growth so low, growth of the average measure of GDP will be as a result somewhat below the level that I would regard as sensible:

(ii) subdued growth in real domestic demand - and particularly consumers' expenditure - between 1988Q1 and Q2:

(iii) a rise in the residual error (the gap between GDP(I) and GDP(E) at current prices) from its average level of just over 1 per cent in 1987.

5. We have been having discussions with CSO statisticians over the past few days in the hope that some of these odd characteristics of the numbers can be removed or reduced in size before publication. I find the low growth of domestic demand - and as a result GDP(E) - scarcely credible given the other indicators we have on the level of activity.

6. If nevertheless the national accounts for 1988Q2 emerge next week with the characteristics summarised in paragraph 4 it will be a little more difficult than it ought to be to argue that the surge in recorded imports, and the associated deterioration in the current account, earlier this year were the results of very fast growth in real output and domestic demand. We will of course have very buoyant indicators (though no data on GDP) for 1988Q3.

P.N.S

P N SEDGWICK

CONFIDENTIAL

FROM: KEVIN DARLINGTON
DATE: 14 SEPTEMBER 1988

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Paymaster General
Sir P Middleton
Sir T Burns
Mr Monck
Mr Scholar
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Hibberd
Mr Gieve
Mr Grice
Mr O'Donnell
Mr Hurst
Mr O'Brien
Mr Cropper
Mr Tyrie
Mr Call

I'm not wholly convinced

THE COST TO INDUSTRY OF CHANGES IN SHORT TERM INTEREST RATES

You asked whether the difference between the Industrial and Commercial Companies' (ICCs') NAFA calculated from the national accounts and from the financial accounts might affect our estimate of the cost to industry of a change in UK short term interest rates set out in my note to you of 9 September.

2. There is a large discrepancy in the ICC accounts where, for recent years, apparently large financial surpluses calculated from data on income and expenditure do not correspond with the identified total net financial transactions. For example, the latest Blue Book shows for 1987 a financial surplus (positive NAFA) of £9 billion calculated from income and expenditure data and a deficit (negative NAFA) of -£5 billion calculated from financial data.

3. If the income side NAFA has been correctly measured, the financial statistics must have underrecorded asset acquisitions. This, in turn, might affect the selected balance sheet (Table 2 of my note of 9 September - copy attached) containing those assets and liabilities sensitive to short-term interest rates.

4. However, whilst grave doubts exist concerning the recording of a number of components in both the income/expenditure and the financial accounts, there is a fair measure of confidence in the accuracy of the statistics for short rate sensitive financial assets and liabilities. The data for the majority of these, eg bank lending and borrowing, come from a relatively small number of financial institutions - <u>not</u> from the ICCs themselves - which

hmm.

tend to be reasonably accurate providers of statistics. These figures are in turn collated and published by the Bank as part of the monetary statistics. The one aspect of the calculation of these statistics about which significant doubts remain, is the attribution of bank lending and deposits to particular sectors. We do not believe that any errors on this score are as large as those affecting the income and expenditure flows or other financial assets or liabilities.

5. If, as we believe, the selected assets and liabilities are well identified, the discrepancy in the ICC accounts should not greatly affect our estimate of the cost to ICCs of changes in short term interest rates.

Kevin Darlington

KEVIN DARLINGTON

I am puzzled by para 4. While corporate interest-variable liabilities are largely in the form of bank borrowing, etc, their interest variable assets will not be largely in the form of bank deposits, etc, but range much more widely: what How much do we know what companies do with their surplus cash? –

Table 2 : ICCs' Assets and Liabilities sensitive to UK short-term interest rates

£ billion

	End 1987 Q4	End 1988 Q1
Assets		
Sterling interest-bearing sight deposits with UK banks	13.3	11.4
Sterling interest-bearing time deposits (incl. CDs) with UK banks	28.6	29.4
Local Authority temporary deposits	0.1	0.1
Building Society shares and deposits	0.5	0.5[e]
Building Society wholesale borrowing	2.1	2.1[e]
Treasury Bills	0.8	0.6
Other	1.8	1.7[e]
Total Assets	47.1	45.7
Liabilities		
Sterling bank lending	71.1	78.8
Issue Debt. holdings of ICCs bills	5.9	8.2
Other	2.8	2.8[e]
Total liabilities	79.8	89.8
Net liabilities	32.7	44.1

e = estimate