PREM 19/1707

Domestic Monetary Policy.

In attached folder. Banking Supervision Report

ECONOMIC POLICY

Part 1: May 1979

Part 15: Dec. 1985

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~6.12.85~~		~~25.9.86~~					
~~11.12.85~~		30.9.86					
~~12.12.85~~							
~~9.1.86~~							
~~15.1.86~~							
~~24.1.86~~							
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~~7.4.86~~		PART CLOSED.					
~~8.4.86~~							
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18.6.86							
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~~31.7.86~~							
~~14.8.86~~							
~~1.9.86~~							
~~2.9.86~~							
~~16.9.86~~							

PART 15 ends:-

DRN to HMT (Meeting Record)
30-9-86

PART 16 begins:-

DRN to Lord. Bruce-Gardyne 1-10-86

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
CC(86) 3rd meeting, item 2	23/01/1986
CC(86) 12th meeting, item 4	20/03/1986

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed _____ Date 12/09/2014

PREM Records Team

SUBJECT
CC MASTER

SECRET

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

30 September 1986

THE MARKETS

My letter recording the meeting held by the Prime Minister this morning to discuss the markets omitted one important conclusion, namely the Prime Minister's view that it would not be helpful to make public the existence of the swop agreement with the Bundesbank.

I am copying this letter to John Footman (Bank of England).

(David Norgrove)

Tony Kuczys, Esq.,
H.M. Treasury.

SECRET

SECRET

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SUBJECT cc MASTER

10 DOWNING STREET

LONDON SW1A 2AA

30 September 1986

From the Private Secretary

Dear Tony,

THE MARKETS

The Prime Minister this morning held a further meeting to discuss the markets. Present were the Economic Secretary, Sir Peter Middleton (HM Treasury), Mr. Frank Cassell (HM Treasury), the Deputy Governor of the Bank of England and Mr. Eddie George (Bank of England). Professor Brian Griffiths was also present.

The Deputy Governor reported that sterling had opened somewhat firmer and there had been no deterioration in money market rates. A swap had been agreed with the Bundesbank with a limit of £1 billion, for 3 months renewable three times. It would be at the discretion of the Government whether and when the existence of this swap might be made public.

The meeting continued the discussion reported in my letter of yesterday about whether the fundamental economic position warranted an increase in interest rates. It was suggested that a depreciation of the size which had occurred would itself justify some increase in interest rates if the full benefits of the depreciation were to be gained. It was also recognised that there tended to be a ratchet effect on interest rates: the markets often seemed to look for particular increases in interest rates regardless of the starting point. This argued for trying to reduce rates at every opportunity where this could be done without unsettling the markets.

As regards the shorter term position it was agreed that the Bank of England should continue to intervene today. Some intervention in London would be a counter-part to intervention to be undertaken by the Bundesbank on the Bank's behalf. Total intervention for today should be kept within a limit of $200 million but within this limit intervention should be kept to an absolute minimum. Intervention on this scale was justified in order to try to guide the markets through to a calmer period. An increase in interest rates still seemed on balance more probable than not, but a postponement might allow a smaller increase.

I am copying this letter to John Footman at the Bank of England.

Yours,

DAVID NORGROVE

A. Kuczys, Esq.,
H. M. Treasury

David

SECRET

PERSONAL AND CONFIDENTIAL

PRIME MINISTER

Interest Rate Policy: hysteria and fundamentals

Market sentiment in sterling is at present a mixture of hysteria and perceived adverse movement of fundamentals.

Questions over the fundamentals

1. Money Supply

Broad money is gowing rapidly reflecting the demand for credit. Most reccently narrow money has begun to grow faster as well. In August Mo grew by ½ per cent.

Changes in 12 months to

	Mo	£M3
June	3.1	18.3
July	3.0	19.3
August	4.1	18.5

2. Unit Labour Costs

Running at 7½% but the CBI report that pay settlements in manufacturing fell to an average of 5½% in the third quarter (lowest figure for three years). Our costs are substantially higher than all our major competitors.

The weaker sterling exchange rate has put companies in a very comfortable position - in which (on the basis of past evidence) they are just as likely to concede cost increases, as to expand in foreign markets.

3. Consumer spending

Up 3¾ in 1985; but Q2 1986 over Q2 1985 up by over 5%. Retail sales in August at record level. Real disposable income was 3½% higher Q1 1986 on Q1 1985. It is this which is driving the demand for Mo.

4. Balance of payments

Current account surplus of £3.6bn for 1985 hass been effeccitvely eroded in 1986. Devaluation will have a positive effect on the non-oil balance but will take time to come through.

5. Credit boom

Rise in equities and home prices substantial: partly fed by increased competition between banks and building societies. But existing interest rate levels are not restraining the demand for credit.

6. Political factors

Election within 18 months is a certainty: outcome less clear than 1983.

7. The dollar and the DM

The US economy is suffering a serious imbalance which requires a lower $. US will not lower interest rates for fear of higher inflation: Germany sees no reason to move: therefore continuedfall in $ accompanied by weakness of sterling

8. PSBR

The market suspects that the PSBR is overshooting its target by £1 1/2 billion.

Conclusion

In the minds of market dealers all of this adds up to a consumer led-boom accompanied by the fear of an easing of monetary and fiscal policy in the run-up to an election. Nervousness over the fundamental behaviour of the economy is therefore producing volatile markets ready to move on the slightest rumours.

The deterioration in market sentiment is clearly evidenced by

(a) the rise in gilt yield over past six weeks;
(b) the devaluation of sterling over the summer
(c) the recent rise in money market rate in recent days

Policy Response

1. It is important to do everything possible to get the Germans to lower interest rates.

2. If this is very limited or does not take place the market itself will almost certainly force up interest rates.

3. The market does not yet know the state of the PES round. A rise in the planning total against this background would almost certainly mean a rise of at least 2 per cent in interest rates.

Recommendation

a. Continued intervention by the Bank in the market could well be giving conflicting signals as the market attempts to read the new "desired" level of the exchange rates. Permit the exchange rate to fall and keep intervention by the Bank to the very minimum.

b. The present slight deterioration in the fundamentals of the economy must be judged against the background of the unhelpful PES round. Ask the Chancellor to present his game

plan on interest rates, taking this into account.

c. It ought to be possible to ride over this current bout of hysteria. But if the market insists on the interest rate increase because it is worried about the fundamentals of the economy rather than the G5 it would be better to lead rather than to follow. If the market forces rates to rise do not attempt to stop them. Far better to turn it to your advantage in the Party Conference as yet another example of your determination to fight inflation. This would have an important psychological effect on market sentiment which will be to your advantage in the difficult run-up to the election.

The worse thing to do would be to delay taking appropriate action in keeping to a sound monetary policy and letting people imagine that you were prepared to gamble on inflation. This would almost certainly prove counter-productive.

Brian Griffiths

29 September 1986

PRIME MINISTER

29 September 1986

OIL PRICES - SHORT-TERM OUTLOOK

In July and August, OPEC oil producers exported roughly 2 million b/d above the underlying level of demand for their oil. That surplus has recently been hitting the major oil markets. Significantly, oil prices have remained fairly steady with North Sea oil trading in the range $13.5 - 15.0 a barrel.

Evidently, oil buyers have been prepared to buy for stock in anticipation that prices will harden. This vote of confidence in OPEC's current efforts to limit their production and boost prices has so far been matched by a surprising degree of self discipline on the part of OPEC members.

My guess is that OPEC's meeting scheduled for 6 October will endorse a continuation of the current production controls. The market will read this positively; OPEC discipline will be maintained; and North Sea oil prices will harden towards $20 a barrel over the next 2-3 months. Thereafter, the outlook for prices will depend on whether some more durable arrangements can be established for balancing world supply against demand.

JOHN WYBREW

SECRET

file

CAT

16

SUBJECT cc MASTER

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

29 September 1986

Dear Tony,

THE MARKETS

The Prime Minister this morning held a meeting to discuss the current pressures on sterling and interest rates. Present were Sir Peter Middleton (HM Treasury), Mr. Frank Cassell (HM Treasury), Mr. George Blunden (Deputy Governor of the Bank of England), and Mr. Eddie George (Bank of England).

The Prime Minister said that much of the present hysteria in the markets had been whipped up by the media. Talk of pressure on sterling tended to be self-fulfilling. The G5 meeting itself had contributed to the problem particularly because of the very public arguments between the Germans and Americans. The Prime Minister said she was also alarmed at the scale of intervention in the foreign exchange markets. Had the UK not recently borrowed $4 billion it seemed unlikely that intervention on this scale would have taken place. With oil prices still weak and with the more rapid growth of wages and even inflation in this country than in many of our competitors there was bound to be a depreciation and probably no point in trying to resist it by increasing interest rates, which were already very high. It would be better to take the pressure on the exchange rate than to raise interest rates, though it might be right to intervene to steady the movement.

As regards the shorter term market position, it was pointed out that a substantial part of the intervention undertaken during the past month (perhaps as much as three-quarters of it) had been undertaken off market. These were sales of foreign exchange which under normal circumstances would have been recouped in the market. This had not been possible against the background of weakness in sterling. The recent intervention had been necessary to avoid an immediate increase in interest rates, larger perhaps than might otherwise be necessary. Intervention now might buy time to allow the markets to calm down and to put the weekend meeting and the IMF annual meeting in perspective.

In further discussion it was noted that some depreciation had been inevitable. But, whilst the calculations were very uncertain, it did seem possible that the exchange rate was now lower than would have been justified simply by the fall in oil

8/10

prices. The balance of payments figures for August had been extremely poor. There were now signs of looseness in the monetary statistics, not only sterling M3 but also in the behaviour of MO. It had been possible to look to the strength of the real exchange rate for reassurance but that was now no longer possible. The public expenditure position was a further cause for market concern, and the prospect of an election was also a background factor. It was hard to judge whether interest rates were high or low, but a huge demand for credit had continued month after month. This background suggested that market concerns were not entirely hypochondria. But these factors ought to be assessed calmly. An immediate increase in interest rates should be resisted.

It was agreed that the authorities should continue with tactical intervention today and that a further meeting should be held if necessary tomorrow. It was recognised that it would not be possible to hold the exchange rate against sale orders which might be as much as £500 million. Sir Peter Middleton would contact the party in Washington and generally consider the problem of news management.

The Prime Minister and the Chancellor then spoke by telephone, and agreed that the Chancellor would seek Poehl's agreement that the Bundesbank would intervene to support sterling.

The Chancellor later reported the results of a meeting with Stoltenberg and then with Stoltenberg and Poehl together. Stoltenberg had been sympathetic. However Poehl had said he could not offer the UK more favourable treatment than was available to ERM members. The Bundesbank was prepared to intervene in sterling but not to carry the exchange risk. The Bundesbank also held only dollars in its reserves.

The Prime Minister accordingly agreed that the Bank of England might negotiate a flexible swap arrangement with the Bundesbank. She stressed that the amount of any intervention undertaken by the use of the swap should be very small. Its value would lie in the signal it would give.

I am copying this letter to John Footman at the Bank of England.

John.

David.

DAVID NORGROVE

Tony Kuczys, Esq.,
HM Treasury

E.R.

DN

PRIME MINISTER

Foreign exchange market has been more stable since opening and interest rates have also remained at around the opening levels of ten and five-eighths per cent for three months money. There is no immediate pressure for an increase in base rates.

David Norgrove

26 September 1986

15

10 DOWNING STREET

Prime Minister

There is a lot of market talk about the need for an increase in interest rates.

DRW
25/9

SECRET

Foreign Exchange Markets: Evening Report

date: 25 September 1986

Previous close		Today opening	Today close	%change $/currency since Plaza
69.4	£ ERI	69.4	68.7	
1.4473	$/£	1.4450	1.4320	+4.2
2.9641	DM £	2.9680	2.9370	
223.77	Yen/£	223.71	221.53	
1.4149	ECU/£	1.4171	1.4107	
110.0	$ ERI	–	110.9	−20.6
2.0480	DM/$	2.0540	2.0510	+39.2
154.61	Yen/$	154.55	154.70	+54.2
	3 month interest rates			
10 1/4	UK interbank £	10 5/16	10 3/8	
6	Eurodollars	6	6	
4 9/16	Euromark	4 9/16	4 9/16	
Oct $13.95 Nov $14.30 Dec $14.45	Brent oil prices	Oct $ 13.55	Nov $ 14.00	Dec $ 14.15

Market Comment The market was largely quiet in the morning with little movement in **sterling**. But after noon, **sterling** came under severe pressure. Rumours that Venezuela might leave OPEC (subsequently denied) brought oil prices down 40 cents. When the pound reached $1.43½ stop-loss selling in Chicago was triggered. Further sales out of the Middle East (£500m) and Eastern Europe proved difficult to resist. So after 2.30pm it was agreed not to intervene further. **Sterling** closed at a new low on the Index. The **dollar** was little changed against the DM and yen.

Since the close, markets have steadied. Rates at 5.25:

$1.4345 (Same at 1900) | DM2.9350 (2.9380 at 1900) | DM/$2.0460 | ¥/$154.60 .

John Fielden

UK reserves transactions ($ million)

(a)

Today	This month so far	Total since 1 July 1986
−95	−96	−102
− 8	−507	−864
−103	−603	−966

(b)

	Estimated end-month position
Market intervention	−79
Off-market transactions	−569
Total	−648
Net borrowing	+3880
Valuation changes	—
Total change in reserves	+3232
Change in the forward book	—

(a) Spot and forward transactions on a done date basis

(b) Spot transactions only on a value date basis, as in published figures

Other countries market intervention ($ million equivalent)

Germany —	US —	Denmark —
France —	Japan —	Holland —
Italy −142 (DM)	Ireland —	Belgium —

EF1 Division 233 5105

Hong Kong	Previous	Today	Change
Hong Kong dollar	7.8035	7.8035	unchanged
Hang Seng Index	2008.30	2012.75	up 4 points
Overnight interbank rate	5 3/4%	N.A. because of Bank fire	—

SECRET

DOMESTIC MARKETS: CLOSING REPORT FOR: Thursday 25 September 1986

MONEY MARKETS

Interest rates	O'night	7 days	1 month	3 months	12 months
£ Interbank	9 ( )	9 3/16 (-1/16)	10 (+1/4)	10 9/16 (+9/32)	10 15/16 (+1/4)
Euro $	( )	6 3/16 (-5/16)	5 13/16 (-11/32)	5 15/16 (-1/16)	6 1/8 (-1/8)
Differential	( )	+3 (+1/8)	+4 1/16 (+3/8)	+4 5/8 (+11/32)	+4 13/16 (+3/8)

Bills (discount rates) (days)	Band 1 (0-14)	Band 2 (15-31)	Band 3 (32-63)	Band 4 (64-91)
Eligible bank bills	9 5/8 - 3/8 (-1/8)	9 3/4 - 11/16 (-1/16)	10 - 9 7/8 (+1/16)	10 1/8 - 9 7/8 (+1/8)

3 month Treasury bills 9 7/8 - 1/2 (—) 3 month Local Authority bills 10 1/4 (-1/8)

Bank money market operations (£M)

Bills:	Band 1	Band 2	Band 3	Band 4
Dealing rates				
Official Purchases (+)	—	—	—	—

Total bills £ — m bought/sold
Repurchase £ — m unwinding on at
Lending £ 70 m

Total operations £ 70 m against ~~shortage/surplus~~ £ FLAT m

STOCK MARKET

FT Ind-ord 1242.3 (-22.2) FTSE 100 1575.9 (-27.5) FT Govt Securities 73.06 (-0.29)

Gilt Edged Market

Authorities bought/~~sold~~ £ 33 m (net)

(Change from opening)	Price £	Yield
Shorts	-3/8	+0.10
Mediums	-5/8	+0.10
Longs	-5/16	+0.04

Gilt Futures Dec. Long Contract Open 111.20 Close 110.14 Volume 14919
Gilt Futures Dec. Short Contract Open 96.36 Close 96.03 Volume 520

FOREIGN EXCHANGE

£ Effective	68.7 (-0.7)
$/£ rate	1.4320 (-0.0153)
DM/£ rate	2.9370 (-0.0211)

US RATES

3 month CD's	5.80 (-0.05)
10 yr Tsy Bond	7.46 (-0.08)
20 yr Tsy Bond	8.06 (-0.12)

Money market rates were firmer on further reflection about yesterday's trade figures and the weaker £ rate.

Gilts improved after yesterday's sharp falls with Shorts up 1/16 and longs up 1/2. The Germans again failed to cut rates. and with Sterling falling prices fell sharply. Despite a better OIS prices were lower at close with Shorts down 1/4 mediums down 3/8 and longs down 1/2.

Equities were depressed on base rate fears.

Richard Lee

14/3

SECRET

GILT-EDGED MARKET : DETAIL

Transactions basis, cash values (£ million); sales + purchases -

ISSUE DEPARTMENT: MARKET TRANSACTIONS

	Today	End Sept + Calendar Oct
1. Gross sales shorts	+41.7	+59.4
2. " " mediums	—	+35.0
3. " " longs and undated	—	+196.5
4. Calls on part-paid Stock sold earlier	—	—
5. Buying in, other than next maturities	-73.8	-374.9
6. CRND: Market transactions	-0.8	-12.3
7. **Total 'gross' sales**	-32.9	-96.8
8. Buying in of next maturities	—	-20.1
9. Redemptions	-0.1	-0.6
10. **Total transactions with market**	-33.0	-117.6

PRICES/YIELDS OF GILT-EDGED STOCKS

	5 years	10 years	20 years
Par yield curve at close last night	10.967	10.753	10.433
at previous close	10.651	10.549	10.248

Representative Stocks
(change from yesterday's close)

	Price	Yield
11% Exchequer 1991	99 5/8 (-3/8)	11.10 (+0.10)
9¾% Exchequer 1998	93 1/2 (-1/8)	10.74 (+0.02)
11¾% Treasury 2003/07	109 1/2 (-5/8)	10.63 (+0.06)
2% Index-linked 1988	120 1/2 (—)	5.14 (+0.01)
2½% Index-linked 2011	103 3/4 (-1/8)	3.84 (+0.01)

TAP STOCKS AND RECENT ISSUES

	Price	Yield	Issue dept
3% Treasury 1991	97 1/8 (-1/2)	8.32 (+0.15)	287

Rates on surrender for tax

< 1	1<3	3<6	6<9	9-12 mnths
9 1/2	9 3/4	10	10 1/4	10 1/4

Certificates of Tax Deposit: Purchases

" " " : **Surrenders**

KNOWN FUTURE GILT-EDGED TRANSACTIONS

	Part Payments (+)	Redemptions/expected buy-ins (-)
Banking		
Banking		
Banking		

Sales required to meet 'Gross' sales Target for Banking

£m

MR. WICKS.

10 DOWNING STREET
LONDON SW1A 2AA

M J Spackman Esq
Under Secretary
HM Treasury
Parliament Street
LONDON
SW1

19 September 1986

Dear Michael,

THE COST OF RISK

Many thanks for your very helpful note of 19 September 1986.

As you rightly say, the viability of the general Treasury assumption of risk neutrality for public sector funding has long been open to genuine academic, as well as practical, debate. We are sincere in our belief that the weight of evidence would now lead us to substitute the alternative assumption that the risk premium on private financing revealed in financial markets is likely to be a good proxy for the risk borne by the Government under public financing. However, these are complex issues and I would be more than happy to take you up on the suggestion of helping to review the Treasury approach on these issues with your staff over the next few weeks.

Nevertheless, as you say, the specific issues with respect to Dartford are easier to define and I believe we are now in agreement on the framework for assessing the comparative finance costs of this project.

I am attaching the revised version of your table, in the form we discussed, which sets out the risk factors and other elements which could contribute to a higher interest cost on private finance, and assesses whether they are true welfare costs or simply a redistribution of risk between Government and/or motorist and the bondholder.

In summary, a number of items could contribute to a higher cost of private finance without having any welfare cost. These are:

1. The risk of a major increase in costs and/or lack of revenue which, under private finance, leads to an inability to repay the bondholder. The expected value of the bondholder's loss represents risk transferred from the motorist or taxpayer who would otherwise continue to carry the project under these adverse circumstances.

2. The risk of political intervention (eg) to limit tariffs. Under public ownership, any shortfall in revenue would be borne by the taxpayer.

3. The risk of a major catastrophe, for the same reasons as above.

In all these cases, the public sector (or motorist) is simply taking out an insurance premium by passing risk to the bondholder. In comparing the options, this part of the additional interest cost should therefore be offset by an equivalent benefit from reduction in the expected value of public sector (or motorist) risk.

Similarly, we identified two market inefficiencies which could contribute to a higher cost of private sector finance and, if large, would be a true welfare cost. These are items:

7. Any premium on private finance due to unfamiliarity with the project or poor structuring of the package.

8. Any extra administrative costs of issuing private finance.

However, as you know, we believe that the proper negotiation of the financing package should make both of these negligible.

The remaining item (item 6) is the premium the bondholder will require for the <u>variability</u> of any large downside risk (ie the uncertainty about his actual payment in the event of default). In our view, as we have discussed, it is reasonable to take the premium attached by the private sector as a reasonable estimate of the cost to the taxpayer or motorist of accepting this risk, although this is an area we still have to fully debate with you. However, since diversification of variable risk allows either public or private risk bearer to eliminate all but the systematic (ie correlated) portion of this risk, on this project the total risk remaining is likely to be small and not a significant contributor to the private finance premium.

In summary, therefore, the most significant reason for the private finance premium is likely to be risk attached by the investors to the possibility of a major downside. Unless you believe that the finance markets hve overestimated this risk (ie that Department of Transport officials are able to estimate it more accurately) this transfer of risk cannot be counted as a welfare cost, and the private sector premium on an efficiently structured finance package should not be counted as an additional cost that favours public sector financing.

I am copying this letter to Howard Blacks (Department of Transport), John Wiggins (Cabinet Office) and your colleagues David Revolta and Sheila Pugh.

Norman Blackwell

NORMAN BLACKWELL

REASONS FOR PRIVATE FINANCE PREMIUM

Expected value of Downside Risk	Private Finance Born by:	Public Finance Born by:	Contribution to Private Finance Premium	Impact on Welfare
1. Increase in costs and/or lack of revenues (such that finance cannot be repaid within 20 yrs)	Bondholder	Motorist and/or taxpayer	✓	None: redistribution of risk
2. Political risk (eg limiting tariffs)	Bondholder (to benefit of motorist)	Taxpayer (to benefit of motorist)	✓	None: redistribution of risk
3. Specific catastrophe risk (eg major sabotage)	Bondholder and motorist	Taxpayer and motorist	✓	None: redistribution of risk
4. General catastrophe risk	Bondholder	Bondholder	X	-
Variability Risks				
5. Small variations in costs and revenues, and hence in tolling period (but not so large as to prevent capital repayment)	Motorist (bondholder also has uncertainty in time to redemption - cost likely to be small)	Motorist (Government also has uncertainty in future funding flows - cost likely to be small)	X?	-
6. Variations in the amount bondholders are repaid under (1) above	Bondholder	Motorist and/or taxpayer	✓ (but small)	Subject of debate

DOMAAN

Additional costs/inefficiencies

7. Premium on private finance due to unfamiliarity with project/poor structuring	Bondholder (should be reduced to small level if finance efficiently negotiated and structured)	-	✓	True welfare cost - but should be eliminated
8. Extra administration cost on private finance scheme	Bondholder (minimal?)	-	✓	True welfare cost - but not likely to be significant

10 DOWNING STREET

David

See letter at flap re. the monetary report. Alex Allan from HMT will 'phone you today. Please let me know if there's any further action for me to take.

Julie
16.9.86

Thanks.

DRN

David

Has Alex Allan 'phoned you? If so, is there any further action?

Yes. No further action thanks.

DRN

OMJ 16.9.

SM1/60

SECRET until 8.45 AM 2/9/86

14

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

2 September 1986

David Norgrove Esq
10 Downing Street
LONDON

1. MEA to see
2 pm.

Dear David,

HMG FOREIGN CURRENCY BORROWING

Thank you for your letter of 1 September. This is to confirm that the syndication of the floating rate note will be going ahead tomorrow morning, subject to any last minute market developments. I attach a copy of our background briefing on all this.

Yours
Alex

A C S ALLAN

2/3065-1

SECRET AND PERSONAL UNTIL 8.45AM ON 2 SEPTEMBER 1986

BACKGROUND BRIEF ON FRN

Factual

- HM Treasury will announce early on Wednesday morning (3 September) that it is issuing US $3 billion of floating rate notes (FRNs).

- The notes carry a coupon of $^1/_8$ per cent below three months LIBID and an all in cost of 8bp under LIBID. The final maturity is ten years (September 1986). But HMG has the option to call the notes at par on any interest payment date after the first 5 years; note-holders have a single put option after 5 years.

- The issue is being organised by the Bank of England on the Treasury's behalf and is jointly lead-managed by Warburgs and Credit Suisse First Boston.

- The notes are being sold in the international market in the normal manner for a eurobond operation.

- The $2.5 billion FRN issued in September 1985 had a maturity of 7 years and a coupon of LIBID.

Line to take

- The issue is essentially the second stage of the process begun with last year's FRN and has the same purpose ie taking a favourable opportunity to strengthen the UK's foreign currency reserves at a time of continued exchange market uncertainty.

- The issue increases the UK's stock of currency reserves by $3 billion and brings them more into line with those held by other countries (see annex).

- This operation, which is larger than last year's and on

better terms extends the average maturity of foreign currency borrowings into the late 1990s. The terms are the finest available to any borrower for an issue of this type.

- There is no immediate intention to use these extra reserves. They will be invested in suitable financial assets. Like the UK's existing reserves, they will however be available for use if needed. Events in the foreign exchanges over the last 12 months have confirmed the importance of holding adequate reserves although in fact the proceeds of last year's FRN have not been required to be used; the reserves now stand at a slightly higher level than they did last autumn.

Defensive

ERM?

No change in our position.

Need to support sterling?

No. Decline in sterling in index and cross rate terms (ie against EMS currencies and the yen) is largely a consequence of the fall in the price of oil which has led to structural changes in the UK balance of payments. Given the size of the oil price movement, sterling has held up well.

Borrowing to intervene

(See line to take). No immediate intention to do so. Like the existing reserves, they will, however, be available for use if needed.

Already spent last year's issue!

On the contrary, even after allowing for valuation changes, our currency reserves are higher now than they were in October 1985, immediately after the 1985 FRN.

	October 1985	end-August 1986
currency reserves $b)	8.3	9.4

Reversal of policy on debt repayment

[Economic Secretary said in Written Answer on 24 November 1984 (col 448) that official debt had been reduced by $10 billion from figure reached by Labour government and that "a proper balance between the figures that we have now reached may well be where we should rest for the time being".]

Policy was to repay substantial part of expensive foreign debt inherited from Labour Government. This we did. Official debt at end of August 1986 was $7 billion lower than in May 1979 and $11 billion below peak at end 1977. Even after this issue it will still be $4 billion below inherited level and $8 billion below peak while level of gross reserves will be broadly the same as in 1979.

Moreover

(i) The new issue, like that in September 1985 is on very fine terms indeed. The repaid debt was much more expensive eg the $2.5 billion and $1.5 billion syndicated credits taken out by the Labour government in 1974 and 1977 were at LIBOR $+3/8\%$ rising to LIBOR $+3/4\%$ and LIBOR $+7/8\%$ rising to LIBOR +1% respectively.

(ii) This is a market operation. The Labour debt included a significant proportion of IMF debt (IMF debt accounted for 10 per cent of total official debt in March 1979, compared with zero now).

Reflects fact that this is a step taken from a position of strength, not weakness.

Running down of reserves to repay Labour debt

Of course a substantial part of the debt repayments were financed

from the reserves. How else would it have been done? What the Government was doing, and taking credit for, was getting rid of large amount of undesirably expensive liabilities.

And NB: (i) Even so, net reserves are $4 billion higher than they were in April 1979.

(ii) The UK's total net external assets, private and public sector combined, have increased almost seven-fold since the end of 1979 (from £12.0 billion at end-1979 to £80.4 billion at end-1985) and are now second only to Japan.

Reasons for changes in reserves

Changes in reserves over time reflect number of factors - intervention, valuation changes and net borrowing. Over whole period since April 1979 there has been a substantial reduction in net borrowing, a number of valuation changes in different directions and a moderate plus from other transactions (including intervention).

Why take a different view from last year about the appropriate level of the reserves?

We did not rule out making a further increments last year. We now judge that a further increase would be appropriate and that an attractive market opportunity exists.

Does this mean we will be coming to the markets every year?

We have a regular programme of foreign currency borrowing through nationalised industries. This will continue. As last year, this particular issue is being made in the Government's own name to take advantage of particular market conditions. But there is no need for the Government to make regular own-name market issues, nor implication that that is what we intend to do. We will continue to take decisions in the light of all the circumstances at the time.

Exchange rate/monetary effects

The issue will not have any significant effects on either the exchange rate or the monetary aggregates.

Effect on the dollar

Proceeds will be added to the reserves. So we will be adding the same amount to the demand for dollar assets (to hold in our reserves portfolio) as to the supply (in terms of the new HMG liabilities). There will therefore be no significant effect on the dollar exchange rate.

Comparisons with other sovereign borrowers

The terms are the finest available to any borrower for an issue of this type.

Choice of lead managers

We are repeating a successful formula.

OFFICIAL DEBT AND RESERVES FACTSHEET

Level of official reserves

$ billion

End-period	Total	o/w convertible currencies
1979	22.5	18.0
1980	27.5	18.6
1981	23.3	13.5
1982	17.0	9.6
1983	17.8	9.0
1984	15.7	7.6
1985	15.5	8.5
1986 Q1	18.8	8.8
1986 (August)	18.9	9.4*

Level of official debt

	Total	o/w HMG borrowing
1979	20.7	9.7
1980	17.4	7.7
1981	13.3	4.6
1982	12.1	3.9
1983	12.0	3.7
1984	11.3	3.4
1985	14.6	5.7
1986 Q1	15.1	5.7
1986 (August)	15.2*	5.6

*NB There is a 3 month lag on the publication of these figures. August levels will not therefore be released until December 1986.

Peaks and troughs

$ billion

		Reserves		Official debt	
		Total	Convertible currencies	Total	HMG
Under Labour (Mar '74-Apr 79)	high	21.9 (Mar '79)	19.3 (Jan '78)	25.5 (Dec '77)	12.9 (Sept '77)
	low	4.1 (Dec '76)	2.5 (Dec '76)	8.7 (Mar '74)	4.5 (Sept '74)
Under Conservative (May '79 to date)	high	28.5 (Mar '81)	19.7 (May '80)	22 (May '79)	10.1 (May '79)
	low	14.0 (May '85)	6.8 (Mar '85)	11.0 (Sept '84)	3.2 (Apr (84)

Major HMG borrowings since 1974

Date	Amount	Description	Terms	Repayment/amount outstanding
March 1974	$2.5 bn	Eurodollar bank credit 10 years on a rollover basis with a 3, 6 or 12 month option	Floating rate yrs 1 & 2: LIBOR + 3/8% 3, 4 & 5: LIBOR +½% 6 & 7: LIBOR +5/8% 8, 9, 10: LIBOR +¾%	Repaid in monthly instalments from May-July 1981
Jan 1976	SDR 1 bn	1975 oil/facility	Floating rate	Equal quarterly repayments from Apr '79 to Jan '83

Date	Amount	Description	Terms	Repayment/amount outstanding
May 1976	SDR 700 mn	1975 stand by arrangement	Floating rate	Repaid by Apr '79.
Jan-Aug 1977	SDR 3.36 bn (Note only SDR 1.64 bn drawn down)	1977 stand-by arrangement. To be drawn down over 2 years	Floating rate	Repaid by Apr '79
April 1977	$677 mn (equivalent)	Foreign currency bonds denominated in $ issued with 5, 7 and 10 yr maturities for $202 mn, $82 mn and $18 million respectively. Others: DM 365 mn, Swfr 360 mn and Yen 21,500 mn issued with single maturity of 7 yrs	5 yr $ bonds at 8 3/8% 7 yr $ bonds at 8 5/8% 10 yr $ bonds at 8 7/8% 7 yr DM bonds at 7½% 7 yr Swfr bonds at 5 7/8% 7yr Yen bonds at 8%	Bulk of repayments made in Apr 1984. Remaining $18 million due for repayment in '87
February 1977	$1.5 bn	Eurodollar bank credit. 7 yrs on a rollover basis with a 3, 6 or 12 month option. Loan drawn down in 2 tranches: $1 bn and $0.5 bn	Floating rate yrs 1 & 2: LIBOR +7/8% yrs 3 to 7: LIBOR +1%	Repaid in monthly instalments from July to Dec 1980
May 1978	$350 mn	$ bond issue in New York: $200 mn with a 7 yr maturity and $150 mn with a 15 yr maturity.	Fixed rate 7 yr : 8½% 15 yr : 8 7/8%	7 yr bonds repaid in May 1985. 15 yr bond due 1993
September 1985	$2.5 bn	Floating rate notes with a 7 year maturity	Floating rate 7 year LIBID with no margin reset and repayable quarterly.	

Reserves movements since before 1985 FRN

$ billion

	End-period	Convertible currencies	Total spot reserves (published)
1985	March (post revaluation)	5.4	14.2
	September	6.0	15.2
	October	8.3	17.6
1986	March (pre-revaluation)	8.1	17.8
	March (Post-revaluation)	8.8	19.9
	August	9.4	18.9

6/5

INTERNATIONAL COMPARISON OF RESERVES

	Total*	June 1986, $ billion of which convertible currencies
UK	15.6	11.5
Germany	48.6	38.9
US	46.3	15.2
Japan	35.0	29.5
France+	35.1	29.5
Italy	22.6	18.3

* gold valued at SDR 35 per oz

+ May data.

SECRET

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10 DOWNING STREET

From the Private Secretary

1 September 1986

FOREIGN CURRENCY BORROWING

The Chancellor this afternoon described to the Prime Minister the present plans for mounting a foreign currency borrowing through a floating rate note. The amount would be $3 billion, over 10 years, and the terms might well be finer than the issue mounted last year. The intention would be to syndicate the issue on Wednesday this week, market conditions permitting.

The Prime Minister was content with this proposal. She was however concerned that the greatest possible care should be taken with the presentation. The issue might attract headlines in view of the dearth of other news at present.

(DAVID NORGROVE)

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

SECRET

3333/4

CONFIDENTIAL cc Mr Norgrove – No. 10 for information

FROM: S J DAVIES
DATE: 20 August 1986

MINISTER OF STATE

cc PS/Chancellor
Sir Peter Middleton
Sir T Burns o.r
Mr Byatt
Mr Cassell
Mrs Lomax
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Sedgwick o.r
Mr Turnbull
Mr Culpin
Mr Mowl o.r
Miss O'Mara
Mr Riley
Mr Pickford
Mr Ross Goobey

NATIONAL INSTITUTE ECONOMIC REVIEW: AUGUST 1986

1. The August National Institute Economic Review, which includes the National Institute's latest forecasts for the UK and world economies, is to be released at 9 o'clock this evening. The review contains four additional articles: the subjects of these are the growth of services purchased by manufacturing industry, seasonal patterns in the British economy, a comparison of measures to reduce youth unemployment in Britain, France, and West Germany, and a model-based explanation of "Stagflation in the UK since 1970".

The Forecast

2. The National Institute's new forecast is based on an average oil price of $12 a barrel during 1987. As usual, the Institute are more pessimistic than other forecasters.

3. The main features of the forecast are:

- real GDP growth is 1.8 per cent this year and next;

- the annual rate of inflation picks up from 2½ per cent now to 3¼ per cent by the fourth quarter of this year and 5½ per cent a year later;

- the current account of the balance of payments is in a small deficit for 1986 as a whole (£0.7 billion); the deficit is forecast to rise to almost £6 billion in 1987;

- the PSBR is forecast at £8.6 billion in 1986-87, and £11.1 billion the following year, on the assumption of no changes in taxes beyond indexation of tax rates and allowances in the 1987 Budget.

- reflecting the impact of special employment measures, adult unemployment is forecast to fall by around 150 thousand from its current level by the end of 1987.

A table at the end of this minute gives a comparison of the NIESR forecast with our latest internal forecast and the published FSBR forecast.

The World Economy

4. The Institute note that in several countries taxes on oil products have been increased, and that OECD countries' structural budget deficits have generally been reduced this year. Together with cut backs in oil production and exploration activity, and a more general tendency of expenditure to be held back in anticipation of lower prices, this has led to a very weak world economy so far in 1986. But by 1987 the Institute expect the influence of the fall in the price of oil to be "substantially expansionary on balance".

5. Growth in the United States is forecast to pick up to 3½ per cent next year; for the OECD area as a whole GDP growth is forecast at 2.6 per cent in 1986, rising to 3.2 per cent in 1987. Consumer price inflation is also forecast to pick up in the United States next year but to be little changed elsewhere on average: primary commodity prices are expected to remain depressed. World trade is expected to rise by 3½ per cent this year and 4½ per cent next, with trade in manufactures rising by up to a point faster than this.

The UK economy

6. The Institute's forecast for UK GDP growth in 1986 is some ½-¾ of a point below both the Treasury's internal June forecast and the current average of outside forecasts. Next year the Institute expect some pick up in growth in the non-oil economy, but this is offset by a fall in oil output, so that overall the rate of economic growth is the same as this year.

7. The Institute's forecast for 1986 follows the pattern of most other forecasts for the UK in showing strong growth in personal sector income and spending, only a modest investment performance, and exports almost static. Next year consumers' expenditure continues to show strong growth; export growth picks up somewhat, but the net trade performance continues to act as a drag on overall growth in GDP.

8. The Institute have pushed up their fixed investment forecast compared with three months ago, as they have taken on board the most recent DTI Intentions survey, and the healthy prospects for private residential investment. Their forecast for non oil private sector investment is now quite similar to our own, in fact. There is a difference between us on oil investment, however, which the Institute expect to fall by 1987 to less than half its 1984 peak.

9. The relatively weak GDP performance forecast reflects both the Institute's projection of investment, and also a forecast step up in imports in the third quarter of this year (the reasons for which, at a time of rather flat demand, are not clear). This rise in imports helps to account for the scale of the forecast deterioration in the current account; but another factor here is a very pessimistic IPD forecast. The Institute expect the surplus on net profit income to be £350 lower in 1987 than in 1984 despite the large fall in foreign oil companies profits earned in the UK over this period: their projection of the IPD surplus for 1987 is almost £3 billion below that in the Treasury's internal June forecast.

10. The Institute do not offer any detailed explanation of why they expect inflation to pick up to as much as 5½ per cent by the end of next year. In particular, they do not make explicit what view they have taken about mortgage rates. All they say is that "real interest rates ... are projected gradually to decline": given their inflation forecast this could even mean they have allowed for a rise in nominal interest rates. It is worth noting that only three months ago the Institute were forecasting 3½ per cent inflation for 1987 Q4. The Institute's inflation forecasting record remains poor: a recent example is that in February 1985 they forecast inflation at 6.5 per cent for 1986 Q4.

11. The Institute also have a well established record of overforecasting the PSBR. A year ago, on the basis of no tax changes other than indexation in the 1986 Budget, and a dollar oil price roughly double its current level, they forecast a PSBR for 1986-87 of £11.2 billion. A year earlier their forecast for 1985-86 had been £10.7 billion (outturn £5.9 billion). The Institute's forecast now of a PSBR of £11.1 billion in 1987-88 differs from our own forecast in particular in allowing for continued substantial growth in debt interest payments (as noted above the interest rates projected in the forecast are not made explicit); and also very high growth in current expenditure on goods and services (almost 9 per cent growth at current prices in 1987-88, after almost 8 per cent growth in 1986-87).

The Institute's Appraisal

12. The Institute's "Appraisal" - which tends to attract press interest - notes that "the slowdown over the past year in the British economy is part of a slowdown in growth that is almost worldwide ... the volume of world trade has stagnated since early last year." On this occasion, they offer no advice on domestic economic policy. Instead they argue that Japan and Germany should expand domestic demand and that "Britain should give energetic support to this policy prescription."

13. The Institute claim that the slowdown that has occurred in the UK is "broadly in line with the forecasts we were making a year ago." This claim can be challenged. Even on the basis of their latest 1.8% growth forecast for 1986, the forecast they made 12 months ago was in fact on the low side (1.4% growth in 1986); and in February of last year they were forecasting only 0.9 per cent growth in 1986.

Line to Take on Forecast

14. The National Institute forecasters have as usual taken a more gloomy view of prospects than other forecasters; but even their forecast implies a fifth and sixth year of sustained growth. The Institute acknowledge that the slower growth in the UK economy over the last year has been closely related to world economic developments. They expect the benefits of the oil price cut to come through strongly to the world economy next year. The implication of their view about the timing of the benefit of lower oil prices is surely that prospects for UK growth in 1987 are better than their forecast implies.

S J DAVIES

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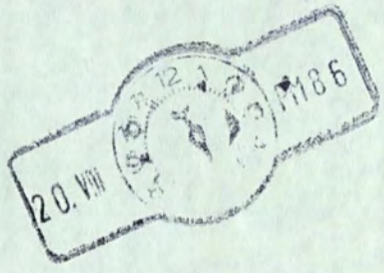
COMPARISON OF NIESR AND TREASURY FORECASTS

	NIESR AUGUST FORECAST		TREASURY JUNE FORECAST (UNPUBLISHED)		TREASURY BUDGET FORECAST	
per cent changes on a year earlier	1986	1987	1986	1987	1986	1987 HI
Gross Domestic Product	1.8	1.8	2.4	3.1	3	2½
Manufacturing Output	0.3	2.2	0.5	3.4	3	2½
Consumers expenditure	3.8	3.5	3.9	4.6	4	4
General government current expenditure	1.1	1.5	1.6	0.3	1	½
Gross fixed capital formation	1.8	1.1	4.3	3.3	5	0
Stockbuilding*	0.4	0.3	-0.2	0.7	0	½
Exports of goods and services	0.9	3.2	0.7	3.5	5	3
Imports of goods and services	3.9	6.3	2.1	6.4	6	5
World trade in manufactures	4.5	5-5.5	3.0**	4.6**	4½**	5**
RPI Q4	3¼	5½	2.3	4.0	3½	3½***
Exchange rate: sterling dollar	1.48	1.44				
Exchange rate: sterling index	74.3	70.2				
Current account (£ billion)	-0.7	-5.8	2.8	-1.4	3½	1½*
PSBR (Financial year (£ billion)	8.6	11.1			7	7

* contribution of change to GDP growth
** UK weighted
*** Q2

* Annual rate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Secretary of State for Trade and Industry

PS/

14 August 1986

David Norgrove Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1

Dear David,

ANSBACHER

My letter to your of 5 November advised that we had put in hand an enquiry under Section 447 Companies Act 1985 into Ansbacher.

The enquiry was into the circumstances in which the company came to pay an interim dividend in December 1984 when there were said to be no available profits from which payment could lawfully be made. A report of the enquiry has been received and its findings have been carefully considered. No criminal offences are disclosed and there are no matters which require action by this Department.

There are statutory restrictions on disclosure of information and documents obtained under Section 447 and there is no question of publishing the report. We are advised, however that the report can properly be provided to the Bank of England under Section 20(1) of the Banking Act 1979 on the basis that disclosure of the information obtained will better enable the Bank to perform its functions under that Act. Accordingly, we are sending a copy of the report to the Governor.

I am copying this letter to Joan MacNaughton (Lord President's Office), Tony Kuczys (Treasury) and Henry Steel (Law Officers Department).

Yours ever,
Michael

MICHAEL GILBERTSON
Private Secretary

1786 1986 BOARD OF TRADE BICENTENARY

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D L C Peretz
Under Secretary

CONFIDENTIAL AND PERSONAL

D Norgrove Esq
No 10 Downing Street
London SW1

31 July 1986

Dear David

CONVERSION OFFERS

We have, at the Chancellor's request, been considering again in the Treasury the argument for and against making conversion offers on existing gilt-edged stock.

2. I attach a series of exchanges with the Chancellor on this, which as you see include a number of quite bulky papers. As I told you on the telephone, the Chancellor asked whether these papers could be shown in confidence to Sir Alan Walters, since he would be interested to have his comments.

3. You told me you had a way of getting confidential papers to Sir Alan Walters, and I should be most grateful if these papers could be sent to him - together with the attached covering letter from me.

Yours ever,

David.

10 DOWNING STREET

Prime Minister 2

It would certainly be worth discussing with the Chancellor at your bilateral next week the scope for and timing of a further reduction in interest rates.

DHW
24/7

PRIME MINISTER 2

24 July 1986

£M_3

The first two pages of this Greenwell's Bulletin are worth reading.

£M_3 has grown much more rapidly over the past 12 months than broad money growth in other countries (see Table 1). The Bulletin advances two arguments which, although not new, are well documented:

a. High short-term interest rates relative to bond yields (negative yield curve) distinguishes the UK from its major competitors (Chart I shows this very clearly).

b. Nominal and real short-term interest rates are significantly higher in the UK than other countries (Table 1).

The result is that short-term financial assets (some of which make up £M_3) make broad money in the UK a very attractive investment.

BG.

BRIAN GRIFFITHS

MONETARY BULLETIN

Greenwell Montagu Research

No. 186 July 1986

Monetary Growth - the UK in a World Context

Markets have reacted adversely to the publication of further buoyant data for sterling M3. These Bulletins have, however, repeatedly stressed that sterling M3 is currently distorted upwards because:

i) the rate of interest on bank deposits is higher than that on most other investments,

ii) short term interest rates are higher than the rate of inflation, by a good margin, ie real interest rates are exceptionally high, and

iii) investors' preference is swinging away from real to financial assets.

The result is that bank deposits are currently an excellent home for genuine savings, hence our argument that the buoyant growth of sterling M3 is reflecting a change in savings behaviour and not permissive monetary policy.

This Bulletin examines the first two of the above explanations in a global context. Because interest rate patterns in the UK are atypical, the conclusion is that the explanations do stand up to scrutiny.

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Table I shows the pattern of monetary growth in six countries. It will be seen that the UK is the only country in which broad money is growing substantially faster than narrow money.

Table I
Monetary Growth over the past twelve months

%	Narrow Money	Broad Money
UK (Mo:£M3)	3	18
US (M1a:M2)	9	8
Japan (M1:M2 + CD)	7	8
Germany (M1:M2)	10	6
France (M1:M3)	6½	4½
Netherlands (M1:M2)	8	4

Notes

UK: Mo - currency + banker's deposit at central bank, latest data June 1986,
£M3 - latest data June 1986.

US: M1a - currency + non-interest bearing sight deposits, latest data June 1986,
M2 - latest data June 1986.

Japan: M1 - currency + demand deposits, including interest bearing, latest data April 1986
M2+CD- latest data April 1986.

Germany: M1 - currency + non-interest bearing sight deposits, latest data May 1986
M2 - latest data May 1986.

France: M1 - New series for currency + non-interest bearing sight deposits, latest data April 1986.
M3 - New series, latest data April 1986.

Netherlands: M1 & M2 - latest data April 1986.

The phenomenon of high broad monetary growth is peculiar to the UK and so is the first of our explanations. Chart I, on page 3, shows the interest rate differentials in the six countries, more specifically the difference between three month interest rates and ten year bond yields. It will be seen that, with the exception of Japan for a relatively brief period, the UK is the only country in which the three month rate have been above the ten year bond yield since the beginning of 1985. In our view, this negative yield curve has contributed to buoyant sterling M3 growth. High short term rates make bank deposits an excellent home for genuine savings.

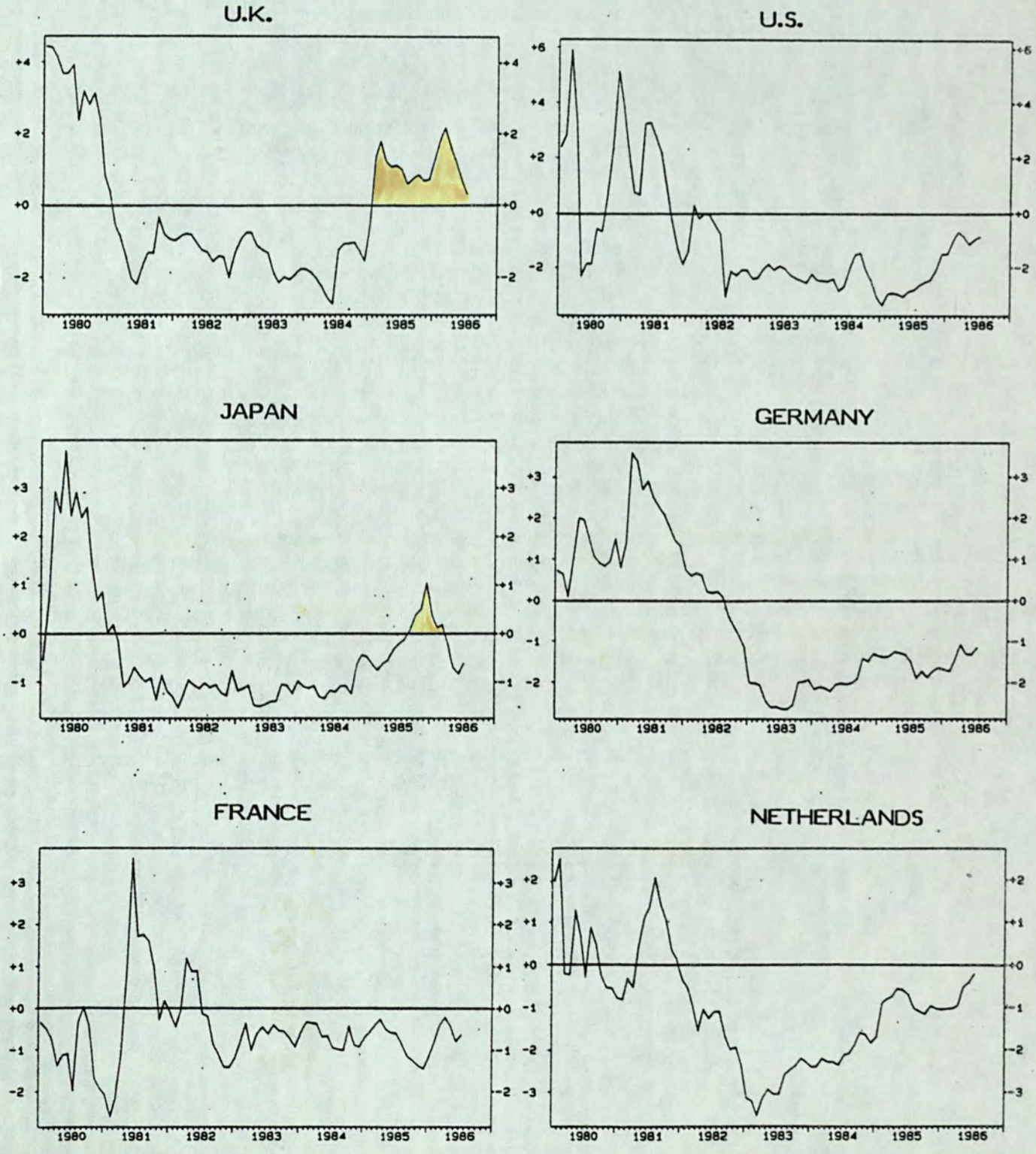
Our second explanation for the buoyant growth of sterling M3 is also peculiar to the UK. Table II shows that UK short term interest rates are the highest in any of the countries, in both nominal and real terms.

Table II - Three Month Interest Rates

% pa	Nominal	Real
UK	10.0	7.5
US	6.7	5.1
Japan	4.3	3.6
Germany	4.5	4.7
France	7.4	5.1
Netherlands	5.7	5.5

Chart I - Interest Rate Differentials

Three Month Money Rates less Ten Year Bond Yields



The two factors provide good explanations for both the high rates of broad monetary growth in the UK as well as for the fact that the rate of growth of broad money is much more rapid than that for narrow money. They give significant reassurance that the sharp rise in the growth of sterling M3 is still not yet a serious worry. This is not to deny that remedial action might well be required when short rates fall significantly, especially relative to long rates.

Monetary Growth in the Month to Mid-June

The seasonally adjusted data for the four weeks to 18th June are shown in Table III.

Table III
Changes in the Month to mid-June

	£m	pa
Mo	76	6%
Currency	131	12%
Retail M1	-78	-3%
M1	737	14%
Sterling M3	1,714	15%
PSL1	1,970	17%
PSL2	3,200	15%
Bank lending in sterling to private sector	2,148	17%

The pattern over the longer term, together with our estimates of the underlying trend over the last six months, are shown in Table IV. Our estimates of the underlying trend make allowance neither for the high relative level of short term interest rates nor for the move away from overfunding, but they do make some downwards adjustment to allow for part of the abnormal increases in banking May.

Table IV
Monetary Growth in the Longer Term

		3 months Published	6 months Published	6 months Underlying	One Year Published	
		% p.a.	% p.a.	% p.a.	%	Notes
Narrow money:	Mo	3.8	4.4	4	3.1	
	Currency	8.0	6.3	5	2.9	1
	Retail M1	16.1	8.6	10	0.2	2
	M1	35.4	20.8	15	18.6	3
	M2	n.a.	n.a.	11	11.5	4
Broad money:	Sterling M3	33.6	23.4	18	18.3	5
	PSL1	32.5	22.5	17	17.2	5
	PSL2	20.1	17.2	17	14.1	6

Notes.
1. Revised downwards because of abnormally low level in December 1985.
2. Upwards revision because of a switch from current accounts to high interest cheque accounts.
3. Revised downwards because of high interest cheque accounts, and the greater use of overnight deposits.
4. The published rate is for the last year rather than the last six months, because the series is too new for seasonal adjustments to be calculated.
5. There is a downward adjustment to allow for arbitraging, and the increase in high interest cheque accounts where funds have not come from other bank deposits.
6. This is the revised series published in last month's Bank of England Quarterly Bulletin. It includes all term shares and deposits with building societies.

Our estimates of underlying monetary growth have generally been slightly raised again in banking June, as shown in Table V, although that for M2 has been reduced by 1%. Mo is estimated to have risen slightly by up to ¼% in banking July, implying three, six and twelve month growth rates averaging under 3%, well inside the bottom half of its target range.

Table V
Underlying Monetary Growth

	Six months growth rates (% pa) to mid-				
	Feb.	Mar.	Apr.	May	June
Mo	3	3	4	4	4
Currency	2	2	2	3	5
Retail M1	8	8	8	10	10
M1	12	13	13	15	15
M2	9	9½	10½	12	11
£M3	13	13	16	17	18
PSL1	12	13	16	16	17
PSL2	12	13	15	16	17

Bank Lending

Bank lending continues to grow rapidly. Lending to companies should be lower in the next few months, as the boost due to the final reduction in capital allowances at the end of last March ends. Personal borrowing, however, especially for mortgages continues to rise rapidly. There is likely to be a drop in the rate of increase in bank lending in the summer but not by so much as there was last year.

Table VI
Bank Lending in Sterling to the Private Sector

	£m	Published	Bills Outside	Adj Total	3 Month Av
1985	Oct	2,237	-9	2,228	1,660
	Nov	2,069	207	2,274	1,768
	Dec	1,851	-55	1,796	2,099
1986	Jan	612	68	680	1,583
	Feb	1,494	-164	1,330	1,269
	Mar	2,461	152	2,613	1,541
	Apr	3,142	538	3,680	2,541
	May	1,683	-	1,683	2,659
	June	2,148	42	2,190	2,514

Ray Richardson
Robert Thomas
Gordon Pepper

MONETARY GROWTH

In Nominal Terms

Percentage Annual rates	Mo	Currency	Retail M1	M1	M2	Sterling M3	PSL1	PSL2
Changes in year to:								
1985 July.	5	4	3	16	7	12	12	13
Aug.	4	4	3	18	7	14	14	14
Sep.	4	4	2	17	8	14	14	14
Oct.	3	2	2	18	9	15	14	13
Nov.	3	2	2	17	10	14	13	13
Dec.	2	2	1	18	9	15	14	13
1986 Jan.	4	2	3	19	10	14	13	12
Feb.	4	2	3	20	10	15	14	13
Mar.	4	2	4	21	10	16	15	14
Apr.	3	2	4	20	11	17	16	14
May.	3	2	7	22	13	19	18	15
June.	3	3	0	19	12	18	17	14
Changes in 6 months to:								
1986 Jan.	4	2	7	19		15	13	12
Feb.	4	1	3	12		13	12	12
Mar.	4	1	6	18		14	14	14
Apr.	5	2	6	18		20	19	16
May.	4	3	10	22		22	20	16
June.	4	6	9	21		23	22	17
Changes in 3 months to:								
1986 Apr.	0	1	4	21		29	29	21
May.	3	4	20	42		39	38	21
June.	4	8	17	35		34	32	20

In Real Terms

Changes in year to:								
1985 July.	-2	-3	-4	9	0	5	5	6
Aug.	-2	-2	-4	12	1	7	7	8
Sep.	-2	-2	-4	11	2	8	8	8
Oct.	-2	-3	-3	12	3	9	8	8
Nov.	-2	-3	-4	12	4	9	8	7
Dec.	-3	-3	-5	12	4	9	9	8
1986 Jan.	-1	-3	-2	14	4	9	8	7
Feb.	-1	-3	-2	15	5	10	9	8
Mar.	-1	-3	-1	16	6	12	11	9
Apr.	0	-1	1	17	8	14	13	11
May.	1	-1	4	19	10	17	16	12
June.	1	1	-2	16	9	16	15	12
Changes in 6 months to:								
1986 Jan.	0	-2	2	15		11	9	8
Feb.	0	-3	-1	9		9	8	9
Mar.	0	-3	2	15		11	10	10
Apr.	2	-1	3	15		16	16	13
May.	1	0	7	19		19	17	13
June.	1	3	6	18		20	19	14
Changes in 3 months to:								
1986 Apr.	-3	-2	0	18		26	26	18
May.	0	1	18	39		36	35	18
June.	1	5	14	32		31	29	17

Chart 1 - Monetary Growth in NOMINAL Terms (% p.a.)

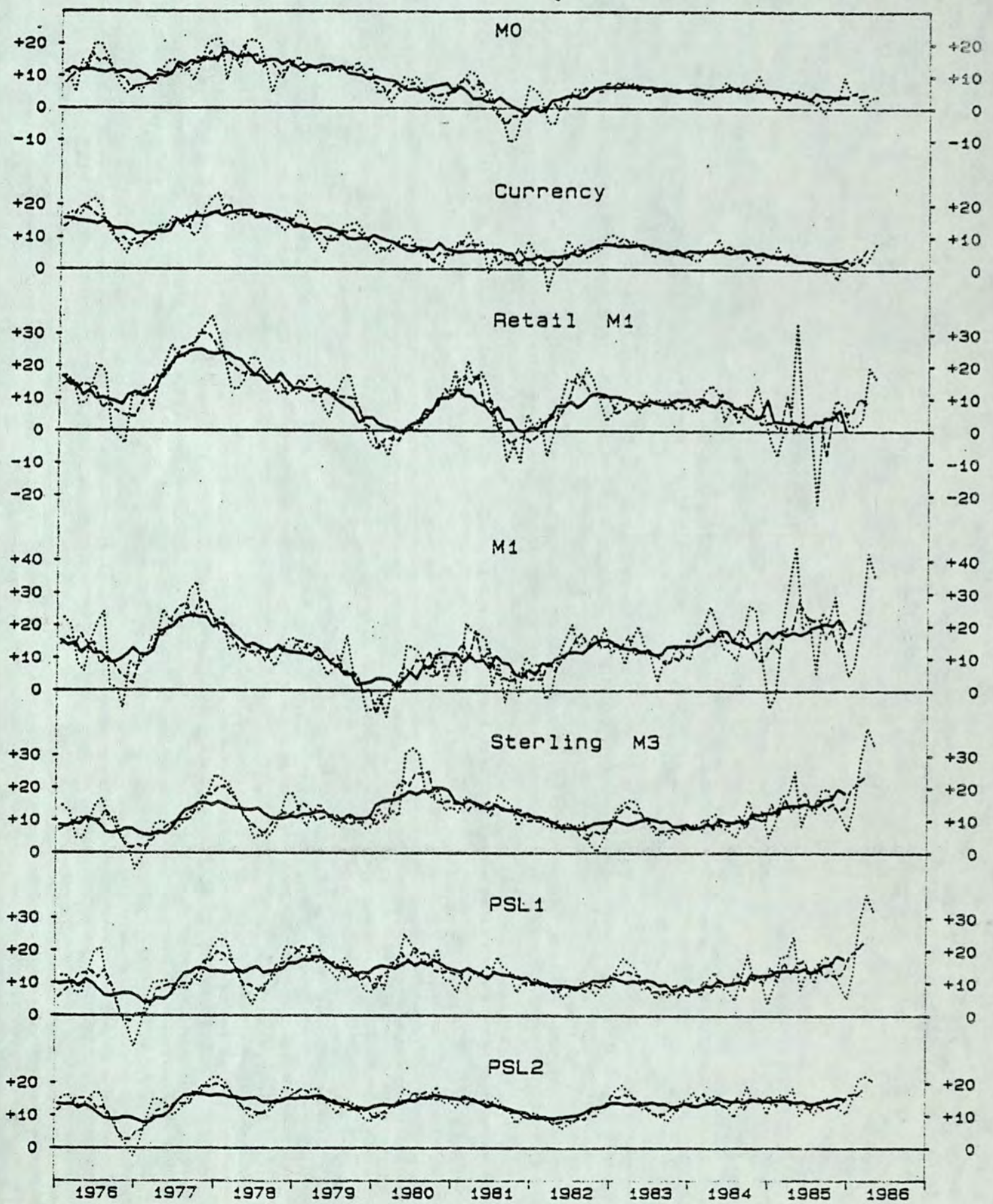


Chart 2 - Monetary Growth in REAL Terms (% p.a.)

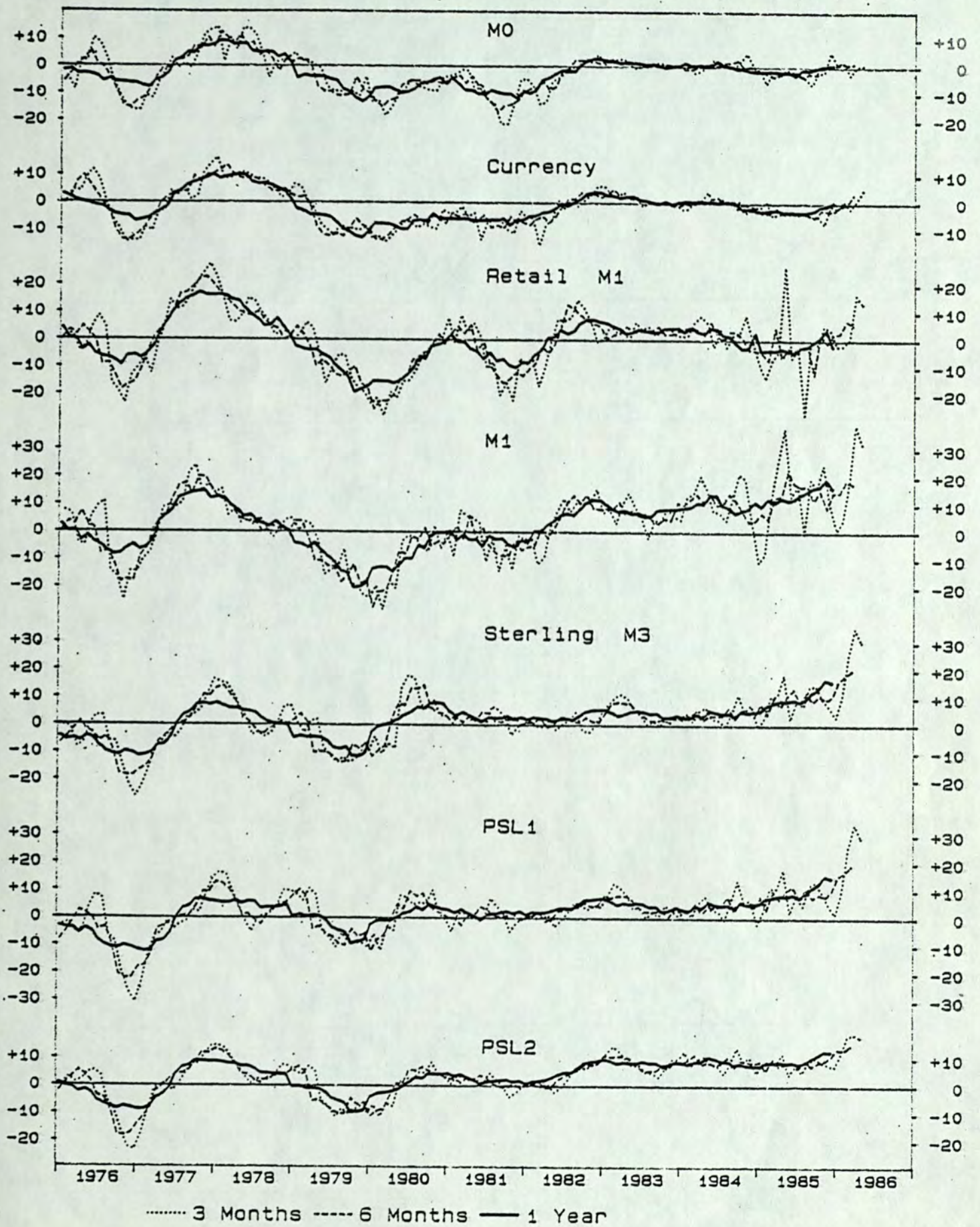
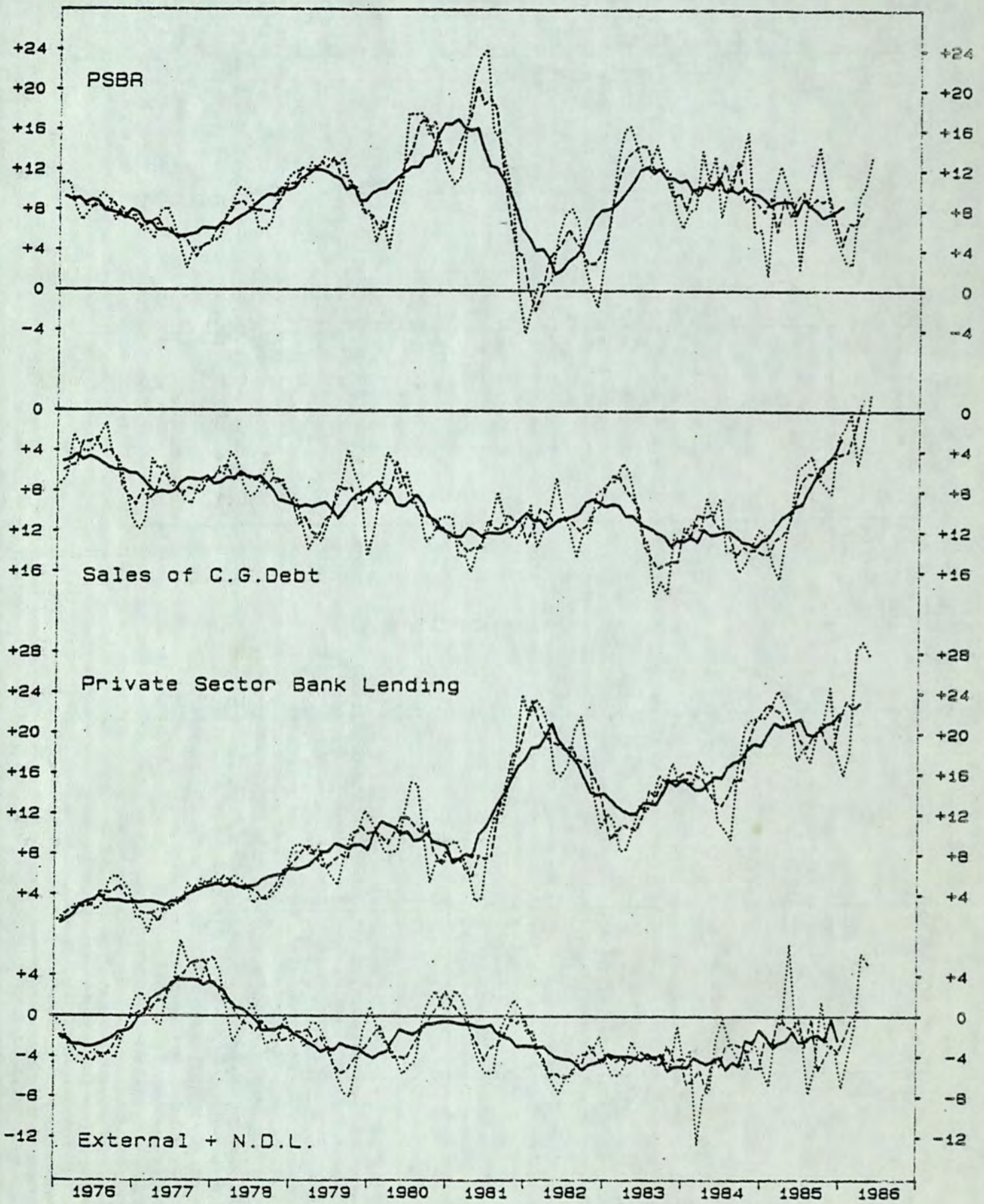


Chart 3 - Components of Monetary Growth (bns)



O/C

CHANCELLOR OF THE EXCHEQUER

David

The Chancellor will be sending out 2 circulars before the end of term:-

(1) An end of term letter to all Conservative MP's -

(2) A separate note on charities to all MP's.

The aim is to get both out on Thursday. The text of (2) is below (though it will of course, appear on Roll notepaper etc as instructed)

Rachel 22/7

11 DOWNING STREET
WHITEHALL SW1A 2AB

22 July 1986

The Rt Hon Margaret Thatcher MP
House of Commons
London
SW1A OAA

B/F 1/10/86.
for Speeches.

Dear Margaret

As the House prepares to rise for the long Summer Recess, I thought it might be useful if, as last year, I took this opportunity to set out how I see the current economic situation and prospects.

I wrote a year ago of the excellent progress the economy has made since we were re-elected in June 1983. That progress has continued. Since I last wrote, output, exports, investment and living standards have all reached new all-time highs; and our growth rate last year, at 3½ per cent, was the highest in the European Community and higher than the United States, too.

And inflation, now down to 2½ per cent, is at its lowest level for almost 20 years. When you compare it with the average rate of inflation of 15½ per cent during the lifetime of the last Labour Government, that is a remarkable achievement by any standards.

The outstanding event on the economic scene during the past 12 months has been the dramatic collapse of the world oil price to little more than a third of its former level - around $10 a barrel compared with $27 a barrel a year ago.

This affects us in a number of ways, some bad, some good. It clearly implies some deterioration in the current account of the balance of payments, and the massive fall in our North Sea oil revenues inevitably limits the scope for reducing the burden of non-oil taxation, at least in the short-term.

But perhaps the most important consequences are the indirect ones, via the effects on world activity and world trade.

The initial consequences have been unfavourable, as those nations and regions that are heavily dependent on their earnings from oil have had to tighten their belts as rapidly as they can. By contrast, the great benefit to oil consumers (which means above all the industrialised world) has so far been felt in terms of higher real income and profitability: the increased activity that this should generate has yet to appear.

I believe it will, and before this year is out. Meanwhile, the way in which we have successfully weathered the unprecedented collapse

in the oil price has exploded once and for all the myth that our new-found economic strength was wholly dependent on North Sea oil. While there has been some inevitable adjustment in the exchange rate, it has occurred in an orderly way. And interest rates are now 2 per cent lower than they were a year ago, while our foreign exchange reserves have actually risen by over 30 per cent.

But the pause in world economic growth not only means that I now expect growth this year to be a little below the 3 per cent I forecast at the time of the Budget. It is also one reason why, despite all the measures we have taken to combat the scourge of unemployment, the numbers out of work have gone on rising and seem likely to rise further in the immediate future, at least until the pause is over.

And this is despite the fact that there are now very nearly a million more jobs in this country since the last General Election - a bigger increase than the whole of the rest of the Common Market put together.

A major cause of high unemployment is that labour costs in Britain continue to rise much too fast - and, in particular, faster than among our major competitors overseas. With inflation down to 2½ per cent, and the overall cost of living, thanks to the tax cut in the Budget, only ½ per cent higher than a year ago, it is madness for companies to increase wages at the rate they are. The result can only be higher unemployment.

The responsibility for getting a firm grip of their wage costs lies fairly and squarely with management. But I have sought to help by campaigning for the wider adoption of profit-related pay. The advantage is twofold: the greater sense of identification between employees and their companies if part of their pay is explicitly linked to profitability, and the greater degree of pay flexibility that results. And I have indicated my readiness to consider a measure of tax relief for such schemes. This is all set out in my recent Green Paper on profit-related pay.

I originally announced this in the Budget, at the same time as I published a Green Paper on the reform of personal taxation, setting out a scheme to remove the discrimination in our tax system against married women. I have also recently published further details of another initiative I launched in the Budget: the Personal Equity Plan. This pioneering scheme, which will come into force on January lst, will enable small investors to invest directly in the shares of British businesses without having to pay a penny piece in tax.

Recent surveys suggest that, since we first took Office, the proportion of adults in this country directly owning stocks and shares has doubled. With the continuing privatisation programme - including British Gas this autumn - as well as the Personal Equity Plan scheme, the prospects for still wider share ownership are excellent. Nor shall we allow Labour's crude threats of renationalisation on confiscatory terms to stop us.

This year's Budget demonstrated two further things: first our continuing commitment to reducing the burden of income tax, and second, the caring nature of Conservatism, with the most far-reaching package of assistance to charitable giving ever - as the charities themselves were the first to acknowledge. I am enclosing a separate note about this last, which I hope you will find helpful.

So what of the prospects for 1987? I expect it to be a better year than 1986. The pause in world growth should come to an end later this year, and inflation should stay low. So the prospect for jobs will improve - particularly if pay settlements respond to the sharp fall in inflation, as they already have in our major overseas competitors.

Meanwhile, the fact that over the past three years we have successfully survived both a 12-month long coal strike and an unprecedented collapse in the price of oil is the clearest possible demonstration of a strong economy and sound policies. It is this, above all, that enables us to face the future with confidence.

NIGEL LAWSON

THE CHARITIES INITIATIVE

I am sending to all Members copies of two new Inland Revenue pamphlets about tax relief for charitable giving. Among other things they describe the new payroll giving scheme, and the new tax relief available to companies wishing to make annual donations without having to covenant.

I believe these schemes will come to be seen as one of the most significant of this Government's innovations. It is vitally important that they become well established in the public consciousness before the General Election. They therefore need all the publicity they can get in the next few months.

The impetus for a broad take-up of the new tax reliefs must come mainly from the charities themselves. They must encourage companies to step up their donations to the limits allowed under the legislation; they must encourage employers and employees to agree among themselves to setting up payroll giving schemes.

Members of Parliament can play a major role in galvanising other people into action. May I ask you, during the coming months, to go out and:

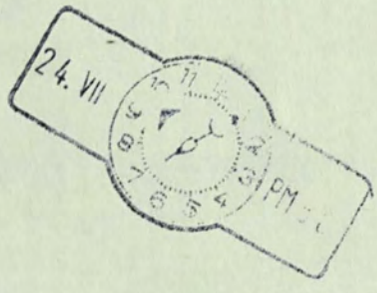
* Press charities in your constituency to take advantage of the new opportunities. This is the most important: they must 'sell' the new reliefs to potential donors.

* Inform local companies of the new and more advantageous way they can give to charity.

* Tell local employers of the simple way in which they can set up payroll giving schemes for their workforce.

The company donation scheme is operative as from now. The payroll scheme comes in for the tax year starting next April, but preparatory work will need to be done well in advance.

N.L.


24. VII
PM

12

PRIME MINISTER

INTEREST RATES

The Treasury and Bank have provisionally agreed to go ahead with a half per cent reduction of base rates on Monday. The Chancellor and the Governor will meet at 1100 on Monday to consider the state of the markets. If they decide then to go ahead the signal will be given at 1200.

I know that you and the Chancellor are firmly in favour of a reduction now, but at the risk of being over cautious may I set out the arguments for waiting?

First though the arguments in favour. The cut in American rates gives cover for us to reduce our rates. The economy clearly is in a very sluggish patch and the recovery may come later than the Chancellor thinks (though there is little doubt that one is on its way at some stage late this year or in the first half of next). A reduction in interest rates now would take time to feed through into increased activity and it is important that the benefits should be coming through in the potentially important period politically of next spring and autumn. It is also the case that after each sharp increase in interest rates the reductions which follow seem always to leave us with a level which is a little higher than before. Moreover, if there is another increase in interest rates to come at some stage, better to start from a lower level because the increase needed to stabilise the exchange rate and restore confidence is likely to be no greater almost whatever the level we start from.

Against this, the Germans are unlikely to follow the Americans and the Japanese may well not. In that case we shall be joining only the Americans and the French. There is a risk that a cut now, which is not being signalled by the markets, will be seen as a "political" reduction. This could revive the fears which have surfaced from time to time over the past year that the Government is in a mood to take risks in order

to help its electoral prospects.

Then there is the public expenditure Cabinet on Thursday to get through. If that goes well, we face the local authority finance announcements on 22 July. The markets have not yet properly woken up to the public expenditure problem, but those announcements could give them a pretty good idea. It also seems very likely that the local authority employers will be putting to the teachers preliminary figures for a pay offer on 22 or 23 July. Those numbers themselves are certain to be high and could reinforce worries both about public expenditure and about the prospects for the coming pay round. On the worst case, other public sector trades union leaders could begin to make aggressive statements on behalf of their own members when they know the starting point for the teachers' talks. The Government could also appear under pressure if the discussions on South African sanctions are going badly.

These are gloomy thoughts and they put almost the worst complexion on the events of the next two weeks. But they lead me to feel that it would be better to wait until those two weeks are past before looking for a further reduction in interest rates. If John Wybrew is right, higher oil prices may then help us. The Chancellor would no doubt say that Monday could be the last opportunity before the autumn. There are arguments both ways. I would still suggest that on balance it is not worth taking a risk at this stage in July. Better to have something in hand with the markets still believing that the next move is more likely to be down than up.

Yes Would you like to be consulted again before the final decision is taken? Or do you want to leave it to the Chancellor and the Governor?

I think we should look at this morning's market very carefully - what worried me was the effect of an article on the front of the Sunday Times business news yesterday. Irresponsible - but it may have some effect.

DN

DAVID NORGROVE
11 July 1986

EL3BHM

EL3BHA

(2)

PRIME MINISTER

COMPOUND INTEREST

David has mentioned to you his neat way of calculating how many years it takes for a sum to double at a particular rate of compound interest. You simply divide 69 (not 67) by the interest rate. You might like to know why this works:

Let x be the rate of interest, and y the number of years for the sum to double.

Then $(1 + x)^y = 2$

Taking logs $y \log (1 + x) = \log 2$

In natural logs, the first degree approximation log (1 + x) is simply x, when x is small. (The next term is a function of x^2. So when x is small, that term and subsequent ones are very small.) The fact that the first order approximation of log (1 + x) for small x is so good is the key to the accuracy and simplicity of David's method.

So $y \log (1 + x) = \log 2$

$\Rightarrow yx = \log 2$ when x is small.

And $\log 2 = 0.69$

$\Rightarrow y = \frac{0.69}{x}$ or where x is expressed as a percentage $\frac{69}{x}$

This approximation works surprisingly well. The following table compares the actual time taken to double the sum, compared with the result given by the approximation.

	Real time to double (years)	Approximation (years)
x = 5%	14.2	13.8
x = 10%	7.3	6.9
x = 15%	4.9	4.6
x = 20%	3.8	3.4

So even for interest rates up to 20%, the approximation gives

a result correct to within nearly a 10% level of error. It always understates, and is of course most accurate when x is small: if one wanted to have a system which was most accurate around, say, 10%, the number 73 could be used instead.

Pardon very much

MEA

8 July, 1986.

EL3BHA

DN to see
DN - thank you
N.L.W.
7.7

10 DOWNING STREET

From the Private Secretary

Prime Minister

This makes depressing reading I am afraid.

See in particular:

- the covering minute
- the summary starting on page 3
- the table on page ~~50~~ 27
- pages 51 and 52 on unemployment.

The main impression is of an economy failing to take advantage of lower oil prices in the way our competitors are, and with pay still the heart of our problems.

DNW 4/7.

E.R.

SRWAFR

PRIME MINISTER

ANNUAL REPORT OF THE BANK FOR INTERNATIONAL SETTLEMENTS

The BIS annual report contains its usual fascinating analysis of the world economy.

The summary on pages 3-7 is worth glancing at if you have time, though as with all these international institutions, the bits which are likely to be widely read tend to be bland.

Two particular points struck me in reading the report.

First, the role of the United States budget deficit and its counterpart in the current account deficit is a recurrent factor which appears in every chapter. Some of its effects are obvious, for example, its role in helping to create unsettling and damaging movements in exchange rates over the past four years. Others are more subtle, for example, its role in encouraging changes in the financial markets. The shift away from direct lending by banks to lending through securities (commercial paper, Euro-notes and bonds, etc.) began before the current account imbalances between the United States and Japan became so extreme. But the Japanese reluctance to engage in direct investment overseas, the BIS believe, has encouraged the growth of securities markets as a way of lending and borrowing. (Japan's direct investment accounted for only 11 per cent of overseas assets at the end of 1984 compared with 33 per cent for the UK.) This could itself help towards future instability because securities can be bought and sold more easily than direct investments.

Secondly, the BIS emphasise the continuing importance of control of the monetary aggregates. They point out that the world's performance on inflation is not as good as it looks, because of the fall in oil and commodity prices which is unrepeatable. They point to the evidence of liquidity ease in industrial countries (the boom of stock market prices, the scale of takeovers and generally the borrowers' markets) as

cause for caution.

In this context they also argue against excessive reliance on goals for nominal income (as of course we have in a modest way) or interest rates (page 116). Furthermore they suggest that for countries within the EMS, other than Germany, interest rates have been assigned as an instrument for managing exchange rates while credit or exchange controls have often been used to permit monetary objectives to be pursued at the same time (page 127). This is of course a point you have yourself made from time to time.

Other interesting points are:

(i) OECD and world bank figures suggest that the proportion of manufactured products subject to non-tariff restrictions in the industrial world may have risen from 20 per cent in 1980 to 30 per cent in 1983 and the trend has almost certainly continued since then;

(ii) only a fifth of the 11 million non-agricultural jobs created in the United States since the end of 1982 have been in industry;

(iii) the table of international comparisons of budget deficits on page 26 - which excludes asset sales - shows ours equal to that of the United States and around three times that of Germany and Japan (though a more sophisticated analysis would also take into account savings ratios, shown on page 63, with our private savings ratio substantially higher than that of the United States and France);

(iv) the fascinating table on page 68 showing real returns on equities, housing and bonds; the returns on all three in the UK have been high in the past three years, particularly for equities;

E.R.

the returns to housing have been poor over the past six years taken together though higher than in all other countries except Japan and much the same as Italy; the return to agricultural land in the US has been negative to the tune of more than 33 per cent over the six years.

Amanda Ross

pp (DAVID NORGROVE)
27 June 1986

SECRET

10 11

COPY NO 54

FROM: H P EVANS

DATE: 24 June 1986

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
PCC members
Mr Burgner
Mr Moore
Mr Odling-Smee
Mr Peretz
Mr Monger
Mr Sedgwick
Mr Spackman
Mr Turnbull
Mr Matthews
Mr Davies
Mr Mowl
Miss O'Mara
Miss Peirson
Mr Riley
Mr Cropper
Mr Tyrie
Mr Ross Goobey

TREASURY ECONOMIC FORECAST: JUNE EXERCISE

I attach a copy of the main report on the June forecast, which makes the same assumptions about UK economic policy as were made in the FSBR and is based on the same oil price assumption. ie $15

2. We have reviewed the judgements made in the FSBR forecast in the light of their internal plausibility and their conformity with recent data. In quite a number of respects, the position in the first half year seems to be turning out differently from expectations. With the exception of the RPI inflation rate (and that to a large extent because of mortgage interest rates) the first half of 1986 looks worse than expected: activity is lower,

unemployment is higher, real wages are higher, and the balance of payments position is less favourable. Like many other forecasters, including the London Business School, we have concluded that growth and inflation will both be lower this year, but that growth will be better next year.

3. In one important respect at least our judgement at Budget time looks to have been too optimistic. Exports have been much lower than expected, reflecting both a weaker world position and, we think, a less favourable UK share. Partly as a result, but mainly because of the big fall in oil revenues, we may now be entering a period in which the current account fluctuates not all that far from balance - a move away from the substantial surpluses of recent years. The timing of this move will depend crucially on the relative growth of domestic demand here and abroad.

4. Another aspect of recent developments is that we do not seem to be getting any gain in competitiveness following the fall in oil prices. This results from a smaller than expected fall in the exchange rate, and from faster inflation in the UK compared with other major countries. But we do see low inflation rates both this year and next. Because we cannot count on further gains on commodity prices, one major factor reducing the rate of inflation this year will fade away. While there should certainly be some offset from the (delayed) response of domestic costs, there may still be some mild tendency for inflation to rise during 1987. That tendency is likely to be exaggerated by the RPI, if we are anything like right about the movement of mortgage interest rates.

5. One message from this forecast is that we need to watch carefully for signs of continued weakness in demand and prices, as much abroad as at home. In constructing this forecast we have had in mind the sentence from the FSBR (paragraph 2.30) that "the MTFS .... provides as firm a guarantee against inadequate money demand as it does against excessive money demand". With money GDP

in 1986-87 now expected to rise a full 1 per cent less than at Budget time, and with only part of that made up in 1987-88, this forecast suggests that the scope for reducing interest rates this year could be bigger than we have allowed. If so, there would also be the possibility of a sharper rise in rates next year.

HPE.

H P EVANS

SECRET

TREASURY ECONOMIC FORECAST

JUNE 1986 REPORT

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TREASURY ECONOMIC FORECAST: JUNE 1986

Report by EA

Introduction

This is the report on the internal June exercise. Detailed reports are being circulated as follows:

World economic prospects, Mr Matthews (EF2).

Public finances, Miss Peirson (PSF).

Oil production and revenues, Mr Owen (EA2).

Financial forecast, Mr Mowl (EA2).

2. In general, we follow the policy framework of the MTFS. The forecast overs the period to early 1988, in summary pages 3-14, and in detail pages 15-57.

3. Because of temporary technical problems with our printer, we are unable to adopt the usual rounding to halves or quarters. Instead, in many tables, the figures are quoted to one decimal place. This should not be taken as an indication of greater than usual confidence in the forecasts.

SUMMARY

3. Since the budget forecast was prepared, there has been plenty of evidence that the world economy - industrialised countries and primary producers alike - has been weaker than expected. A crucial element in our assessment is the extent to which the weakness in UK output, particularly evident in the manufacturing sector, and lower UK inflation reflects world developments.

4. Our conclusion - based on uncertain data for only a short period thus far in 1986 - is that not all the weakness in the UK can be attributed to developments elsewhere. In at least one crucial aspect, the performance of exports relative to world trade, the budget forecast took what now looks to be an overly optimistic view.

5. With both world output and prices weak, this has provided scope for more falls in interest rates, here and abroad. From the second half of 1986 in particular, we think, the benefits from lower prices and lower interest rates will stimulate demand and activity. So although 1986 is weaker, 1987 may show stronger growth combined with low inflation. Our revised forecast for the UK is as follows:

	GDP percentage changes		RPI calendar years (fourth quarters in brackets)	
	FSBR	June	FSBR	June
1986	3.1	2.4	3.8(3.6)	3.1(2.3)
1987	2.4	3.1	3.7(3.3)	3.3(4.0)

6. We have based this forecast on a $15 barrel world (and UK) oil price from about now. Although this is rather higher than spot or futures prices at the moment, analysis by the Department of Energy suggests that a substantially lower price, like $10, was probably not sustainable in the longer term. On balance, we felt there was no strong case for a major change in the oil price assumption.

Activity: World and UK

7. There was a fairly widespread weak first quarter. There was a small fall in manufacturing output in the UK, and in parts of Europe, and US output growth was sustained only by some involuntary stockbuilding. In addition, the recent fall in UK exports to many primary producers suggests weak demand there too. Early signs - production figures for UK, France and Germany in particular - point to some recovery in the second quarter, as we have assumed, but the latest CBI survey results for the UK are again distinctly weak.

8. Large increases in real income for both consumers and companies are the main reason for expecting domestic demand to become more buoyant. But on our forecast it could be well into the autumn before there are convincing signs of upturn. This could follow the usual pattern in which manufacturing output rises faster than total:

per cent changes

	GNP/GDP		Industrial/manufacturing output	
	Major 7	UK	Major 7	UK
1986	2.8	2.4	2.3	0.5
1987	3.6	3.1	5.6	3.4

Unemployment

9. The weakness in manufacturing output in the UK in recent months seems to have been quickly reflected in the labour market, with the trend of unemployment (discounting the effect of Selective Employment Measures) rising at some 20 thousand a month in the last half year. The renewed upturn in activity forecast may be enough to halt and perhaps reverse the trend in unemployment. But most forecasts in recent years underestimated the rise in unemployment (see chart on page 48).

Interest Rates

10. There is some downward pressure on interest rates in many OECD countries because of the weakness in both output and prices. We expect rates both here and abroad to fall slowly for a while. But with a somewhat faster growth of output established by 1987 and with the inflation rate tending to rise from very low levels once the direct effects of lower oil and commodity prices have been passed through, there may be some tendency for interest rates to rise next year.

Monetary policy targets and indicators

per cent changes

	Money GDP		£M3		MO	
	F'Cast	MTFS	F'cast	MTFS range	F'cast	MTFS range
1985-86	9.7	9.5	13	(5-9)	4.4	3-7
1986-87	5.8	6.8	17	11-15	4.0	2-6
1987-88	7.0	6.4	14	-	5.1	2-6

11. We have raised our forecast of £M3 growth in 1986-87 in the light of recent data. Wider aggregates show more stable growth. Much of the extra credit to consumers is taking the form of mortgages, and with the amount of mortgage lending rising in real terms, and the supply of houses only responding very slowly, house price rises may continue in double figures. (This price rise is not being picked up in most aggregate measures of inflation.)

12. We judge this monetary outlook consistent with some further fall in inflation this year and some modest rise before the end of 1987. The main short term influence on changes in inflation stems from the combination of commodity price and exchange rate movements, shown in the changes in import prices in the table in paragraph 17.

Exchange rates

13. Sterling is currently some 3-6 per cent higher in relation to the second half of last year than we would have expected given the fall in oil prices, the interest differential and the fall in the dollar. We have allowed for a 5 per cent fall in the sterling index over the next year. This judgment takes account of the move by the current account towards a small deficit next year; the need in the longer run for the real exchange rate to adjust to the fall in oil production; and maintenance of something like the current interest rate differential, reflecting both higher UK inflation and higher real rates here.

14. The sterling index and the rate against the dollar might look as follows:

	Sterling index	£/$
1985 Q4	80	1.44
1986 Q4	74	1.52
1987 Q4	70	1.47

This is consistent with not much change in competitiveness: the gains expected as oil prices fell have been offset by a combination of a smaller fall in the exchange rate and higher UK inflation. Hence the UK is getting more of the benefit from the fall in oil prices on inflation; but because of the absence of competitiveness gains, less on output.

Balance of Payments

15. The current account surplus, now put at nearly £4 billion in 1985, looks set to fall away, perhaps into deficit next year. Not only was 1985 the peak year for oil, but it also saw an exceptionally strong performance in manufactures in both overseas and domestic markets, which seems not to be continuing. There should be some offsets, mainly in the form of higher invisible earnings.

The forecast shows −£1½ bn in 1987 compared with +£3bn in 1986.

Inflation

16. Most measures of (price) inflation in the UK will soon be in the region of 3 per cent; and similar figures are expected for much of 1987. Low rates of inflation make the difference between different measures more obvious. The RPI, in particular, because of its dependence on the mortgage rate, will show some very low figures this autumn: perhaps not much more than 2 per cent. Other measures of inflation will also show lower figures later this year, and low (but rising) figures in 1987.

Inflation rates, per cent

	Producer prices	GDP deflator	RPI	RPI less mortgage interest payments	World: Major 7 consumer inflation
1984 Q4	5.7	3.8	4.8	4.1	4.1
1985 Q4	5.9	7.3	5.5	5.2	3.6
1986 Q2	4.5	4.7	2.9	3.3	2.0
1986 Q4	3.3	2.1	2.3	3.1	0.9
1987 Q4	3.7	3.4	4.0	3.4	1.7

1986 Q2 figures are partly or wholly forecast.

17. The downward shift in UK inflation from about 5 per cent in the period 1983-85 to 3 per cent or so later this year reflects a good part of the world wide fall in inflation, which in turn results to a large extent from the fall in **real** commodity prices. The failure of inflation in the UK to fall as much as in other countries reflects both the fall in sterling and cost developments in the UK. The table below shows the large swings in import prices:

Influences on prices

	Import prices (total)	Unit labour costs (private sector)	Profitability (non-oil)
1985 Q4	- 5	+5.4	11.4
1986 Q4	+ 1	+4.6	11.7
1987 Q4	+ 6	+3.6	11.3

18. Faster UK inflation could arise from a sharper decline in sterling, or a more rapid recovery in commodity prices. Previous forecasts, however, have tended to understate the weakness in commodity prices, for a given level of world activity.

THE FISCAL PROSPECT

19. The fiscal prospect is the subject of a separate report by PSF. Our forecasts, assuming a PSBR set at 1.75% of GDP in 1987-88, compare with the Budget forecast as follows:

PSBR	1984-85	1985-86	1986-87	£billion 1987-88
Budget forecast/MTFS	10.2	6.8	7.1	7(2)
June forecast	10.2	5.9	7.5	7(2)
Financial Deficit				
June forecast	15	9	12	11

(fiscal adjustments in brackets)

20. As a measure of the fiscal position, the public sector financial deficit, which does not allow for privatisation proceeds nor for net lending by the public sector, shows more of a fall in 1985-86 and a larger rise in 1986-87. The low figure in 1985-86 reflected in particular high oil revenues, compared with 1986-87; and low coal strike costs, compared with 1984-85.

Changes since the Budget

21. Overall, the PSBR forecast for the current year **1986-87** is only a little higher from the Budget estimate of £7 billion. Within the total, the main changes are as follows:

(i) The forecast of the planning total is higher by £1 billion: we think that the £4.5 billion Reserve is likely to be overspent. (See table in paragraph 26.)

(ii) Oil revenues are £0.6 billion lower, mainly because of the firmer £/$ exchange rate and lower average $ oil prices, but non-oil revenues are higher, despite a lower forecast of the rise in money GDP, especially income tax and National Insurance Contributions because of the higher forecast wages bill. In total revenues are little changed in 1986-87.

22. The FSBR quoted an average error of £4 billion for the PSBR in 1986-87, based on the forecasting record of the last 10 years. With only a limited amount of extra information available, the record of June forecasts, on average, is a little better than Budget forecasts. In recent years, the June 1983 forecast correctly anticipated a sizeable overshoot; the June 1984 forecast failed to anticipate the overshoot because of a more extended coal strike than expected. The June 1985 forecast correctly anticipated little change in the PSBR from the Budget estimate.In forecasting the PSBR we make allowance for normal contingencies but not for major costs such as the coal strike.

23. For **1987-88,** the MTFS projections for public expenditure were on the basis of the PEWP planning total, despite earlier forecasts that it would be substantially exceeded. The MTFS also scaled down the revenue projections to keep the published fiscal adjustment close to our underlying forecast. It is not surprising, therefore, that the June forecast shows both expenditure and revenue substantially higher than in the MTFS. The main changes from the MTFS projections are as follows:

(i) The forecast of the planning total is higher by £4 billion: see below.

(ii) Tax revenues and NICs are forecast over £3 billion higher. A substantial reduction in non-oil corporation tax receipts (because of lower forecast profits in 1986) is more than offset by further large additions to income tax, NICs and expenditure taxes.

(iii) Other smaller changes, including a reduction of £0.2 billion in net debt interest payments.

Public expenditure planning totals

24. The forecast of public expenditure is explained in detail in the PSF report. It takes account of changes in the economic environment and of likely policy changes in the Survey, as assessed by the expenditure side of the Treasury. We forecast net overspends on the 1986 PEWP programmes in 1986-87 and 1987-88 of some £5.6 billion and £10.2 billion respectively, compared with Reserves of £4.5 billion and £6.25 billion. This assumes privatisation proceeds at the PEWP figure of £4.75 billion a year. Our forecast therefore suggests that the Reserves will be insufficient by about £1 billion and £4 billion (and much more in 1988-89).

25. Pressures on programmes, reflected in our forecast of substantial overspends, are greatest in the usual areas of social security (despite lower inflation) and local authority current expenditure. In addition, very large bids for local authority capital have been made, and overspend in this area remains high. Bids in cash-limited areas are numerous.

26. The broad picture is as follows:

	1986-87		£billion 1987-88	
1986 PEWP programmes	139.3		142.3	
Forecast overspends (including Survey bids)	5.7		10.3	
Of which:				
social security		1.4		1.4
local authority current		2.4		4.3
local authority capital		0.7		1.5
cash-limited expenditure		0.3		1.7
other demand-led		0.9		1.4
Less				
Privatisation proceeds	-4.75		-4.75	
Forecast planning total	140.2		147.8	
1986 PEWP planning total (programmes plus Reserve less privatisation proceeds)	139.1		143.9	
Net overspend	1.1		3.9	

27. If we exclude privatisation proceeds and coal strike effects from the planning total, the forecast shows the following pattern:

	per cent increases on a year earlier		
	1985-86	1986-87	1987-88
Cash	5.0	7.1	5.3
GDP deflator	6.2	3.1	3.9
Cost terms	-1.2	+4.0	+1.4

The sharp slowdown in the rise in the GDP deflator because of lower oil prices has little effect on the cash figure for public expenditure in 1986-87: this contributes to the sharp rise in cost terms in 1986-87.

28. Public service pay is assumed to rise a little faster than private sector pay, including an additional £1.25 bn for teachers' pay over 4 years. That is substantially faster than the GDP deflator used to calculate cost terms figures: in 1987-88, over 7 per cent compared with 4 per cent. Consequently the volume figures - it is assumed that there is no squeeze on employment except for the target fall in civil service numbers - show no change in 1987-88, despite the forecast rise of over 2 per cent in cost terms.

General government current expenditure on goods and services

£billion

	1984-85	1985-86	1986-87	1987-88
Cash	71.3	73.7	80.1	85.2
Cost terms*	71.3	69.4	73.2	75.0
Volume*	71.3	70.0	72.3	72.6

* 1984-85 prices

SUMMARY TABLE AND COMPARISON WITH THE FSBR

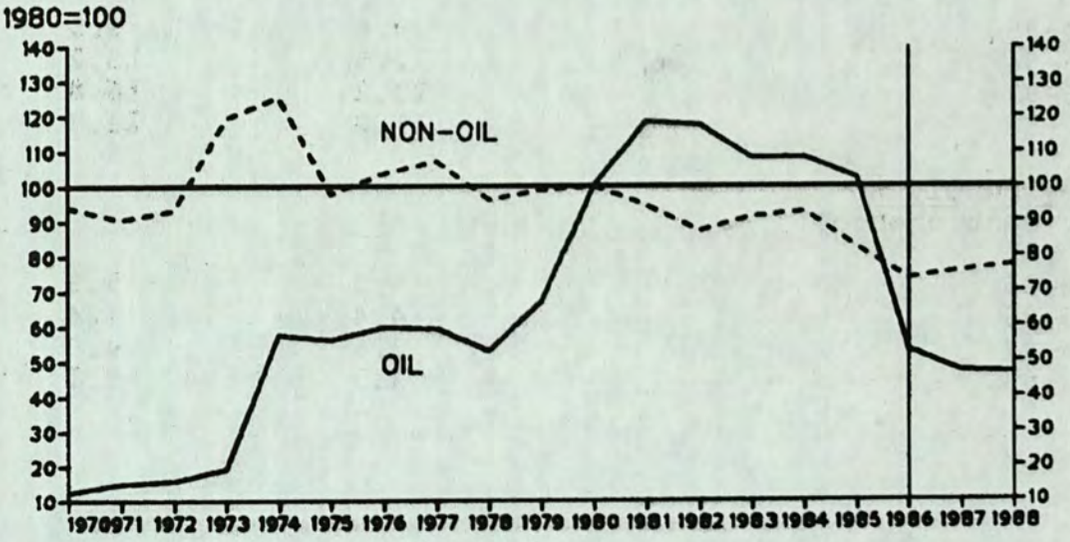
	FSBR/MTFS MARCH 1986	JUNE 1986 FORECAST
1. World GNP (major 7)		
(Per cent change on year earlier)		
1984	4.7	4.7
1985	2.7	2.8
1986	3.4	2.8
1987	3.9	3.6
2. Effective Exchange Rate (1975=100)		
1984	78.6	78.6
1985	78.2	78.2
1986	73.7	75.2
1987	71.5	71.7
3. Nominal GDP (market prices)		
(per cent change on year earlier)		
1984-85	6.9	7.0
1985-86	9.6	9.7
1986-87	6.8	5.8
1987-88	6.4	7.0
4. GDP Volume		
(per cent change on year earlier)		
1984	2.6	2.6
1985	3.3	3.3
1986	3.1	2.4
1987	2.4	3.1
5. RPI		
(per cent change on year earlier)		
1984 Q4	4.8	4.8
1985 Q4	5.5	5.5
1986 Q4	3.6	2.3
1987 Q4	3.3	4.0
6. Unemployment		
(UK s.a. excluding school leavers, millions)		
1984 Q4	3.10	3.06
1985 Q4	3.18	3.12
1986 Q4	3.13	3.26
1987 Q4	3.07	3.14

		FSBR/MTFS MARCH 1986	JUNE 1986 FORECAST
7.	**Current Balance** (£ billion)		
	1984	0.9	1.6
	1985	3.0	3.8
	1986	3.6	2.9
	1987	2.6	-1.4
8.	**PSBR - £ billion** (per cent of GDP in brackets)		
	1984-85	10.1(3.1)	10.2(3.1)
	1985-86	6.8(1.9)	5.9(1.6)
	1986-87	7.1(1.9)	7.5(2.0)
	1987-88	7.1(1.7)	7.1(1.7)
9.	**Fiscal Adjustment (annual not cumulative** (£billion)		
	1986-87	-	-
	1987-88	2	2
10.	**Interest Rates (Short-term)** (per cent)		
	1985 Q4	11.6	11.6
	1986 Q4	11.0	9.0
	1987 Q4	9.5	9.5
11.	**Money Supply £M3** (per cent change)		
	1984-85	9.6	9.5
	1985-86	12.9	13.2
	1986-87	13.2	16.8
	1987-88	11.2	13.7
12.	**Money Supply MO** (per cent change)		
	1984-85	5.5	5.5
	1985-86	4.4	4.4
	1986-87	2.6	4.0
	1987-88	3.9	5.1

THE WORLD ECONOMY

29. In the last couple of months oil prices have fluctuated between $10 and $15 per barrel, having fallen from an average in 1985 of $27 per barrel. In the short run a significant strengthening in oil prices depends primarily on how far OPEC succeeds in restricting supply. This may prove possible later in the year, helped by the seasonal strengthening of demand, but probably only to achieve a price of around $15 per barrel (rather than, say, $20 per barrel). For the purposes of this forecast, we have chosen to stick with the FSBR oil price assumption of $15 per barrel until the end of 1987. This compares with a futures price of West Texas Intermediate on 20 June of some $13 for the second half of 1986. Significantly lower prices, like $10 a barrel, may not be sustainable in the longer run. Prices of non-oil primary products are likely to remain weak as supplies continue to be abundant relative to demand, though we have allowed for a little recovery from current low levels.

COMMODITY PRICES
(IN RELATION TO PRICES OF MANUFACTURES)



30. The collapse in oil prices, coming on top of the continuing effect of the counter-inflationary macro economic policies pursued in recent years, has produced a further sharp fall in inflation: consumer prices in the major industrialised countries have risen on average by only 2 per cent over the past year. The low point for inflation could well be in the second half of 1986. But even if there is some pick up in the course of 1987, the inflation rate for 1987 as a whole should still be very low. The effects of the fall in oil prices on the general price level are in large part once-and-for-all, although there will be some continuing effect from, for instance, lower earnings growth. Inflation is likely to remain at negligible levels in Japan and Germany, but could well increase significantly in the U.S. in the later 1980s.

31. World output and trade have grown only slowly in recent months, turning out below the levels assumed in the FSBR forecast. In part, as in 1985 Q1, this can be attributed to extremely cold weather in Europe. There have been cutbacks in oil exploration and investment, and demand from outside the OECD has been weaker: there seems to have been little increase in imports by non-oil developing countries (because of depressed commodity prices and low capital inflows) and substantial cuts in OPEC imports (as first oil export volumes and then prices fell).

32. The increases in real incomes in oil-importing countries, produced by lower oil prices, have not been translated straight away into higher spending; the initial effects on world demand of the redistribution of income effected by lower oil prices may thus be negative. Higher saving ratios have, though, been accompanied by growth rates of money supply and liquidity in several countries in excess of the authorities' target ranges. Lower interest rates, strong equity and bond prices and other leading indicators also suggest stronger growth in the second half of 1986 and 1987.

World Economy

	Per cent changes on a year earlier			
	1984	1985	1986	1987
Major Seven countries[1]**:**				
Real GNP	4.7	2.8	2.8	3.6
Consumer prices	4.5	3.9	1.7	1.3
World trade, at constant prices				
Total imports	9.9	3.5	3.5	4.9
UK export markets[2]	8.4	5.0	3.0	4.6

[1]US, Japan, Germany, France, UK, Italy and Canada
[2]Manufactures

33. In the US short-term interest rates have fallen by 2 per cent in little more than a year and long rates by nearly 4 per cent, so that the yield curve is now virtually flat. These reductions reflect the slow down in inflation, which is mainly due to oil prices, and the better prospect of cuts in the Federal Budget deficit. Depreciation of the dollar, lower interest rates, high stock market prices and the boost given to real incomes by lower oil prices should all help strengthen growth in the US. There is however a wide range of views at present about prospects for the US economy, with our forecast for 1987 being toward the top end of the range of projections made by US forecasters.

Real GNP in US: per cent change on previous year

	WEP	"Blue Chip Consensus"		
		Average	Lowest decile	Highest decile
1986	2.6	2.8	2.3	3.5
1987	4.1	3.5	2.2	4.6

34. In Germany and Japan exports are forecast to grow much more slowly than in 1985 and could even fall following the appreciation of their currencies against the dollar. And domestic demand has been slow to strengthen in response to the real income gains produced by the improvement in their terms of trade. Real GNP in Japan is likely to grow in 1986 at a rate closer to 3 per cent than to the official forecast of 4 per cent. Output in Germany should also grow at about 3 per cent in 1986. Growth in both countries could pick up to about 3.5 per cent in 1987, but, given the relatively strong growth which we are forecasting for the US, these rates are insufficient to produce any marked reduction in the pattern of current account imbalances.

35. The forecast for the overall growth of world trade in 1986 shown in the table in paragraph 34 is very similar to that made by the OECD and the IMF in their latest forecasts, but is about one percentage point higher for 1987. The evidence is rather scanty at present, but developing countries (NODC) imports appear to have fallen in the second half of 1985 and early 1986, producing very low year on year growth between 1985 and 1986. OPEC members have also been reducing their imports and, unlike the NODCs, are forecast to continue to do so. The appreciation of the Yen produces faster growth of Japanese imports, but the usual difficulties for foreign manufacturers in penetrating the Japanese market are likely to limit the extent of this. The relatively high income elasticity of demand for imports in the US means that

its imports continue to grow, despite the depreciation of the dollar. The forecast assumes no major changes in levels of protection. On this picture of the world economy, the US current account deficit stops rising, but falls only a little. We have allowed for only moderate (3-4 per cent per year) further falls in the dollar: there is a clear risk that at some stage a more rapid depreciation of the dollar will lead to tighter US policies.

World import volumes, annual growth rates

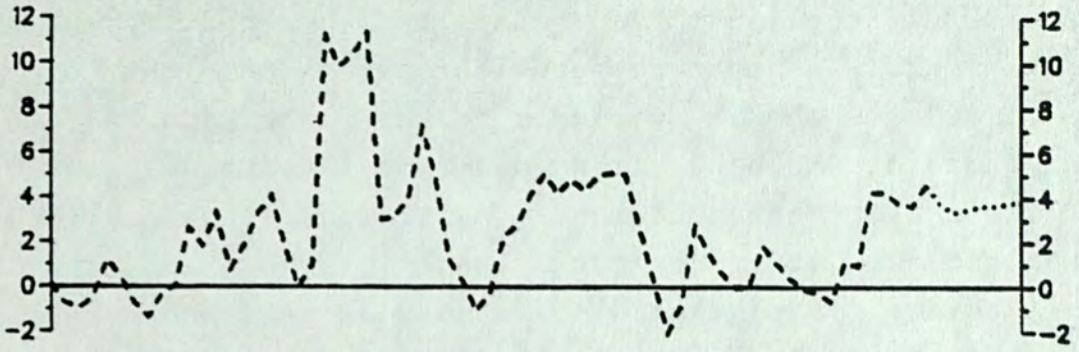
	US	Japan	Europe*	OPEC	Developing countries	Other	Total
Weights in 1985	18	7	31	6	17	21	100
Per cent changes on a year earlier							
1984	24	11	6	-10	8	10	9.9
1985	4	0	5	-14	3	7	3.5
1986	7(7)	5(9)	4(8)	-20(-16)	1(7)	5(6)	3.5(5.5)
1987	4	9	8	-20	6	4	4.9

* Germany, France, UK, Italy, Netherlands and Belgium
FSBR forecasts in brackets

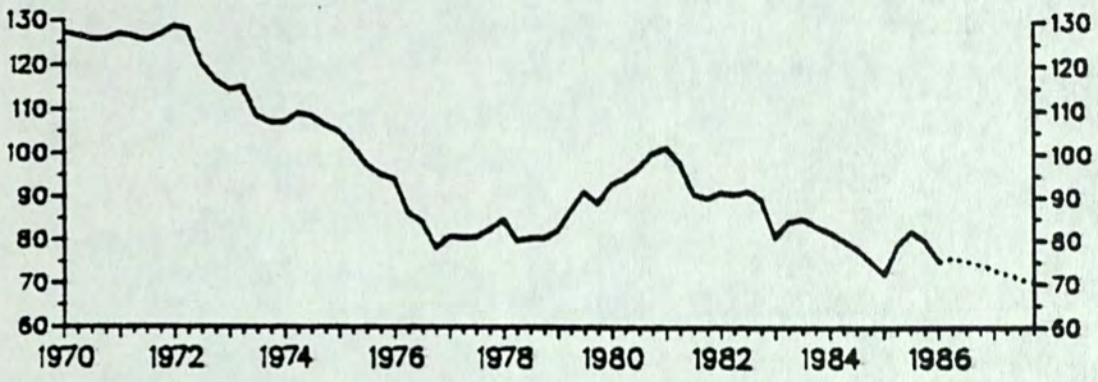
EXCHANGE RATES AND COMPETITIVENESS

36. Since the Budget the sterling index has been steady around 76, some 2-3 points above the level assumed in the FSBR forecast. Although sterling is some 6 per cent below its 1985 second half level it is still higher than we would have expected given the fall in oil prices. Our rules of thumb indicate that the fall in oil prices should have reduced sterling by over 10 per cent, other things equal. We suspect that the influence of oil prices may be a little less than we assumed and that more intangible factors, such as the market's favourable reaction to the Budget and the 1985-86 PSBR outturn, may have helped sterling.

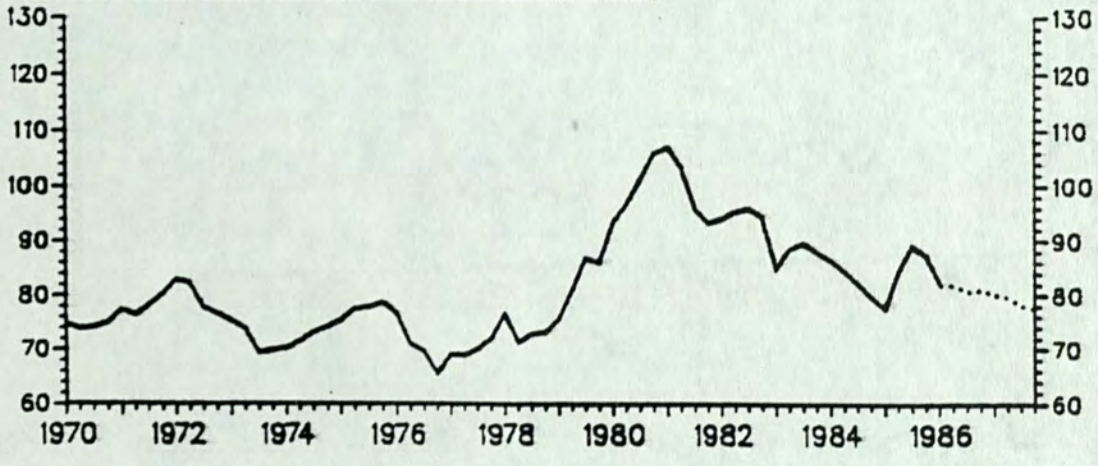
UNCOVERED DIFFERENTIAL AGAINST WORLD



EFFECTIVE RATE (1975=100)

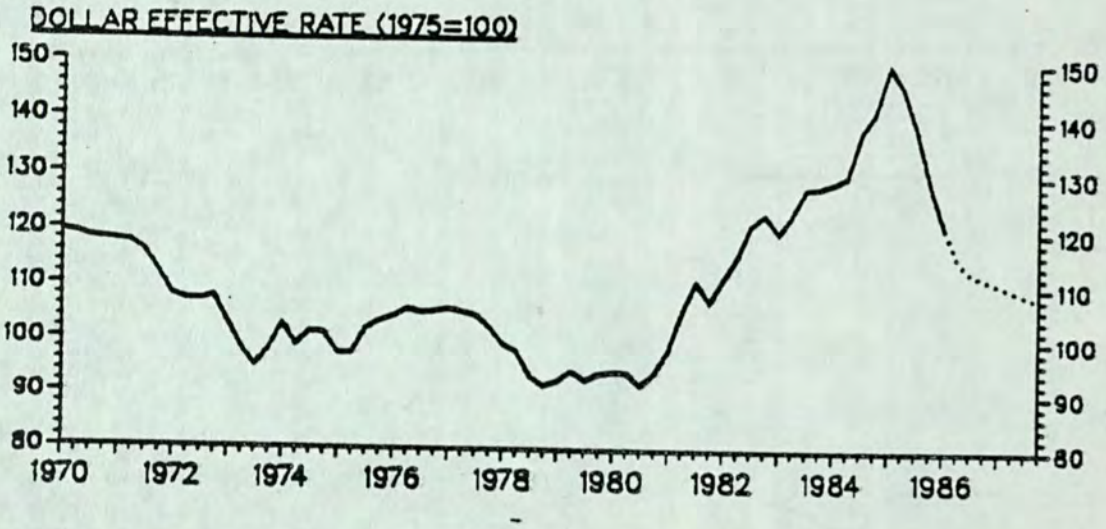


REAL EFFECTIVE EXCHANGE RATE (1980=100)



37. The market's implicit expectation, as reflected in forward rates, is for sterling to depreciate by 3 per cent a year over the next two years. In most respects our forecast of the UK economy is similar to those available to the market and there does not appear therefore to be a strong case for departing significantly from the market's expectation for sterling. The deterioration in the current account is however slightly larger in our forecast than outside forecasts and so we have assumed that sterling will be slightly below the level implied by forward rates.

	Dollar Index	Sterling Index	Dollar/ Sterling	DM/ Sterling
1984 Q4	142	75	1.22	3.72
1985 Q4	129	80	1.44	3.71
1986 Q4	112	74	1.52	3.27
1987 Q4	108	70	1.47	2.97



38. Domestic costs are still rising faster than those overseas as shown in the next chart. The table below shows that the relatively modest depreciation assumed leaves the average levels of price and cost **competitiveness** this year and next similar to the 1983-85 level. But the gains to competitiveness expected from a big fall in oil prices are not materialising: partly because the fall in the exchange rate has been less than expected, partly because the underlying inflation rate in the UK is above that in most other countries.

Manufacturing competitiveness

	Sterling Index	Relative actual unit labour costs	Relative export prices	Import price Competitiveness
	(1975=100)	1980=100		
1983-85 Average	80	86	90	97
1986	75	85	92	100
1987	72	83	90	98

TRADE AND THE BALANCE OF PAYMENTS

39. Helped by recent upward revisions to the invisible surplus, the current account is now estimated to have been in surplus by nearly £4 billion in 1985. A somewhat smaller surplus is forecast for 1986, a little less than anticipated in the FSBR forecast. But the underlying position, particularly for visible trade, is more fragile than these figures suggest and a move towards balance and, for the first time since 1979, perhaps deficit in 1987 is likely.

40. The current account position in 1985 was very strong, particularly after taking account of costs of the coal strike and the delay in EC refunds:

Current Account of the balance of payments

£billion

	Estimate Forecast (1)	Coal Strike (2)	EC refunds (3)	Estimate/ Forecast underlying (4)	of which NS Oil contribution (5)	Underlying less NS oil (6)
1984	1.6	2.8	-	4.4	3.9	0.5
1985	3.8	1.3	0.4	5.5	4.5	1.0
1986	2.9	-	-0.4	2.5	3.0	-0.5
1987	-1.4	-	-	-1.4	1.8	-3.2

(4) = (1)+(2)+(3)
(5) = net exports of oil less NS oil debits
(6) = (4)-(5)

41. Some deterioration in the current account is expected in both 1986 and 1987 because of:

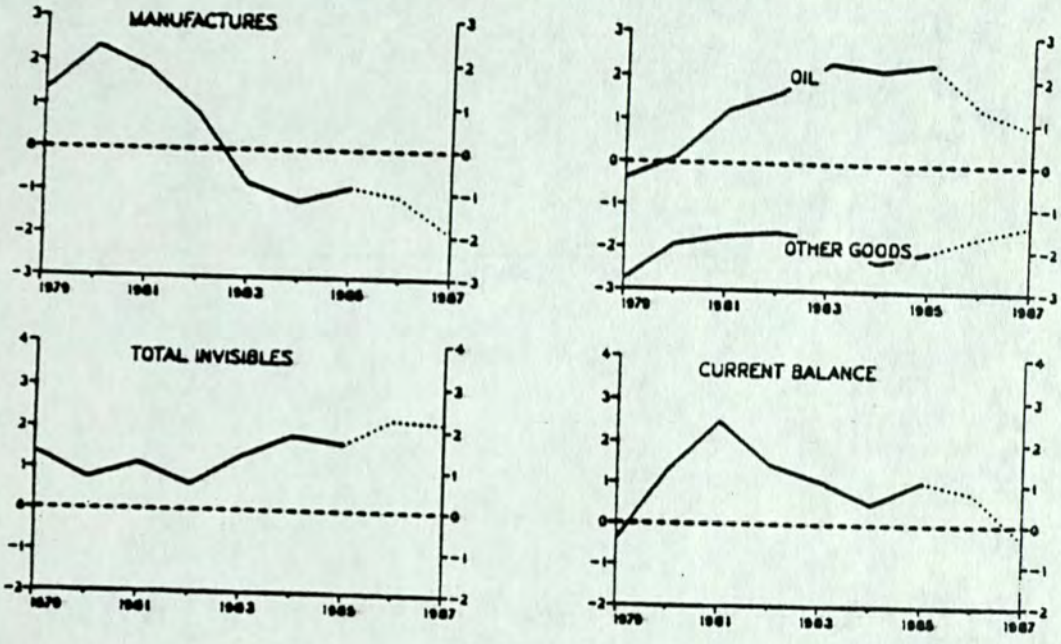
(i) The fall in the oil balance

(ii) The tendency of the UK to lose share (in volume terms) in domestic and overseas markets. In the past this has been compensated by a slower growth in UK domestic demand; but in this forecast domestic demand grows at much the same rate as in other countries. In addition the UK's export markets are comparatively weak because of falls in imports into OPEC and some other countries (especially South Africa and Australia)

(iii) The terms of trade (on goods other than oil) in the first five months of 1986 were 2.7 per cent higher than the 1985 average, but we have allowed for a 1-2 per cent fall in 1987, with a mild recovery in commodity prices.

42. The forecast of the various components of the current account are summarized in the next chart. 1985 shows up with a strong performance in manufactures in relation to the growth in markets.

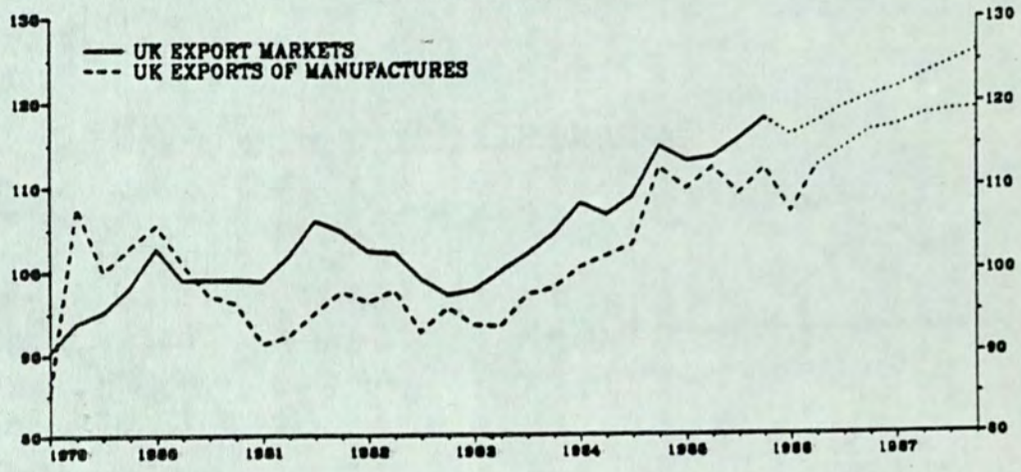
TRADE BALANCES AS SHARE OF GDP



Trade in manufactures

43. Both export and import volumes were lower in the first quarter of 1986 than anticipated in the Budget forecast. In the case of exports some of the explanation lies in weaker than expected growth of UK export markets. This forecast assumes both a sharp recovery in the second quarter and steady export growth from now on, but the level of manufactured exports in volume terms in 1986 could still be 4 per cent below the Budget forecast. Taking 1986 and 1987 together we expect the volume of exports, boosted from April 1986 by arms sales to Saudi Arabia, broadly to keep pace with the growth of our export markets, as shown in the next table and chart. Changes in relative prices and costs should have only a minor impact.

UK EXPORTS OF MANUFACTURES AND THEIR MARKETS, BY VOLUME
(1980 = 100)

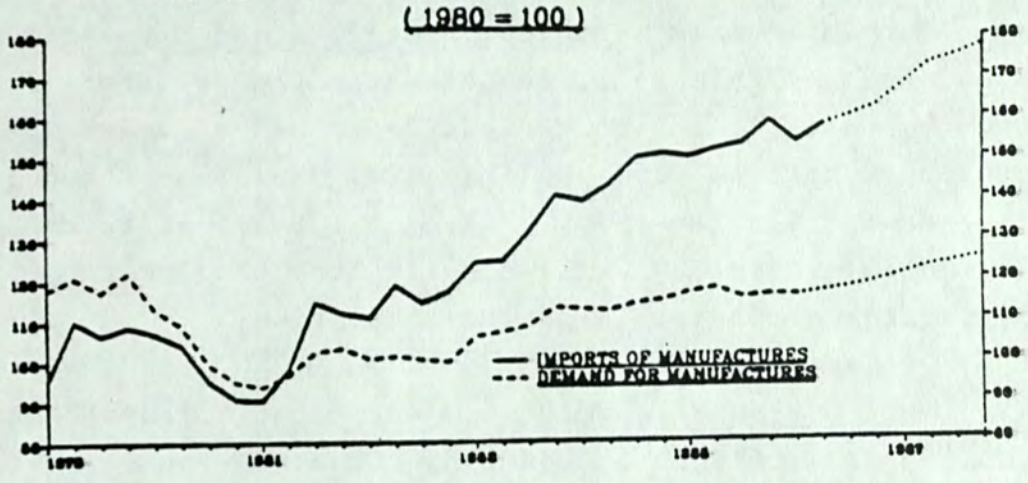


Trade in manufactures: per cent change on previous year

	VOLUMES				TERMS OF TRADE
	Export markets	Exports	Domestic demand	Imports	
1982-85 Average	4.7	5.0	5.0	9.5	-0.1
1986	3.0	1.7	0.7	3.3	+2.2
1987	4.6	5.2	5.0	9.4	-1.8

44. The table above shows imports of manufactures growing nearly twice as fast as domestic demand, a long established trend of rising import penetration. Growth in exports is expected to be close to the growth in markets.

IMPORTS AND DEMAND FOR MANUFACTURES, BY VOLUME
(1980 = 100)



45. The terms of trade in manufactures improved sharply in the second half of last year, but with a falling exchange rate some deterioration is likely by next year. Together with adverse volume movements this contributes to a sharp rise in the deficit on manufactured trade in 1987.

Invisibles

46. There are signs of some weakening in the services account, after very strong growth to mid 1985. The loss of American

tourists on account of their concern about terrorism is currently forecast to amount to about 1 per cent of total service exports (£0.2 billion). More important is the worsening competitiveness of services and the sharp cutback in service imports by OPEC. The pick up in world activity, and some regaining of competitiveness (to which services seem sensitive) together with the fall in the exchange rate this year and the projected gentle decline should improve the balance but not before 1987. The deficit on transfers, unusually low this year because of the late receipt of the rebate on the UK's 1984 EC contribution, is likely to rise again next year.

47. Earnings from interest, profits and dividends (IPD) should rise strongly this year, despite a poor provisional first quarter figure, and again next year as the value of overseas assets continues to rise, and profitability remains strong. Oil IPD, depressed last year by BP's once-for-all write off of losses on its Sohio subsidiary, will benefit from the lower profits earned by foreign companies in the North Sea.

48. Net overseas assets are estimated to have been £87 billion (25 per cent of GDP) at end-1985 compared with £12 billion (6 per cent of GDP) in 1979. While the run of current account surpluses has made a major contribution to the build up of net assets, currency and asset price changes have been the dominant influence in recent years. This is also true of the forecast. Net assets are projected to rise by over £30 billion in 1986 and 1987 to over £120 billion (31 per cent of GDP) by end 1987. There have already been large positive revaluations in 1986 and the recent rise in the US stock market, which we assume will not be reversed, has been particularly important.

INFLATION

49. It was clear a year ago that the inflation rate was likely to fall substantially in 1986: in the forecast completed in June 1985, when RPI inflation was running at 7 per cent, we forecast that inflation would be down to 4 per cent during 1986. Developments over the last year have meant progressively more favourable prospects for inflation. The outlook has improved again since the Budget: world prices and world and UK interest rates have been weaker than expected while the sterling exchange rate has been stronger. As a result our forecast for the RPI for the remainder of this year and early 1987 has been revised down further. We now expect the RPI to be only 2.25 per cent higher in 1986Q4 than it was a year earlier.

50. The fall in inflation experienced in the UK has been matched and often surpassed in other industrial countries. And in other countries there are clear signs of the slowdown in prices being reflected in lower growth in average earnings. In none of the four largest countries should average earnings grow by as much as 4 per cent over the next year, while in the UK there is still no sign of a fall in the rate of increase of earnings.

Percent changes in: **Measures of Inflation in UK and abroad**

Consumer/Retail Prices	**1985**	**1986**	**1987**
UK	6.1	3.1	3.3
Other Major 6 Countries	3.7	1.6	1.1
Wholesale Output Prices			
UK	6.3	4.1	3.6
Other Major 6 Countries	1.7	-2.1	1.0
Average Earnings			
UK	7.8	7.7	7.3
Other Major 6 Countries	5.0	3.6	3.3

Producer and retail prices

51. The recent small monthly increases in **producer prices** have reflected both the fall in input costs over the last year and the downward pressure exerted by low inflation in competitor countries.

Manufactures

percent changes on a year earlier

(annual average)

	unit labour costs	cost of materials and fuels	total costs	domestic output prices	prices of imported manufactures
1984	2.6	8.7	4.9	5.6	7.3
1985	5.1	4.2	5.0	6.3	6.4
1986	6.3	- 10.4	0.2	4.1	2.8
1987	3.7	2.8	3.1	3.6	6.8

52. These low output price increases are also showing up in the sections of the RPI which they affect such as consumer durables, household goods, and clothing and footwear. CBI survey results confirm the prospect of little growth in producer output prices over the next few months.

53. **Nationalised Industry Prices** paid by households should now rise less this year in aggregate than we had assumed at the time of the Budget. The Budget forecast did not allow for the passing through of lower fuel costs to household consumers that is involved in the 3.5 per cent cut in electricity prices announced in early June. The forecast now also allows for a further reduction in electricity prices in the late autumn, as well as a small cut in gas prices soon after privatisation.

54. Food commodity prices have been weaker than expected. Even coffee prices, which were the one serious exception to the generally weak trend earlier in the year, have fallen back and the retail price of coffee may have peaked. Assuming normal harvests this year in the UK and abroad, growth in **retail food prices** is not likely to change much from the 3 per cent increase recorded over the last year.

53. The main changes to the Budget RPI forecast have been to **housing prices.** The April increase in Local Authority rates as recorded in the RPI was about 3 percentage points less than expected. But the biggest revision to the price forecast reflects the lower interest rates now projected. The Budget forecast had only a 1 point cut in mortgage rates during 1986 from the 12.75 per cent level of last winter; in fact mortgage rates have already come down by 1.75 points and a further cut of a point now seems possible by the end of the summer. This revision to the forecast is worth roughly 5 per cent off the housing index in 1986Q4, and about 0.75 per cent off the RPI.

54. On our assumption of a $15 a barrel oil price, the prospects for **petrol prices** are little changed from what was in the Budget forecast. From a level of 162 p per gallon recorded in May, the average retail petrol price has already started to rise, as it often does during the summer months. We expect it to average about 169 p in the fourth quarter of 1986.

55. The forecast for the main components of retail prices is given in the table below (FSBR forecast figures in brackets).

		per cent changes on a year earlier			
	Weights	**1985 Q4**	**1986 Q4**	**1987 Q2**	**1987 Q4**
Food Prices	19	3.2	3.1 (3)	3.1 (3.5)	2.0
Nationalised Industry prices	9	5.4	3.0 (4)	0.6 (3)	1.6
Housing Prices	14	9.3	1.2 (7.5)	2.3 (5)	9.3
Other Prices	58	5.3	2.2 (3)	3.4 (3.5)	3.6
of which:					
Petrol	5	1.6	-11.2 (-10.5)	7.7 (1)	6.8
All Items	100	5.5	2.3 (3.5)	3.0 (3.5)	4.0
All items excluding mortgage interest payments		5.2	3.1 (3.7)	3.4 (4.4)	3.4

56. The recent experience of rapid falls from month to month in the recorded annual inflation rate will soon be over. Retail prices rose by only 0.9 per cent between June 1985 and January 1986: this makes it difficult to achieve a substantial further decline in inflation in the second half of 1986. Nevertheless, although there may be months where the rate of inflation rises a little, some further net decline in the inflation is expected by the end of the year.

Forecast of monthly inflation figures

(per cent changes on a year earlier)

	RPI	RPI excluding Mortgage Payments
May	2.8	3.1
June	2.6	3.5
July	2.5	3.4
August	2.1	3.4
September	2.6	3.4
October	2.4	3.2
November	2.2	3.0
December	2.3	3.1

Alternative Measures of Inflation

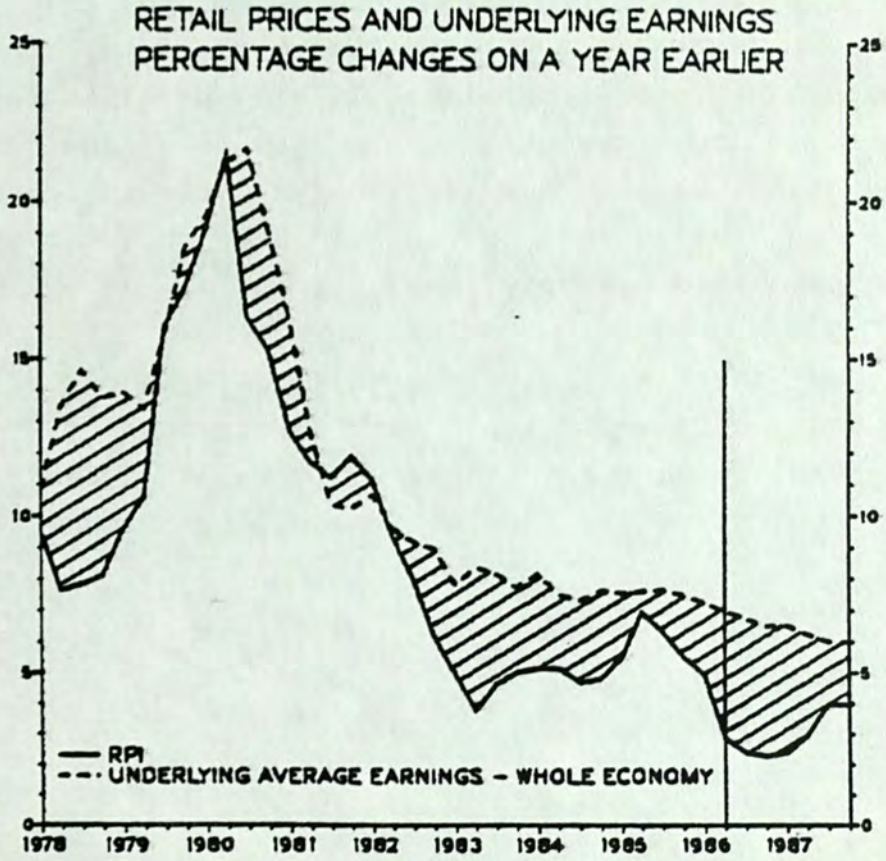
57. The tables above indicate the impact on the RPI of forecast changes in mortgage interest rates which means that the RPI will rise less than other price indices over the next year. The **GDP deflator,** which measures the price of UK "value added" is not, of course, directly affected by movements in interest rates. But it too is subject to temporary downward influences during 1986: because it is affected by movements in oil company profits, the collapse of oil prices since last year will show up for a while in a markedly lower rate of growth of this measure of inflation. The table below shows that we expect growth in the GDP deflator to be below the MTFS path in 1986-87, but to rise back to it in 1987-88.

GDP Deflator, per cent change on a year earlier

	1984-85	1985-86	1986-87	1987-88
MTFS	4.2	6.1	3.7	3.8
June forecast: total	4.3	6.2	3.1	3.9
total less oil	3.5	8.1	5.6	3.4

Pay

58. Pay settlements in the private sector may on average be marginally less over the current pay round as a whole than in 1984-85, but there is no sign yet of any significant response in settlements to the recent decline in price inflation. With an increase in settlements in public services since last year, it is only the fall in overtime working and subsequent loss of earnings in manufacturing industry that is keeping underlying earnings growth for the whole economy down to the now familiar level of 7.5 per cent. Real earnings growth over this pay round will be around 5 per cent, almost half of which may have been unanticipated given the forecasts current at the start of the round. Past experience suggests that this difference will have little effect on pay bargaining in the next round.



Factors Influencing private Sector Earnings, Pay Rounds

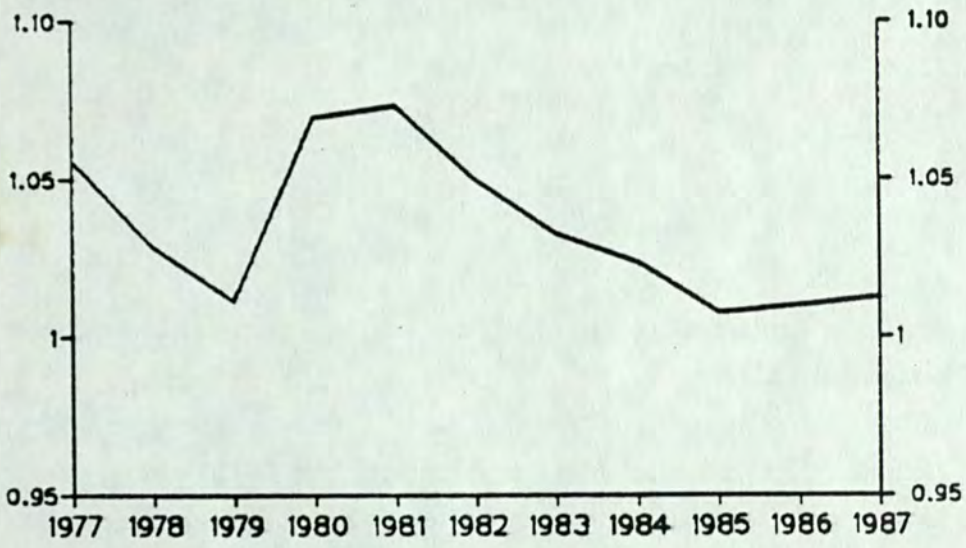
	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88
RPI inflation		(figures in brackets are forecast)				
(i) At start of round, Q3.	8.0	4.6	4.7	6.3	(2.4)	(4.0)
(ii) Outcome on inflation, Q3	4.6	4.7	6.3	(2.4)	(4.0)	
Unemployment						
Level at start of round	11.0	11.9	12.3	12.5	(12.9)	(12.5)
Real take home pay						
(per cent, second half year on second half)	0.3	3.6	1.5	2.3	(5.4)	(3.5)
Profit Share per cent (Non North Sea ICCs)	8.8	10.0	11.8	12.7	(13.5)	(13.3)
Underlying Earnings Growth per cent change on a year earlier	8.3	7.8	8.5	7.8	(6.5)	(6)

59. The fall in non labour costs over the last year has meant that firms have been able to provide large real pay increases and still increase their profit margins. It will be a little less easy for them to be as generous over the next pay round. The large increase in living standards over the last year and the impact of recent inflation figures on expectations should also help to lower settlement rates at the start of the next pay round.

60. We think that earnings may grow by about 6.5 per cent over the pay round - this would imply settlements falling to around 4.5 per cent. While such an outcome would be below the range of settlements experienced since the 1960's, it would still imply a further growth of

real earnings (before tax) of some 3 per cent. With real incomes of both employees and employers rising strongly in 1986, the possible range of outcomes on pay is wide: either side would still be quite comfortable if earnings growth were 1 or 2 per cent higher or lower.

RELATIVE EARNINGS IN PUBLIC SERVICES
TO WHOLE ECONOMY EARNINGS (UNDERLYING)
(JAN 1980=1)



61. Pay in the public services fell relative to private sector earnings between 1981 and 1985. The chart suggests that on average the fall over this period was sufficient to offset the relative gains made by public sector employees in 1980.

62. Pressure to prevent further or reverse relative declines in the pay of various groups in the public sector has been evident over the last year, most notably in the protracted disruptive action taken by schoolteachers. For the forecast we have assumed that public sector employees other than school teachers on average achieve earnings increases in line with the private sector from now on: given the lower drift experienced in the public sector this will mean public sector settlements 1 point or so higher than settlements in the private sector. Teachers are forecast to do somewhat better than this.

COMPANY INCOME AND SPENDING

65. In spite of the slowdown in output growth and higher growth in unit labour costs over the last year, the financial position of non-oil companies remains very healthy: about half the fall in oil companies' share in national income is reflected in an increase in the share of non-oil companies.

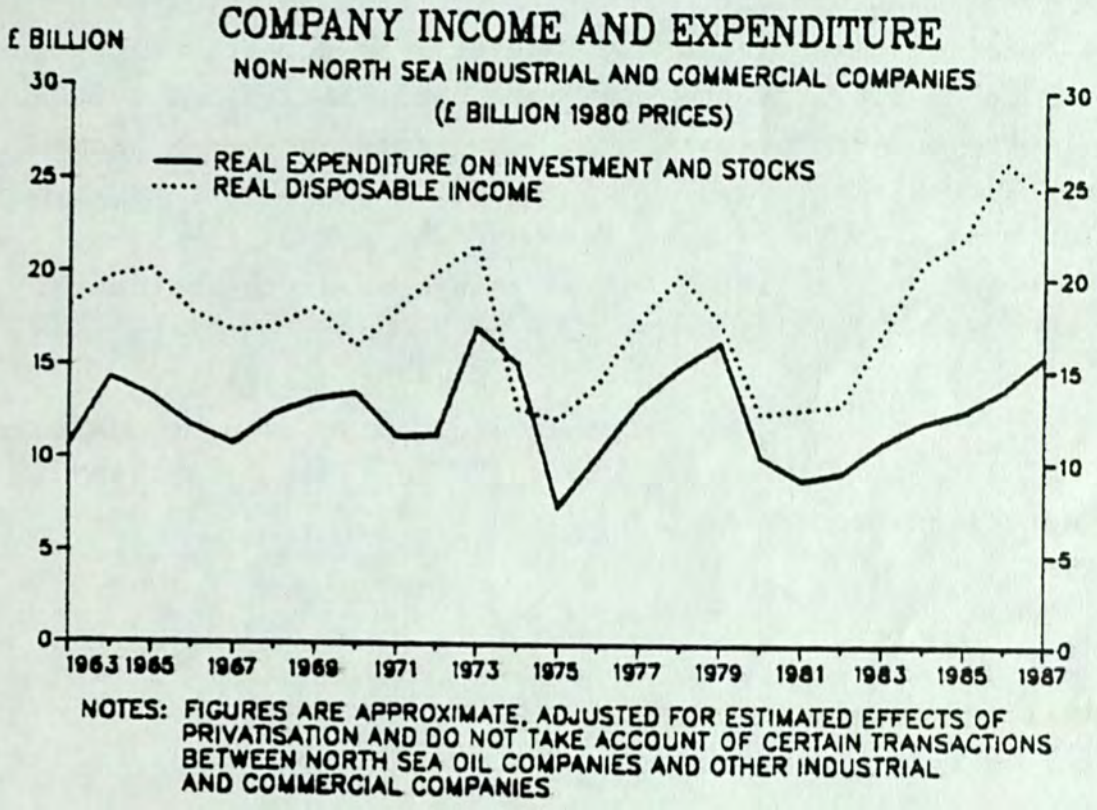
Industrial and Commercial Companies'

	Profits As a Share of Total Income*		Rate of return on assets, non-North Sea*
	Oil	Non-oil	
1973-1983 average	2.5	10.3	5.3
1984	6.9	11.1	6.5
1985	6.0	12.4	8.1
1986	2.7	13.6	9.1(9.6)
1987	2.3	12.9	8.6(9.3)

* Net of stock appreciation; adjusted for privatisation
( ) FSBR forecast

66. The margin of uncertainty about these figures as represented by the balancing item in the ICCs accounts is now smaller than it was. Following successive revisions, the £10 billion "black hole" for 1984 that we were faced with a year ago is now a somewhat more manageable £3 billion; however, the current estimate of the balancing item of 1985 is over £6 billion. This makes for a large gap between the sizeable financial surpluses of companies and their overall borrowing needs.

67. The forecast for non-oil company spending is relatively little changed from the Budget forecast, and remains rather subdued in total relative to company income. Although companies increased their dividend payments by nearly 30 per cent in 1985, they seem likely to continue to run large financial surpluses over this year and next.



Business Investment

68. As anticipated, business investment picked up strongly in the first quarter ahead of the phasing out of capital allowances. However, the increase in investment in non-manufacturing industry over the fourth quarter (3 per cent) was lower than in the corresponding period last year (12 per cent), and also lower than we had forecast. (The rise in manufacturing investment - at 6 per cent - was much as

forecast). The extent to which investment would be brought forward into the first quarter was always a matter of considerable uncertainty, and the results for the first quarter do not mean that the Budget forecast for the year as a whole was too high.

69. The DTI Intentions Survey published at the beginning of June shows an improvement in prospects for investment this year (particularly in manufacturing industry) as compared with the previous survey, and confirms the view on non-oil business investment that we took in the Budget forecast. In the forecast we assume that the latest Survey is right about 1986. For 1987 the Survey suggests a similar growth in investment to that expected for 1986: we think investment may do a little better than the Survey indicates.

Fixed Investment

Percentage change on previous year

	1985	1986	1987
Manufacturing* (£6.4 billion in 1984)			
DTI Survey	6.5	3	2
HMT	6.5	3	3
Non-oil, non-manufacturing** (£14.5 billion in 1984)			
DTI Survey	6	4	5
HMT Forecast	6	4	6

* Including leased assets

** Adjusted for privatisation and excluding assets leased to manufacturers.

70. Manufacturing investment remains low in relation to output: between 1979 and 1985 the ratio of investment (including leased assets) to output in manufacturing industry fell by 10-15 per cent. This fall does not seem to reflect compositional changes in manufacturing output to any significant extent. Although there have been major compositional changes in manufacturing output since the 1970's, and although some of these changes (for example, the decline in the importance of the steel industry and the rise in importance of

electrical engineering) are in the direction of a less capital intensive mix, these changes are offset by the increased weight in total output of chemicals, which is an exceptionally capital intensive section of manufacturing industry.

71. The relatively low rate of manufacturing investment seems to reflect business caution following the severe recession of 1980 and financial factors such as high interest rates: further rises in investment over the next few years seem likely as long as there is not a prolonged period of weakness in the demand faced by UK manufacturing industry. Although the number of firms reporting a lower than normal rate of capacity utilisation has risen since last summer, it remains well below the numbers recorded in the period before mid 1984. Indeed, with the gross capital stock in manufacturing (according to the CSO's measure of it) rising by less than 1 per cent a year, a return to growth in manufacturing output at a rate of 2 to 3 per cent a year would at some stage require a step up in the level of investment - though there must still be considerable scope for making productivity improvements without expanding the capital stock.

72. The table below summarises the forecast for fixed investment, with the FSBR forecast shown in brackets. Figures for 1987 were not published in the FSBR.

	Fixed Investment, £billion,1985	**per cent change on year earlier**		
		1985	**1986**	**1987**
Business Investment	29.9	3 (2)	3 (5)	3(1)
Residential Investment	9.4	-1 (0)	8 (5)	3(3)
General Government Investment	6.6	-5 (-5)	4 (2)	6(-2)
Total Fixed Investment	45.9	1 (1)	4 (5)	3(1)

Stockbuilding

73. Stockbuilding has remained subdued throughout the recovery. Of the £0.7 billion real increase in stocks in 1985, £0.5 billion was accounted for by the stocks of the Intervention Board for Agricultural

Produce. Energy stocks were little changed over the year, following a £0.1 billion rise in oil stocks in the last quarter of 1985. There was a £0.5 billion fall in manufacturers' stocks in 1985 as a whole but distributors stocks showed a small increase.

74. Published figures show that the decline in manufacturers' stocks continued into the first quarter of 1986. Nevertheless the fall recorded in output in the first quarter means that there was a (presumably undesired) rise in manufacturing stock output ratios. We expect that this will be corrected by further destocking in manufacturing during the remainder of 1986; at the same time the surprisingly large rise in wholesalers' stocks in the first quarter is also likely to be run off over the rest of the year. With little growth in stock prices this year, the real cost of holding stocks is currently at an exceptionally high level and the decline in stock output ratios of the last few years is likely to continue throughout this year. In total we expect the evolution of stockbuilding to make a somewhat more negative contribution to GDP growth in 1986 than we thought at the time of the Budget.

75. Later this year and into 1987 the cost of holding stocks is forecast to fall. Stock output ratios may start to stabilise, and higher stockbuilding may make a perceptible contribution to GDP growth in 1987.

PERSONAL INCOME AND SPENDING

Consumers' expenditure

76. A year ago we forecast that growth in consumers' expenditure would rise from 1.6 per cent in 1984, to 2.1 per cent in 1985, and 3.9 per cent in 1986. It is now clear that the acceleration in consumer spending occurred in the first half of 1985, rather sooner than forecast, with a 3 per cent increase in spending between the first and third quarters of last year. Consumers' expenditure in the first quarter of 1986 is estimated to have been 4.7 per cent higher than a year earlier.

77. As far as we can tell (the data on personal income is quite likely to be revised) the rise in consumers' expenditure during 1985 exceeded the rise in personal disposable income: ie there was a fall in the saving ratio. However, as inflation fell away at the beginning of 1986 the growth in income exceeded the continuing growth in consumers' spending and the saving ratio returned to around its level of early 1985.

78. At the time of the Budget, we expected growth in real personal disposable income of around 5 per cent in 1986, and growth in consumers spending of around 4 per cent. This remains our forecast for 1986. It allows for a rise in the saving ratio of over half a point between 1985 and 1986: such a rise is normal in the early stages of a period of exceptionally fast growth in income.

79. The improved inflation prospect and the limited adjustment of pay settlements to lower inflation means further strong growth in real personal disposable income in 1987. With spending still adjusting to the rapid income growth and falling interest rates and inflation of 1986, the saving ratio is expected to fall during 1987 to give a rise in consumer spending of around 4.6 per cent against income growth of 3.6 per cent. (The forecast allows for a £2 billion reduction in income taxes in the 1987 Budget, little changed from the FSBR projection.)

The Housing Market

80. The strength of house prices and housing starts over the last year is one of the more surprising features of recent economic developments in the UK. When mortgage rates rose sharply in the early months of 1985 housing starts appeared to be on a downward trend and building trade forecasts for 1985 were pessimistic. But 1985 saw buoyant demand and prices in the more prosperous parts of the country, and private housing starts rose during the year. So far in 1986 the strong growth in personal incomes, the easy availability of mortgages and more recently falling interest rates, have led to a quickening of house price rises over much of the UK. The amount of mortgage finance has been rising strongly: see table below. Although some of the extra lending will have been used, in effect, to finance goods other than

housing (and we take account of that in our consumption forecast), and to finance the purchase of financial assets, the fact that this credit is made available in the first place through the housing market is a factor in the rise of house prices.

Net Mortgage Advances (£ billion)

(by building societies, banks, and other lenders)

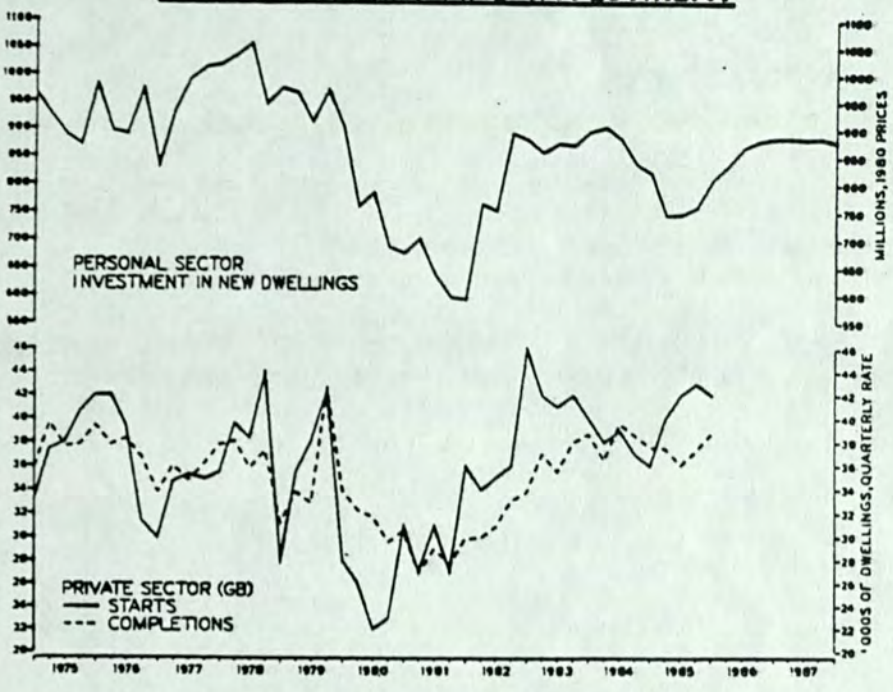
		In real terms (1984 prices)	
	Current prices	Deflated by new house prices	Deflated by the CED
1984	16.9	16.9	16.9
1985	18.1	16.8	17.2
1986	21.6	18.0	19.7
1987	25.5	19.2	22.5

81. We identify two elements of private housing investment: investment in new dwellings, and improvements to existing dwellings. The latter category fell sharply after the first half of 1984 following the extension of VAT and changes to the system of local authority improvement grants: in the first half of 1985 spending on improvements was 6 per cent lower than in the first half of 1984. But this spending picked up again during 1985 and is likely to reflect the fast growth in personal income over the forecast period.

82. Investment in new dwellings was at a low level in 1985: for the year as a whole it was 13 per cent lower than in the previous year. This low level of investment (in effect low sales of new houses) reflected in part a 3 per cent decline in private housing completions during 1985, which in turn was the result of a fall in housing starts the previous year. Moreover with stocks of uncompleted but unsold dwellings having been run down in the previous two years there seems to have been less scope for sales out of stock in 1985.

83. The rise in starts during 1985 should be reflected in higher completions and higher investment in dwellings this year and in early 1987.

HOUSE BUILDING AND INVESTMENT



84. The recent acceleration of house prices will have helped to increase the profitability of housebuilding. It is not yet possible to detect any further upward movement in housing starts over the levels of late 1985. Whether such an increase occurs later on this year will depend in large part on the elasticity of supply of the inputs used by housebuilders. Previous house booms have been associated with surges in the price of land and big rises in wages paid in the construction industry, which have quickly eroded the effect of higher house prices on builders' margins. There is certainly no sign of earnings in construction picking up (and given the generally depressed state of the construction industry we would not expect shortages of labour to be a problem.) The evidence on land prices so far is more mixed. Land prices have been rising by around 20 per cent a year on average over the last 3 years or so. There may have been some acceleration in land prices during 1985, but its extent is not clear.

85. For this forecast we have assumed that private housing starts do not pick up much further from current levels. The pick up in completions may do something to help moderate the rise in house prices; but house price inflation is expected to remain in double figures throughout 1986 and 1987: in total new house prices may rise by about 25 per cent over the two years as a whole.

Personal sector: summary

86. The table below summarises the forecast for personal income and spending.

Personal income and spending
(per cent changes on a year earlier)

	RPDI	Consumers' expenditure	Investment in new dwellings	Total housing investment	Persons' net acquisition of financial assets (£bn)
1984	2.5	1.9	1.1	2.1	11.8
1985	2.5	2.8	-12.7	-2.5	10.9
1986	4.6	3.9	-10.5	10.2	13.3
1987	3.6	4.6	4.2	4.2	10.8

DEMAND AND ACTIVITY

87. The UK economy has shown sluggish growth for a year now. According to figures published by the CSO on 20 June, after adjustment for the recovery from the coal strike GDP rose by only about 1.5 per cent in the year to 1986Q1. There was a rise of about 0.7 per cent in GDP between the fourth quarter of 1985 and the first quarter of 1986; half of this rise was attributable to higher oil output.

Indices of GDP, 1980 = 100

	Average estimate of GDP	Strike adjusted GDP	Strike adjusted Non-oil GDP
1985 Q1	108.7	110.0	108.1
Q2	110.5	110.8	109.2
Q3	110.1	110.1	108.5
Q4	110.6	110.6	109.0
1986 Q1	111.3	111.3	109.4

88. This sluggish period follows three years up to the first quarter of 1985 when growth was in the range 3-3.5 per cent: during 1984 strike adjusted growth in GDP was at the top of this range. The performance of manufactured exports played an important part both in the recent weakness of demand overall and in its earlier strength; exports of manufactured goods rose by 9.2 per cent in the year to 1985Q1, and fell by 2.5 per cent over the most recent year.

89. Growth in domestic demand has not changed much overall in the last year, athough there has been a major change in its composition, with consumers' expenditure buoyant and most categories of fixed investment at least temporarily depressed. The table below sets out the path of domestic demand (at constant prices).

	Per cent changes on a year earlier				
	1983	1984	1985	1986	1987
Personal consumption	3.9	1.9	2.8	3.9	4.6
Public consumption	1.8	1.4	0.3	1.6	0.3
Total investment	5.2	8.1	0.8	4.3	3.3
Change in stockbuilding (as per cent of level of GDP)	0.9	- 0.4	0.4	- 0.2	0.7
Total domestic demand	4.5	2.5	2.2	3.2	4.1
GDP	3.4	2.6	3.3	2.4	3.1

Within domestic demand, the demand for manufactures is usually a lot more cyclical than the total and seems to have been relatively weak early this year: an acceleration is expected later this year and in 1987, bringing with it faster growth in imports.

90. **North Sea output** was at much the same level in the first quarter of 1986 as it was a year earlier. 1986 is expected to mark the peak level of production; the start of the decline in North Sea output may take around 0.6 of a point off GDP growth next year.

91. **Manufacturing output** was about 0.7 per cent lower than a year earlier in the first quarter of 1986: the fall in manufactured exports has clearly been the main influence. The fall in output has not occurred across the whole range of manufacturing industry. Most of the fall has been accounted for by electrical engineering, which had shown exceptionally strong growth during 1983 and 1984: the electrical engineering industry appears to have been depressed world wide since 1985, and UK electrical exports have fallen sharply over the last year. As world trade and exports recover during the rest of this year, manufacturing output should also start to grow again, and growth in activity overall should pick up.

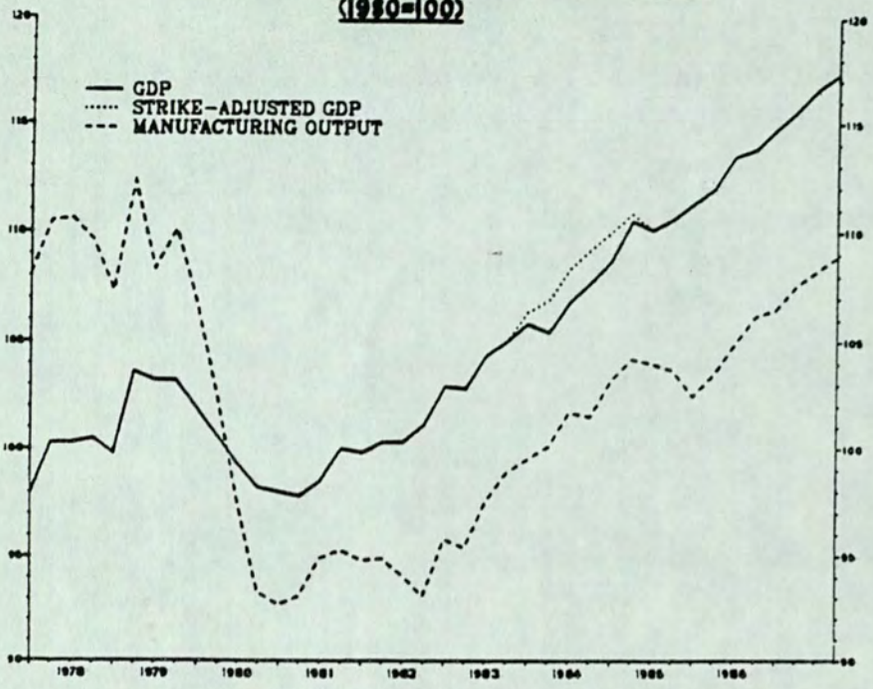
92. The table below shows the path of GDP before and after allowing for the coal strike. It also shows the path of manufacturing output.

1980 = 100, and per cent changes on a year earlier

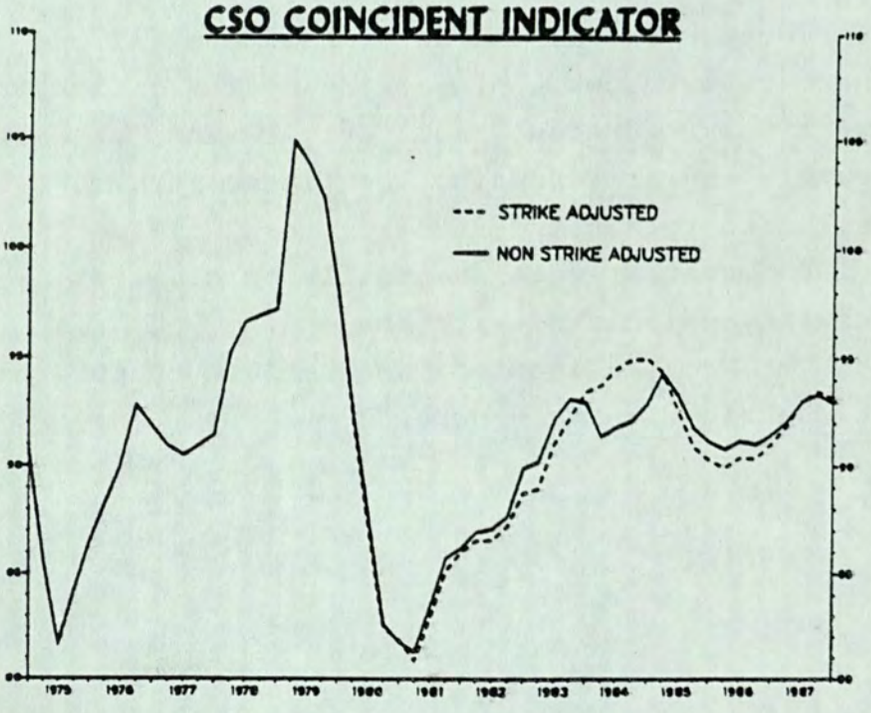
	1983	1984	1985	1986	1987
GDP Average Measure	103.7	106.4	110.0	112.6	116.1
	(3.4)	(2.6)	(3.3)	(2.4)	(3.1)
Contribution of North Sea production to GDP changes	0.5	0.3	- 0.1	0.1	- 0.6
Effects of coal strike	-	- 1.3	0.9	0.4	-
GDP less contribution of oil and coal strike	2.9	3.6	2.5	1.9	3.7
Manufacturing output	2.8	3.9	3.1	0.5	3.4

93. The CSO's coincident cyclical indicator has been falling since early 1985. The chart below shows a projection of the indicator that the CSO have made using our forecast for output and expenditure. Although the indicator may rise during the latter part of 1986 and 1987, it is not forecast to regain the level of early 1985. The peak at the beginning of 1985 may therefore eventually be classified as the start of a mild downswing, coinciding with the ending of roughly 10 years during which the expansion of North Sea output made a significant positive contribution to growth.

GDP AND MANUFACTURING OUTPUT
(1980=100)



CSO COINCIDENT INDICATOR



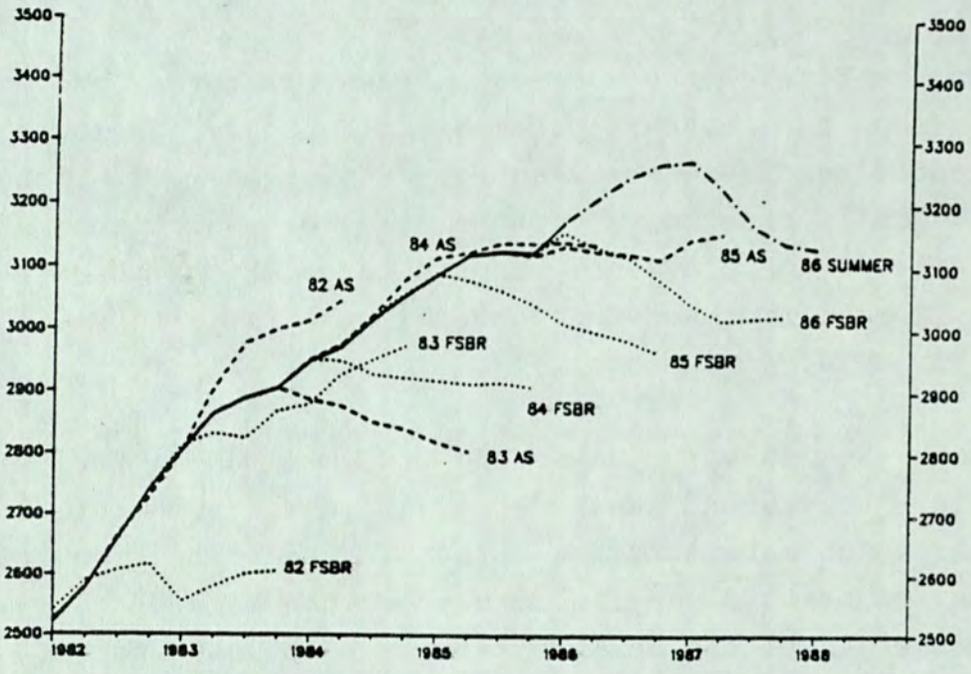
PRODUCTIVITY, EMPLOYMENT AND UNEMPLOYMENT

94. There have been some substantial changes to our forecast for employment and unemployment since the Budget. The main results of the 1985 Labour Force Survey were published in April: recent employment figures were revised upwards in the light of these results, as we had suggested in January might happen. Further revisions are expected when the 1984 Census of Employment is published later this year.

95. At the time of the Budget we knew of three bad unemployment figures (for the months December to February) following the run of more encouraging figures between May and November of last year. We have now got three more months figures which show a substantial further rise in unemployment. In the three months to May, as in the previous three months, the underlying rise in unemployment was probably over 20,000 a month.

96. With the downward revisions to the data for manufacturing output in the second half of last year, and a fall in exports of manufactures and manufacturing output in the first quarter of this year, we understand a little better than we did the reason for the sudden worsening of the unemployment trend at the end of 1985. The underlying growth in the economy slowed down from over 3 per cent in the year to early 1985 to under 1.5 per cent in the year to early 1986, with the slowdown particularly marked in manufacturing (from almost 4 per cent growth to a fall of almost 1 per cent). It is not at all surprising in retrospect that this turnround in output led to a deterioration in the unemployment trend. It is, however, disappointing that the record of downward bias in our unemployment forecasts (see chart) should, so quickly, be confirmed again in our most recent forecast.

COMPARISON OF UK ADULT UNEMPLOYMENT FORECASTS
(000's, SEASONALLY ADJUSTED – ADJUSTED FOR CLASSIFICATION CHANGES)



97. In the early eighties our forecasts for unemployment were too low primarily because productivity growth exceeded expectations, and employment fell more than expected. Between 1983 and 1985 employment growth exceeded our forecasts, but growth in working population exceeded the forecasts even more. Our most recent forecasting error is probably mainly associated with manufacturing output turning out lower than expected.

98. The upward revisions to the employment figures in the light of the LFS, and the lower estimates now being made for manufacturing output last year mean that recent productivity growth in manufacturing now looks lower than we previously thought. Following four years in which output per man grew by 5.4 per cent a year on average, it grew by only 2.8 per cent in 1985. For the whole economy excluding the oil sector and the effects of the coal strike, productivity grew at a rate of around 1.5 per cent in 1985 compared with an average of around 2.5 per cent between 1980 and 1984. Such a slowdown in productivity is quite normal when output growth weakens, and does not in itself lead us to change our view of medium term trends in productivity: our current estimates of these are shown below.

99. Variations in the trend in productivity in manufacturing reflect changes in relative factor costs over a period of years: these are currently tending to push down manufacturing productivity growth, as is the state of the cycle. Productivity growth in non-manufacturing industry over this year and next should reflect major improvements in some nationalised industries (particularly in British Coal, but also in British Rail and the Post Office). On the other hand some selective employment measures, particularly the expansion of the Community Programme, tend to reduce output per man, as does the continuing trend towards part-time employment.

Productivity Growth, per cent per annum

	Manufacturing		Non-manufacturing		
	Trend	Actual	Trend per full-time Worker	Trend per Head	Actual
1973-79	1.5	0.7	1.4	0.9	0.6
1979-85	3.0	3.4	1.4	0.6	0.9
1985-87	2.4	2.6	2.5	1.7	1.5

The trends in this table discount purely cyclical effects.

100. The results of the 1985 LFS indicate that the labour supply grew by just over 200,000 between mid 1984 and mid 1985, compared with a rise of over 500,000 in the previous year. The growth of the labour force would have been lower still had it not been for an unexpectedly large growth in the population of working age. As of mid 1985 the population was 77,000 higher than had been forecast by OPCS a year ago: the error is attributable to emigration having been much lower than expected (immigration was much as expected). The working population (ie the employed labour force plus unemployed claimants) rose by about 500,000 between mid 1984 and mid 1985. The difference between this figure and the growth in labour supply over the same period reflects the difference between the survey based estimate of unemployment (which fell between mid 1984 and mid 1985) and the claimant count (which continued to rise).

Labour Force Estimate of Unemployment and the Claimant Count

(millions)

	Spring 1983	Spring 1984	Spring 1985
(1) Labour Force estimate of unemployed persons seeking work (on basis of one week period)	2.91	2.90	2.81
(2) of which:			
not claiming benefits	0.76	0.87	0.76
(3) Claimants not "unemployed"	0.84	0.94	1.08
of which:			
not looking for work	0.67	0.74	0.88
in employment	0.17	0.2	0.2
Claimant count (= 1-2+3)	2.99(2.9)*	2.98	3.13

* Figure in brackets adjusts Spring 1983 figure for the discontinuity caused by the removal of some older men from the Claimant Count following the 1983 Budget.

101. The table above helps to explain why the slower growth in the labour supply noted in the previous paragraph had little beneficial impact on the trend in unemployment. A large proportion of new jobs continued to be taken by women not claiming unemployment benefit. In the more recent period many of these women getting jobs were already classified as being in the labour supply (ie they had previously been looking for work although they were not claiming benefit). The rise in part-time jobs for women thus helped to reduce the numbers of non claimant unemployed (row (2) in the above table), with a correspondingly lower
effect on the number of claimant unemployed.

102. Department of Employment have not yet revised the labour supply projections that they published last July. OPCS have overestimated emigration and hence underestimated growth in working population for the last two years. The recent change in the trend in (net) emigration may well persist (to the extent that it is caused by such factors as the reduced attractions of South Africa). We have therefore assumed labour force growth above the Department of Employment's figures.

Projections of Labour Supply Growth

	(GB)	(UK)	000's
Mid Years	**Employment Gazette July 1985**	**Treasury Forecast**	
1984 to 1985	228	209	
1985 to 1986	179	224	
1986 to 1987	160	197	
1987 to 1988	103	130	

103. Even after the bad figures of the last six months, the increase in adult unemployment between Q2 1985 and Q2 1986 will have been lower than over the previous year. But we estimate that this improvement is more than accounted for by the impact of employment measures, and the restructuring of national insurance contributions. "Underlying" unemployment grew more over the last year than over the previous year, as employment growth slowed down. Over the next year a recovery of employment growth (to the rates of 3-400,000 a year experienced in 1983 and 1984) as the economy picks up again, and a bigger impact of employment measures, means improved prospects for unemployment. GDP growth of 3 per cent in 1987 (3.5 per cent excluding oil production), together with the forecast slower growth in labour supply, could be sufficient for unemployment to start falling.

Adult unemployment, 000's, changes

	Underlying Unemployment	Selective Employment Measures	Restructuring of NICs	Unemployment
1983Q2 to 1985Q2*	+166	-39	0	+127
1985Q2 to 1986Q2	+187	-88	-10	+89
1986Q2 to 1987Q2	+160	-117	-28	+15
1987Q2 to 1988Q2	-111	-16	-14	-141

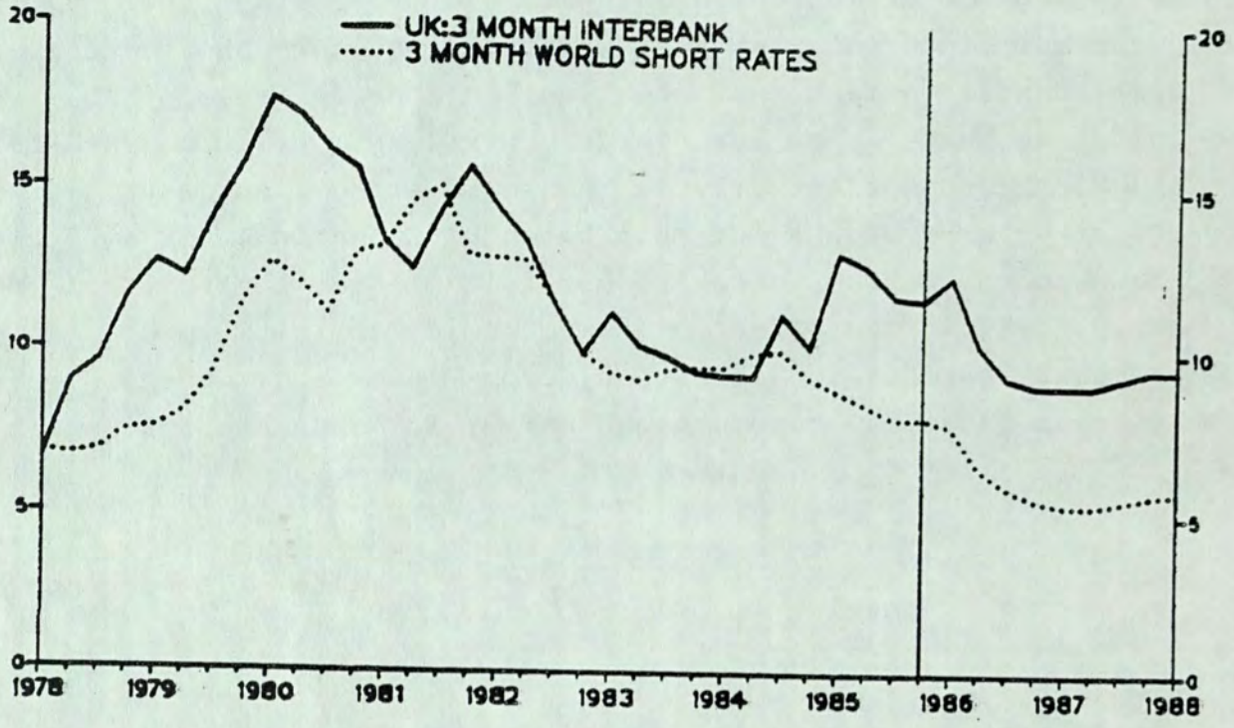
* annual average

FINANCIAL FORECAST

104. Short term **interest rates** in the UK have fallen about 2 percentage points since the Budget, a little more than the fall in overseas interest rates. Nevertheless the short term interest differential in favour of sterling, at 3 percentage points, is still quite high by past standards. Falling inflation and relatively sluggish economic activity in the world economy suggest that downward pressure on overseas interest rates will continue for a little longer and we have allowed for a further fall of over 1 percentage point by early 1987. Thereafter, as economic activity picks up and the temporary benefit to inflation from lower oil prices wears off, interest rates may rise, though mainly in North America.

	3 month interest rates		Mortgage Rate	UK 20 year rate
	World Basket	UK		
1985 Q4	8.0	11.5	12.75	10.25
1986 Q4	5.5	9.0	10.0	9.0
1987 Q4	5.75	9.5	10.5	9.0
(June 20)	(6.6)	(9.9)	(11.0)	(9.25)

105. Given the medium term prospect for a modest decline in sterling it seems likely that a positive interest differential in favour of sterling will remain necessary. The forecast suggests however that UK interest rates could fall in line with overseas rates without jeopardising achievement of the Government's monetary and inflation objectives. In other words maintenance of current interest differentials seems a plausible scenario. The resulting forecast for the levels of overseas and domestic rates is shown in the table above and chart below. The mortgage rate forecast is based on the assumption that the current differential over base rate will be maintained. In the absence of any further change in funding policy or major changes in inflationary expectations we anticipate little or no change in long rates.

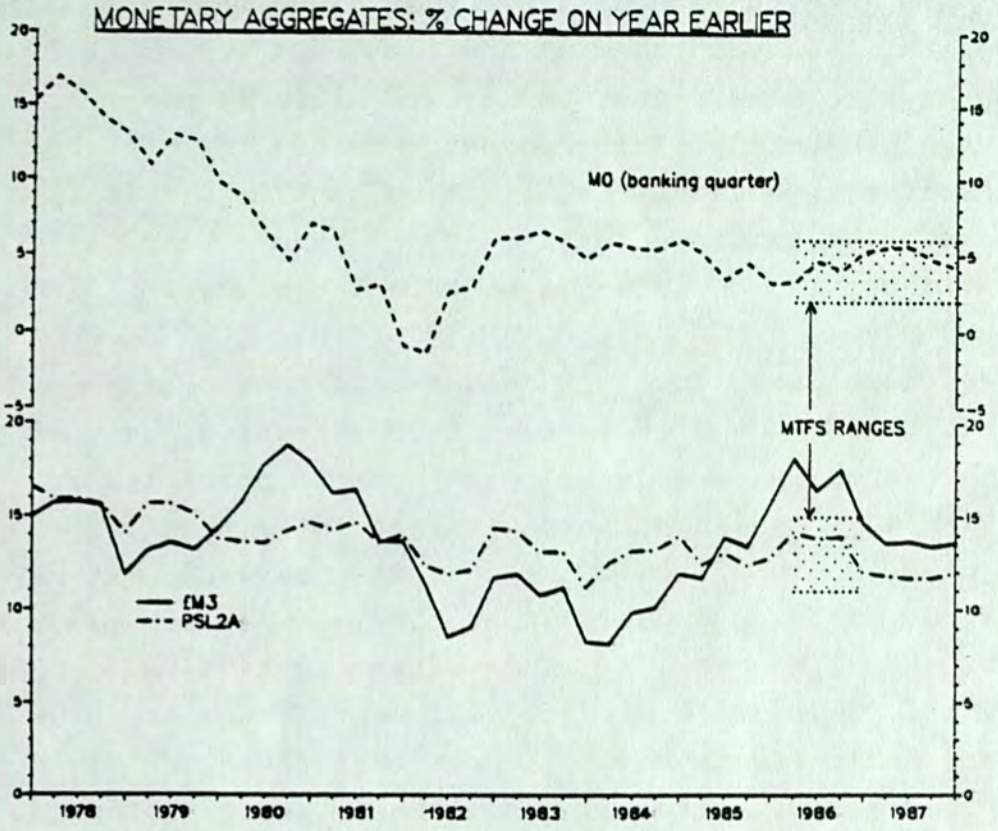


106. The forecast of the **monetary aggregates** is summarised in the table and chart below.

Average per cent growth rates in financial years

	MO		£M3		PSL2A*
	MTFS range	Outturn/ Forecast	MTFS range	Outturn/ Forecast	Outturn/ Forecast
1984-85	(4-8)	5.5	(6-10)	9.5	12.9
1985-86	(3-7)	4.4	(5-9)	13.2	12.8
1986-87	2-6	4.0	11-15	16.8	13.6
1987-88	2-6	5.1	-	13.7	11.8

* revised PSL2 from 1984 onwards



107. **MO**, currently 3.4 per cent higher than a year ago, has behaved much as expected. If, as we assume, the trend in velocity remains broadly unchanged, we expect the growth of MO to pick up through the rest of this year and during the early part of 1987. Past and forecast interest rate reductions and buoyant personal incomes and expenditure should all impart an upward boost. Although MO growth may approach the top of its target range next year, it is unlikely go above and could be back down towards the middle of the range by the end of 1987-88. **NIBM1** is more sensitive to interest rate changes than MO and its growth could well pick up more strongly. Its rate of growth is already rising, but the figure for May, 6.6 per cent on a year earlier, could well include an erratically high element. Nevertheless growth rates of this magnitude would not be unexpected for the end of 1986 and we put average growth in 1987-88 at 8-9 per cent.

108. We did not anticipate in the Budget forecast the recent surge in £M3 growth above its target range and have little by way of explanation to add to what has been said elsewhere. The latest monthly forecast sees £M3 growth above 17 per cent in August and we are projecting similar growth rates for the rest of 1986. Thereafter we have £M3 falling back to within a 13-15 per cent range. The past record suggests however that little, if any, confidence can be attached to this forecast.

109. There are however reasons for expecting a deceleration. First building societies have been switching out of gilts into bank deposits over the past year, possibly in response to relatively high short term interest rates. While the societies' acquisition of liquid assets this year and next may be weighted towards money we doubt whether they will switch existing liquidity out of gilts to the same extent as last year. Secondly it is unlikely that stock markets will be as buoyant over the coming year and there is some prospect therefore that the balance sheets of other OFIs, and within them their money holdings, will grow more slowly than in the recent past. Thirdly once the period of falling non-labour costs is over industrial and commercial companies' profits and liquidity might increase more slowly. Finally the rate of growth of personal sector bank deposits, nearly two-thirds of total £M3, has risen over the past year as the banks' response to competitive pressure from the building societies became more effective. While the banks may compete just as effectively from now on they are unlikely to do more than hold their current market share, with bank deposits rising therefore at the same rate as total personal sector liquid assets. These are somewhat easier to predict than many other monetary and liquidity aggregates - we do not expect them to grow any faster than they are now and they may grow more slowly.

110. We expect the wider aggregates, such as PSL2A, (revised PSL2), to continue growing in the 12-14 per cent range.

111. The gross gilts **funding** requirement, at £15.7 billion for 1986-87 or rather over £1200 million a month from now on, is a little higher than at Budget time. This reflects a slightly higher PSBR, the assumed rise in the foreign exchange reserves and larger projected substitution by the local authorities of borrowing from the central government for market borrowing. This latter factor means more sales of central government debt and fewer sales of local authority debt. National savings are assumed to bring in £3 billion net. Total **market assistance** has fallen some £5.6 billion since the start of the financial year to under £8 billion in banking June, but is likely to be back around £10 billion at the end of the financial year.

ANNEX: COMPARISON WITH OUTSIDE FORECASTS

1. The table overleaf compares the June forecast with the average of outside forecasts. The forecasts used are listed below. Not all forecasts are used in calculating each average outside forecast - only those which are directly comparable.

2. The average of outside forecasts for **GDP growth** is in line with the Treasury June forecasts for 1986, but somewhat lower in 1987.

3. The average of outside forecasts shows **£M3 growth** of under 11 per cent in 1986-87 - below the 1986 FSBR target range. Outside forecasters expect the outturn for **MO growth** to be within the 1986-87 target range.

4. Since the Budget the average outside forecast for the **PSBR** has been revised downwards by around £1 bn for each of 1986-87 and 1987-88. However, the average remains above Treasury forecasts, particularly for 1987-88. (The average outside forecast is for a £2 bn **Fiscal adjustment** in 1987-88 - in line with the June forecast.)

5. Outside forecasts of the **RPI** have also been revised downwards since the Budget. But the Treasury forecast for RPI inflation during 1986 is 0.75 per cent lower than the outside average.

Forecasts used: NIESR, LBS, Phillips and Drew, Simon and Coates, Henley, Cambridge, Oxford, Liverpool, CBI, OECD, CUBS and EC.

ANNEX COMPARISON WITH OUTSIDE FORECASTS

	June forecast	Outside average	Outside range	
£M3 (% change on year earlier)				
1986-87	16.8	10.8	9.1 (LBS)	12.1 (Henley)
1987-88	13.7	10.5	6.8 (LBS)	13.6 (Henley)
PSBR (£ bn)				
1986-87	7.5	7.8	6.7 (NIESR)	9.1 (C'bridge)
1987-88	7.1	8.8	6.9 (L'pool)	12.5 (Henley)
Exchange rate (1975=100)				
1986Q4	74.4	71.9	71.0 (P&D,Henley)	73.0 (S&C)
1987Q4	70.0	69.2	69.0 (S&C,LBS,Hen)	70.0 (P&D)
Current account (£bn)				
1986	2.9	2.0	0.1 (CBI,NIESR)	8.1 (L'pool)
1987	- 1.4	0.2	- 3.2 (C'bridge)	8.6 (L'pool)
Average earnings (% change on year earlier)				
1986	7.7	7.4	6.5 (L'pool)	8.3 (CBI)
1987	7.3	6.3	4.6 (L'pool,C'bridge)	7.5 (LBS)
RPI (% change on year earlier)				
1986Q4	2.3	3.1	2.8 (NIESR,LBS)	3.5 (CBI)
1987Q4	4.0	4.2	3.0 (LBS)	5.1 (Henley)
RPDI (% change on year earlier)				
1986	4.6	3.4	2.7 (LBS)	4.1 (S&C)
1987	3.6	2.9	2.0 (CUBS)	3.4 (LBS,P&D)
Import volume: goods and services (% change)				
1986	2.1	4.2	2.3 (NIESR)	6.0 (CBI)
1987	6.4	5.0	3.5 (Henley)	6.1 (CBI)
Export volume: goods and services (% change)				
1986	0.7	2.7	0.7 (NIESR)	4.6 (CBI)
1987	3.5	3.4	2.0 (OECD)	5.9 (CBI)
GDP volume (% change)				
1986	2.4	2.5	1.9 (NIESR)	3.7 (CUBS)
1987	3.1	2.7	1.7 (NIESR)	4.7 (CUBS)
UK adult unemployment (millions)				
1986Q4	3.3	3.11	3.06 (NIESR)	3.17 (Henley)
1987Q4	3.1	3.05	2.92 (NIESR)	3.21 (Henley)

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LOSADU
cc Prof Griffiths

10 DOWNING STREET

From the Private Secretary

18 June 1986

MONETARY POLICY

At the bilateral between the Prime Minister and the Chancellor this afternoon, the Chancellor mentioned that the Bank of England were working on a paper which will discuss the recent behaviour of the monetary aggregates, and particularly £M3. The Chancellor undertook to report this work to the Prime Minister.

BF 11

The Prime Minister also raised again with the Chancellor the possibility of undertaking a conversion of debt in order to reduce the cost of debt service now that interest rates have fallen. The Chancellor suggested that a saving would arise only if the conversion were into indexed gilts, but said that work was in progress on this idea also.

DAVID NORGROVE

Mrs. Rachel Lomax,
H.M. Treasury.

CONFIDENTIAL

SECRET

9 10

PRIME MINISTER

MONEY AND INTEREST RATES

The Chancellor and the Governor did not in fact meet today and now plan to meet towards the end of the week.

The Chancellor has stopped looking for a further reduction in interest rates this week. He wants to wait until further information about the money numbers is available. The money numbers are, of course, at present pointing in different directions with the exchange rate so firm. But the Chancellor thinks it prudent to wait and the Bank believe that a further reduction at the moment would not go down well with the markets.

Lillian

p.p. DAVID NORGROVE

2 June 1986

SUBJECT
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10 DOWNING STREET

From the Private Secretary

22 May 1986

FOREIGN CURRENCY BORROWING

The Prime Minister today dicussed with the Chancellor the possibility of further foreign currency borrowing by HMG.

The Prime Minister agreed that a further foreign currency borrowing could be mounted this year when a suitable opportunity arises. The Prime Minister's preference was that this should be carried out during a recess if possible, but she accepted that market circumstances might not allow this.

David Norgrove

Mrs. Rachel Lomax,
H.M. Treasury.

JB

RC2.34

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

14 May 1986

David Norgrove Esq
10 Downing Street
LONDON
SW1

Dear David,

UK'S RELATIVE ECONOMIC PERFORMANCE

... Further to my letter of 13 May, I attach the additional information you requested.

Yours ever,
Cathy

CATHY RYDING
Assistant Private Secretary

69/043

FROM: A M DOLPHIN
DATE: 14 May 1986

MS RYDING

cc: Mr Hacche

UK'S RELATIVE ECONOMIC PERFORMANCE

You reported that No 10 had asked for some further information following your letter of 13 May. This is contained in the attached tables.

2. In 1979 the UK's productivity growth was second lowest among the Summit countries (growth was lower in the United States), but in 1985 UK productivity growth was exceeded only in Germany and France.

3. Similarly, in 1979 the UK's GDP growth only exceeded growth in the United States among the Summit countries, whereas in 1985 the UK had risen to third place in the league table behind Japan and Canada.

A. M. Dolphin

A M DOLPHIN

PRODUCTIVITY GROWTH* (AVERAGE ANNUAL CHANGE, PER CENT)

	1979-1985	1981-1985
United States	3.1	4.1
Japan	3.1	3.7
Germany	3.0	3.7
France	4.3	5.2
United Kingdom	4.0	4.8
Italy	4.3	3.8
Canada	3.2	4.8

* Output per manhour in manufacturing

REAL GDP GROWTH (AVERAGE ANNUAL CHANGE, PER CENT)

	1979-1985	1981-1985
United States	1.9	2.4
Japan	4.0	4.0
Germany	1.2	1.5
France	1.1	1.3
United Kingdom	1.1	2.7
Italy	1.3	1.0
Canada	2.1	2.0

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cc BG.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

13 May 1986

David Norgrove Esq
10 Downing Street
LONDON
SW1

Dear David,

UK RELATIVE ECONOMIC PERFORMANCE

... I attach the information you asked me for on the telephone yesterday on the UK's performance compared to other Summit countries between 1979 and 1981 and now.

Yours ever,
Cathy

CATHY RYDING
Assistant Private Secretary

69/037

FROM: A M DOLPHIN
DATE: 13 May 1986

MS RYDING

cc: Mr Matthews
Mr Hacche

UK RELATIVE ECONOMIC PERFORMANCE

You asked how the UK's current economic performance compares with the other Summit countries and how it compared in 1979 and 1981. I attach some tables showing information on growth, employment/unemployment, inflation and current balances.

These tables show:

(i) Real GDP growth in the UK in 1985 was higher than in the US and higher than in each of the major European countries. In 1979 and 1981 the UK had the lowest growth rate (except for the US in 1979 where growth was marginally lower) among the Summit countries.

(ii) The UK's relative performance on employment growth has improved since 1979 but growth in the UK remains lower than in the other six Summit countries overall.

(iii) Unemployment (as a percentage of the labour force) is now higher in the UK than in any other Summit country, as it was in 1981, but not in 1979 when the US, France, Italy and Canada all had higher unemployment.

(iv) Italy was the only Summit country with higher inflation than the UK over the twelve months to March 1986.

(v) Unit labour costs in the UK grew faster than in the other Summit countries in 1985 and in 1979, but in 1981 UK growth was below the average for these countries.

A.M. Dolphin

A M DOLPHIN

1. Growth of GNP/GDP (per cent)

	1979	1981	1985
United States	2.5	1.9	2.2
Japan	5.3	3.7	4.6
Germany	4.0	-	2.4
France	3.3	0.5	1.1
Italy	4.9	0.2	2.2
Canada	3.2	3.3	4.5
Major six (excluding UK)	3.5	1.9	2.6
United Kingdom	2.6	-1.5	3.3
Major Seven	3.4	1.6	2.7

2. Growth in employment (per cent)

	1979	1981	1985
United States	2.9	1.1	2.0
Japan	1.3	0.8	0.8
Germany	1.8	-0.6	0.8
France	-	-0.6	-0.3
Italy	1.0	0.3	0.5
Canada	4.1	2.8	2.8
Major six (excluding UK)	2.2	0.7	1.4
United Kingdom	1.1	-3.9	1.1
Major Seven	2.1	0.3	1.4

3. Unemployment (per cent of labour force)

	1979	1981	1985	March 1986
United States	5.9	7.6	7.2	7.1
Japan	2.1	2.2	2.7	2.7
Germany	3.3	4.9	8.2	9.2
France	6.2	7.7	10.8	10.3
Italy	7.7	8.4	10.6	11.2
Canada	7.4	7.5	10.5	9.6
Major six (excluding UK)	5.0	6.2	7.1	7.2
United Kingdom	5.4	9.5	13.1	13.0
Major Seven	5.0	6.5	7.6	7.7

4. Consumer price inflation (per cent)

	1979	1981	1985	March 1986
United States	11.3	10.4	3.5	2.3
Japan	3.6	4.9	2.1	1.1
Germany	4.1	6.3	2.2	0.1
France	10.8	13.4	5.8	3.0
Italy	14.8	18.7	9.2	7.3
Canada	9.1	12.5	4.0	4.1
Major six (excluding UK)	8.8	9.7	3.6	2.1
United Kingdom	13.4	11.9	6.1	4.2
Major Seven	9.2	9.9	3.8	2.3

5. Growth in unit labour costs in manufacturing (per cent)

	1979	1981	1985
United States	10.6	7.3	1.6
Japan	-2.1	1.8	0.1
Germany	2.4	5.1	-0.1
France	9.3	11.9	1.4
Italy	9.7	19.0	4.4
Canada	7.8	13.8	2.3
Major six (excluding UK)	6.8	7.6	1.3
United Kingdom	17.3	6.8	5.4
Major Seven	7.7	7.5	1.6

6. Current balances (US $ billions)

	1979	1981	1985
United States	-1	6	-118
Japan	-9	5	50
Germany	-6	-6	13
France	5	-5	-
Italy	6	-8	-4
Canada	-4	-5	-2
Major six (excluding UK)	-9	-12	-60
United Kingdom	-2	13	4
Major Seven	-11	1	-56

13. V.
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UNCLASSIFIED
SAVING TELEGRAM

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FRAME ECONOMIC

TO FCO TELNO 5 SAVING of 29 APRIL 1986. Info all EC Posts, UKDel OECD, UKMis Geneva, all Consulates-General in the Federal Republic, Washington, Tokyo, Vienna.

THE FIVE INSTITUTES' SPRING REPORT

Summary

1. The Five major economic institutes published their forecasts and recommendations yesterday. They forecast an increase in real GNP of 3.5% in 1986. The number of employed is expected to rise by about 300,000 while the number of unemployed is forecast to fall by 70,000 to 2.23 million; inflation, cost of living index, will be 0.5% while the current account surplus will be around DM 60 billion compared to DM 38.6 billion in 1985. Growth in 1986 will stem from domestic demand, investment and exports. Broadening and strengthening economic activity will produce an even higher GNP outturn in 1987.

2. The report supports the main thrust of the Government's economic policy but is mildly critical about the lack of progress on privatisation and on reducing subsidies and about the disappointing progress recorded on deregulation and deburocratisation. The Five Institutes warn the Government that a further fall in interest rates will result in increased capital intensive investment and will consequently adversely affect the labour market.

3. The report has been welcomed by the Government as a vindication of its economic policies.

Detail

4. The five leading economic institutes (Berlin, Hamburg, Munich, Kiel and Essen) produced their latest half-yearly report yesterday. They forecast real GNP growth of 3.5% in 1986 based on the following assumptions:

/a)

a) world trade will expand by 4%;

b) mineral oil prices will average about 15 US$ per barrel;

c) the US$ will average about DM 2.30 over the year. There will be no further revaluation of the DM against most EMS currencies;

d) financial policy will adhere to the course laid down in the 1986 draft budget;

e) the present expansive course of monetary growth will cease and lead later in the year to growth in the upper band of the Bundesbank's CBM target range;

f) wage agreements will be about 1 percentage point higher on average than last year.

Details of the forecast are as follows:-

Private Consumption

5. Private consumption will increase strongly in 1986 as a result of higher wages, an increase in the number of employed persons and tax relief in the wake of the introduction of the first stage of income tax reform on 1 January. Gross incomes will increase by 5.5% nominal ie. a good two percentage points more than 1985. These factors plus an improvement in profits will lead to an increase of 5.5% (nominal) in disposable incomes. Given virtual price stability, the real increase will be only slightly lower than the nominal.

6. As a result of falling interest rates the savings ratio is forecast to increase by between half and one percentage point. Therefore real private consumption will growth by 4.5% during the course of the year, the highest rate of increase for 10 years. Demand for consumer goods is expected to be strong especially for electrical appliances and cars, while expenditure on services, particularly travel, will also be high.

/Machinery and Equipment

LR1.52

CONFIDENTIAL

CCBH

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

8 April 1986

David Norgrove Esq
10 Downing Street
LONDON SW1

Dear David,

JOHNSON MATTHEY BANKERS

The Prime Minister should be aware that Customs and Excise have now completed their enquiries into JMB's possible involvement in gold fraud and have concluded that they have insufficient evidence to justify proceedings against either JMB itself or any of its employees.

In brief, they are unable to prove either that the senior management of JMB were personally aware of the transactions until early December 1985 (at which point they made enquiries and stopped the trade by the end of the following month) or that those who did handle the transactions within JMB had been told about gold frauds. JMB had been buying gold for ten months in circumstances which ought to have aroused suspicion of VAT fraud; and when the director in charge of the gold business stepped in and stopped the trade, he did not take the prudent step of telling Customs (or Bank of England colleagues) that the gold JMB had been buying over this period might have been the result of VAT fraud. But this is not evidence of fraudulent conduct, and Customs are now satisfied that no further evidence to warrant proceedings is to be found.

The Chancellor proposes to announce this conclusion by means of the following arranged Written PQ, which is being tabled tonight for answer tomorrow.

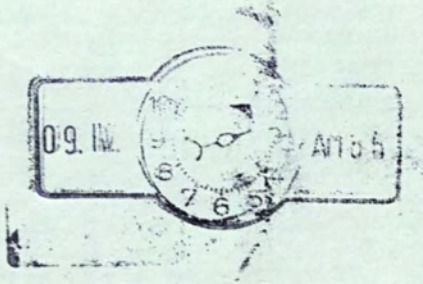
Q. To ask Mr Chancellor of the Exchequer, what has been the outcome of HM Customs and Excise investigations at Johnson Matthey Bankers.

A. HM Customs and Excise have completed their enquiries at Johnson Matthey Bankers in connection with possible VAT offences in relation to gold bullion. I am informed by the Commissioners that there are no grounds for prosecuting JMB or any of its employees.

Treasury and Customs Press Offices will be briefed to the effect that they cannot add to this Answer.

Yours ever
Rachel

RACHEL LOMAX
Principal Private Secretary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CONFIDENTIAL

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
Telephone (Direct dialling) 01-215)
GTN 215) 5422
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Secretary of State for Trade and Industry

PS/

CONFIDENTIAL

8 April 1986

David Norgrove Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1

Prime Minister 2

DEV
8/4.

Dear David,

UK PROVIDENT INSTITUTION

In Box

My letter of 4 April warned of the problems of this company and mentioned the two potential merger partners.

UKPI and Friends Provident announced today that they will be entering into an operational merger. UKPI has now ceased writing new with-profits business and, subject to necessary approvals, its assets and liabilities will be transferred to Friends Provident. FP envisages that over the next 2 years a cut of only 10 per cent will be made in rates of additional bonus on policies becoming claims. For other policies, no additional reversionary bonuses will be declared for two years: bonuses would then be declared in respect of the past years at rates reflecting the valuation of the funds's assets and liabilities at that time. UKPI has ceased to enter into new contracts. Some of its staff will be made redundant and others will be taken on by FP.

Although the TSB, the other merger partner mentioned in my last letter, may have been prepared to offer better terms, there was a considerable doubt as to whether that merger could be brought to fruition - not least the important banking supervisory issues mentioned in Vivien Life's letter of 7 April. In the end, there was just not enough time to UKPI and TSB to complete their discussions.

I am copying this letter to Philip Wynn Owen and Vivien Life (Treasury).

Yours ever,
Michael

MICHAEL GILBERTSON
Private Secretary

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DOMESTIC
MON. POLICY
PT 15

2816/58

COMMERCIAL IN CONFIDENCE

Treasury Chambers, Parliament Street, SW1P 3AG

Michael Gilbertson Esq
PS/Secretary of State for Trade and Industry
Department of Trade and Industry
1-19 Victoria Street
LONDON
SW1H QET

7 April 1986

Dear Michael

UK PROVIDENT INSTITUTION

The Financial Secretary has seen your letter of 4 April. The Treasury's responsibility - working closely with the Bank of England - is the prudential supervision of the TSBs.

As your officials are aware, the TSBs made an informal approach to the Treasury and Bank of England on Friday. However the TSBs have yet to reach a considered view themselves on the desirability of involvement with UKPI and so there is no definite proposal from the TSBs on the table at the moment, nor has our approval been invited. We understand the TSBs are unlikely to take an authoritative decision before the end of this week.

As the Bank of England made clear to the TSBs, any proposal of the kind they are contemplating (apparently involving the investment of up to some £250m) would raise several very important supervisory issues which would require serious and detailed consideration. Of course if the TSBs put forward a proposal it would be considered between the Treasury and the Bank of England as quickly as possible, consulting your officials as necessary. But the TSBs have been warned that the importance of the issues raised mean that consideration could well take a number of days, with no assurance of a favourable outcome.

I am copying this letter to David Norgrove (No 10).

Yours ever
Vivien

VIVIEN LIFE

COMMERCIAL IN CONFIDENCE

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SECRET

File 4 CAJ 8

10 DOWNING STREET

From the Private Secretary

7 April 1986

J.M.B.

The Chancellor this afternoon described to the Prime Minister the two bids which had been received for the substance of J.M.B. The Prime Minister accepted that the Bank of England could this evening tell Westpac that their bid had been successful.

DAVID NORGROVE

Mrs Rachel Lomax,
H.M.Treasury

SECRET

BM.

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Secretary of State for Trade and Industry

PS/

COMMERCIAL IN CONFIDENCE

4 April 1986

David Norgrove Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1

Prime Minister 2
Rumours have reached the press. DTI will provide a line for Question tomorrow.
DLS
7/4.

Dear David,

UK PROVIDENT INSTITUTION

I am writing to give you prior warning of a matter concerning an insurer which may shortly become public knowledge and which arises from the exercise of the DTI's role as supervisors of the insurance industry.

2 The insurer is the United Kingdom Provident Institution (UKPI) - a long established mutual life office of good standing and with a high proportion of with-profits policy holders.

3 In the course of the DTI's regular monitoring of insurers it came to our notice that UKPI's cover for its statutory solvency margin might be less than adequate. A combination of poor investment performance, the cost of financing a rapid expansion of business and high bonus declarations had eroded UKPI's investment reserves. The major factor in the poor investment performance was a decision in 1979 to make substantial investments in "unquoted situations" e.g. small deposit takers and investment management companies here and in the US and oil development in the US.

4 Since this came to light we have examined carefully with UKPI the solvency margin position and the need for effective corrective action by the company to rebuild its reserves. We now believe that the statutory solvency margin is covered but there is no way in which the company can properly continue to maintain previous levels of bonus declarations or seek to obtain new with-profits business on the basis of those previous levels except in association with another company willing to inject a substantial amount of new capital.

1786 1986 BOARD OF TRADE BICENTENARY

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COMMERCIAL IN CONFIDENCE

5 There are potentially two partners: one (the Trustee Savings Bank) who would envisage a capital injection and the other (a large mutual life office, Friends Provident) who would not inject new capital so that a reduction in bonuses would be inevitable. These discussions continue but we are not willing to let them drag on not least because it is clear that the UKPI needs to bring its sales promotion into line with its revised prospects.

6 Given speculation in the market place that UKPI may be in difficulty we think that an announcement will have to be made next week of agreement in principle to one of the two mergers or that UKPI has closed for new business. We would want any announcement to highlight the fact that the UKPI position is special to that office and not typical of other parts of the life insurance industry.

7 It is important to underline that this is not a situation where an insurer is about to collapse with losses falling on the insured. We believe that UKPI is covering its statutorily required margin of solvency; that should ensure that whatever results from the current discussions contractual benefits are fully covered and that substantial bonuses will still be available to policy holders, albeit on a lesser scale than they have become accustomed to in recent years.

8 I am sending a copy of this letter to Philip Wynn Owen (Treasury).

Yours ever,

Michael

MICHAEL GILBERTSON
Private Secretary

JF5BBK

1786 1986 BOARD OF TRADE BICENTENARY

04. IV.
PM 86

SECRET AND COMMERCIAL IN CONFIDENCE

TF

FROM: F CASSELL
4th April 1986

PS/CHANCELLOR

cc PS/Financial Secretary
PS/Economic Secretary
Sir P Middleton (o/r)
Mr Peretz
Mr Norgrove - No 10

STANDARD CHARTERED

You will have seen Ms Life's minute of earlier today. with TF.

The Deputy Governor rang this afternoon to say that the discussions between Jeremy Morse and Lord Barber had reached no agreement. Lord Barber said that Standard would not welcome a bid from Lloyds except if Standard itself was under attack from a predator.

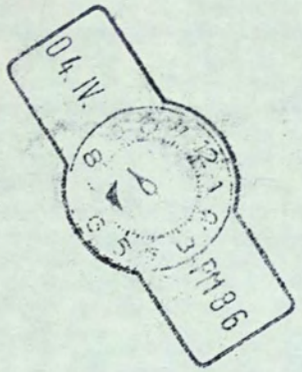
Standard's share price, however, has rocketed up - from 639 at last night's close (and 450 a few weeks ago) to over 800. Lloyds therefore felt itself obliged to make an announcement that it had approached Standard with an offer of 750p a share. Lloyds is also, I understand, asking for a Stock Exchange inquiry into the price movements in Standards shares.

Standard has itself put out an announcement expressing surprise at the bid. Its board is meeting on Tuesday to discuss the bid.

The Deputy Governor told me he was concerned at the speed of events today. The way Standard shares had shot up suggested that there may be another potential bidder in the background. The Bank think that a Lloyds/Standard grouping would make good

sense, and strengthen British banking. The Deputy hoped that this may still come about. From his conversations today relations between Jeremy Morse and Lord Barber seemed to be good, and the Standard Board when it meets on Tuesday might take a favourable view of linking with Lloyds. But the massive increase in the share price, which leaves the present Lloyd's offer stranded, was not helpful in this context. Nor, more generally, does it reflect well in the City.

F CASSELL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SECRET
and COMMERCIAL IN CONFIDENCE

6 2

FROM: VIVIEN LIFE
DATE: 4 April 1986

PS/CHANCELLOR

cc PS/Economic Secretary
Sir P Middleton o/r
Mr Cassell
Mr Peretz
Mr Norgrove - No 10
PS/Secretary of State for Trade and Industry

1. The Deputy Governor telephoned the Financial Secretary this morning to warn him that Lloyds Bank Board have decided to make a bid for Standard Chartered. Jeremy Morse would be seeing Lord Barber this morning and the bid may go public very quickly - possibly today.

2. The Bank's view was that this move would make a lot of sense in that it would create a third British Bank of a similar size to Nat West and Barclays. In addition, Standard Chartered was beginning to look vulnerable to predators, in particular from the US.

3. Their advice would therefore be not to stand in the way of the bid.

4. The Financial Secretary took note of this without comment.

VIVIEN LIFE

SECRET
and COMMERCIAL IN CONFIDENCE

Prime Minister 2

DLS .

10/3

London Business School

Sussex Place
Regent's Park
London NW1 4SA

LBS Financial Outlook, March 1986

EMBARGO : 00.30 hours, Monday 10th March

- The Summary (p.1) argues that the present boom in personal borrowing and in money supply arises because no-one expects interest rates to stay high. Lenders are depositing their extra temporary interest income at banks and Building Societies, while borrowers are taking out higher loans to tide them over. If interest rates fall, then this effect will end. If interest rates stay high, the lenders will start spending more of their extra interest income and the borrowers will cut back expenditure. Either way, bank loans will slow.

- The Viewpoint (p.2) produces evidence to show that North Sea income has been used to accumulate domestic fixed capital over the last four years, not just foreign assets. The authors, Francis Breedon and Giles Keating, show that the need to build up capital in advance of lower oil income accounts for a high proportion of the domestic and overseas investment over the last decade.

- Investment at home and abroad attributable to the oil will yield the UK an income of over £4bn in perpetuity, and as the oil runs out the assets will cushion the adverse effect on the current account. In addition, the current fall in oil prices will have little effect on expenditure if it has been anticipated.

Press calls to Giles Keating day : 262 5050 ex 380
evening : 727 6432

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Financial Outlook

The London Business School Centre for Economic Forecasting

EMBARGO
00.30 hrs MONDAY
MARCH 10th

Gower Publishing

Financial Outlook

This issue of Financial Outlook *is a forecast update. It describes the main changes to our previous forecast published in November 1985. The Viewpoint (page 2) argues that recent shifts in investment in the UK and abroad mainly represent long-term saving of the oil income, so the current fall in oil output will have little effect on living standards or on the current account.*

Summary

The news worsens for those who are alarmed by growth in personal sector bank credit. The rate of increase accelerated to 21.9 per cent during 1985, if direct loans are combined with bank loans to Building Societies (which are on-lent to persons) and with non-bank consumer loans (which are financed by borrowing from banks). Even assuming a low January figure, the growth is extraordinarily high compared to an annual increase of 8 per cent in the value of consumer spending.

The boom in consumer loans contrasts with sluggish corporate borrowing. Companies have borrowed less and turned to buoyant internal funds or to new issues, which are more attractive under the new CT regime. Why have individuals borrowed heavily when the savings ratio is high (now around 13 per cent) and the personal sector financial surplus a healthy £12bn for 1985-86?

One explanation is that the cost of borrowing is falling. Individuals are increasing yet further the proportion of general consumer spending financed cheaply through house purchase loans. Also, the APRs charged on some other loans have been cut back in the intense competition for market share.

Another explanation is that house price inflation is about 10 per cent (more in some areas) so the real post-tax cost of mortgage borrowing is zero or negative. A further factor is that up to 1981 individuals had less borrowing than they wanted because of restrictions on bank and Building Society lending. As the average life of a mortgage is about seven years, the level of borrowing is still adjusting to the desired level.

None of this explains why the personal sector is prepared to boost both sides of its balance sheet. Personal sector deposits at banks and Building Societies grew by about 13 per cent during 1985, with the banks' market share rising. Combined with large inflows to the banks from companies, whose liquidity has grown substantially, this gave an increase in sterling M3 of around 15 per cent.

Why increase both sides of the balance sheet? A few individuals may have taken out mortgages larger than needed for current purposes, leaving the spare funds on deposit until required. More important, the phenomenon may reflect contrasting actions by two distinct groups within the personal sector: borrowers and lenders.

Very high real interest rates have had opposite effects on the two groups. Because such rates are so unusual, neither group expects them to continue. The borrowers have reacted to increased outgoings by raising loan demand so they can maintain spending. The lenders have put the extra income on deposit rather than spending it because (as explained in the Viewpoint) that is the appropriate reaction to a temporary rise in income.

This cannot continue. If real interest rates fall, borrowers' interest payments will decline, improving their finances and allowing them to reduce loan demand. The lenders' income will fall to normal levels, making it unnecessary for them to build up assets at an abnormal pace.

If instead real interest rates stay high, people will revise up their estimates of normal rates. The borrowers will reduce their borrowing and cut back their spending. The lenders will step up their spending, which is the appropriate response to a *permanent* improvement in income. They will no longer need to put most of the extra income on deposit.

Either way, the growth of both loans and deposits will decline. If this happens as a result of interest rates staying high, then income will have been lost to the borrowers, and the lenders (many of whom have benefitted from recent rises in asset prices) will have gained.

G.B.K.

Viewpoint

Permanent benefits from the North Sea

FRANCIS BREEDON and GILES KEATING

The value of North Sea oil is in decline, with the price reduced and the volume falling. We argue that this will cause little worsening in living standards nor, in the short run, in the current account. We show that movements in domestic capital expenditure since 1982 and in net investment abroad since 1973 are consistent with a long-term savings plan for investing the oil income. These shifts in investment were not merely short-term reactions to the ending of exchange controls or the 1984 changes in capital allowances. We calculate that the investment has been sufficient to give the UK an income from the oil of nearly £4½bn in perpetuity.

Introduction

North Sea oil production has reached its peak and will decline from now on. The House of Lords select committee (in the 'Aldington' Report) argues that this decline will worsen our balance of payments substantially and that significant policy changes will be necessary.

We disagree with this view, because the decline has been anticipated ever since the oil was first discovered. We offer evidence which suggests that the UK has used the income from oil to build up capital assets rapidly enough to generate a permanent income of £4.4bn p.a. that will continue in perpetuity. Until 1981 this mainly involved transactions in overseas assets but since then it has resulted in domestic investment. We show that movements in the current account and in imports of capital goods are closely in line with the investment path suggested by our permanent income approach. Our conclusion is that the current account surplus will fall much less rapidly than the direct income from the North Sea, and that no policy change is required.*

The Permanent Income Approach

The income from North Sea oil, whether received by oil companies, the government or (via appropriate fiscal policies) the general public, is transitory. When the scale of the recoverable oil reserves first became apparent in the early 1970s and the first oil price shock made many fields potentially profitable, it was thought that the output would peak after about a decade. What was the reaction of the potential beneficiaries to this temporary source of income?

We will argue that their reaction was to try to convert the high transitory income from oil into a lower, permanent income that would continue in perpetuity. This would not have prevented them from spending part of the oil income on consumer goods. On the contrary, our calculations suggest that after allowing for sufficient saving to give a permanent income in future, the oil has allowed the UK as a whole to raise its consumption by £4.4bn p.a. (at today's prices).

How is the high temporary income from oil converted to a lower permanent stream of income? An analogy is given by an individual who expects to receive a large temporary income over the next few years. This individual could, in principle, sell the rights to this income to some third party for a lump sum. (The recent flotation of a company owning the income receipts from popular musicals is an example.) This lump sum could be used to purchase an annuity from an insurance company. The annuity would pay a continuing stream of income, lower than the temporary income but lasting forever (or at least throughout the individual's lifetime).

Why should an individual want to spread the income over time in this way, rather than simply spend the original temporary high income as it was received? The answer is that the extra utility from the income in the later years (after the temporary income has run out) is greater than the utility that would have been gained by spending much more in the early years, even if we allow for the individual's preference for consuming sooner rather than later. This argument only applies to an individual whose personal circumstances do not change over time. In practice, people have family obligations when they are younger and so tend to want to spend more then, but this complication is of little relevance once we return to the whole economy, where the distribution of the population by age is changing only slowly.

For the UK as a whole, it is not possible to capitalise the oil income (although we argued for a form of hedging in an article in the November 1985 issue of *Financial Outlook*). Nor is it possible to purchase an annuity. However, we can produce the same effect by carrying out the appropriate borrowing and investment ourselves. In the mid-1970s, when the oil income was negative (because of exploration costs) or very low, we could borrow to finance increased consumption. In the late 1970s and throughout the 1980s, we have been able to invest to the extent that the oil revenues exceed the permanent increase in consumption. As the oil gradually runs out, we will obtain an increasing income from our cumulated investment. Eventually the investment will provide all the income for our higher consumption, just as the annuity did in the

* Our analysis implies an improvement in both overseas earnings and in manufacturing and/or services trade. The possibility of the latter is discussed in, for example, 'Manufacturing prospects after OPEC III', LBS *Economic Outlook*, February 1986, by Bill Robinson and Alister McCullough.

case of the individual.

Note that an individual, by capitalising temporary income and buying an annuity, can pass on the risks both of the original income and of the investment. The UK has continued to bear these risks itself and so has suffered from the recent fall in oil prices, (which reduces the value of the temporary income) but has benefitted from unexpected capital gains on the investments. These effects are discussed further below.

In our analysis we consider the consumption and investment activities of the UK as a whole. The income from oil accrues mainly to the government, with oil companies also receiving some benefit. The extent to which the government should adjust its fiscal policy to allow for the transitory nature of the oil revenues has been discussed elsewhere*, to the extent that private agents are willing or able to adjust their own consumption and investment in response to the oil income, it is not necessary for the government to do so. Such questions are beyond the scope of this article, which concentrates on the appropriate pattern of investment and consumption for the economy as a whole.

The investment can take two forms. It may be in overseas assets or in capital at home, both of which generate the long-term return required to maintain permanent income.

We show below that these two have very different implications for the current account, and the split between them may affect the level of employment in the UK. However, provided their rate of return is the same, then the choice between home and overseas investment is irrelevant for computing permanent income.

On our assumption that the beneficiaries from the oil revenues have tried to generate a permanent income, we can use estimates of oil production and the discount rate (i.e. the return on investments) to estimate the permanent revenue from North Sea oil and the path of investment required to generate that income.

* See "Approaches to the PSBR" by J. Odling-Smee and C. Riley in *National Institute Economic Review*, August 1985.

Calculating Permanent Revenue

Permanent revenue is defined as the permanent stream of income that can be derived from a windfall gain whereby instead of spending all of the gains, a part of it is invested, thus allowing a constant proportion of it to be spent in perpetuity.

To calculate permanent revenue we first choose an appropriate discount rate. This is equal to the difference in the utility that individuals obtain from income now and the same income next year. For simplicity we assume that it is also equal to the real rate of return on assets. For our central case we assume a discount rate of 2.5 per cent. Given this, permanent revenue is equal to:

$$PR = r\ (\Sigma_s\ AR_s\ (1 + r)^{-s})\quad (1)$$

where

PR = permanent revenue

r = discount rate (assumed to be 2.5 per cent in our central case)

AR = actual revenue

The expression in brackets is equal to the net present value (ie the capital value) of the actual revenue, so:

$$NPV = PR/r$$

where

NPV = Net present value

Having calculated the permanent revenue we can now calculate the path of investment required to generate that revenue:

$$CTTR_t = (AR_t - PR_t)\ ((1 + r)\ CTTR_{t-1})\quad (2)$$

where

CTTR = cumulative total transitory revenue

Equation 2 calculates the value of the cumulated stock of assets for any one period. By definition when actual revenue from the windfall gains reaches zero the cumulated stock of assets must equal the net present value of the windfall gain as calculated at the base period. This can be seen by comparing equations (1) and (2). For the permanent revenue to be generated for ever, it must equal the returns from the cumulated stock of assets. If it was greater than this, we would have to sell an increasing proportion of our assets each period until we had none left. Given this we can see that if the cumulated stock of assets (CTTR) is to remain constant when actual revenue is zero, the cumulated stock of assets in the last period multiplied by the discount rate must equal the permanent revenue.

The other variables discussed in the article are calculated in the following manner:

$$IR_t = r\ (CTTR_t)$$

$$TR_t = AR_t + r\ (CTTR_t)$$

where

IR = interest revenue

TR = total revenue

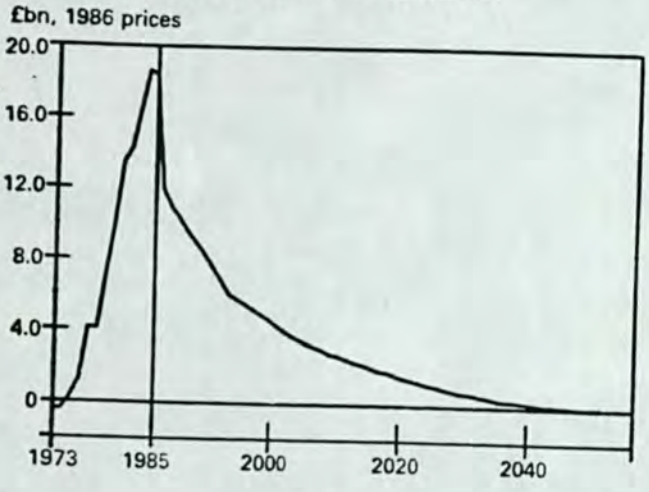
Estimating Oil Production

To estimate Britain's net earnings from North Sea oil we calculate the volume of total oil production multiplied by the price of oil for each period. From this we deduct interest, profits and dividends due abroad as a result of overseas investment in the North Sea. We also deduct imports of goods and services required for North Sea oil production. This gives us the standard figures for the direct benefits from North Sea oil that are shown in official statistical publications.

Using the LBS forecast of these variables (based on an oil price of $20 per barrel, with a decline in real terms until 1994), we have constructed the long-term forecast of North Sea earnings shown in Chart 1.

Chart 1

EARNINGS FROM THE NORTH SEA



We use this forecast as an estimate of the future earnings expected from North Sea oil. This does not mean that every recipient has this forecast in mind. It simply means that on average this is representative of the figures being used.

Permanent Revenue from North Sea Oil

We have calculated (see box 1) the capital value in 1973 of the North Sea earnings. This is the sum of money that we could in principle have sold the oil for in 1973, if world capital markets had been large enough and if everyone had believed the forecast in Chart 1. Assuming a real interest rate of 2.5 per cent, this capital sum would have been £174bn (at 1986 prices).

Had we been able to use this money to buy an annuity, it would be yielding us £4.4bn p.a. Therefore our permanent income from the oil is £4.4bn. This is the extra amount that we can spend in perpetuity either on extra imports, or by diverting exports to domestic consumption, or by producing more goods at home using capital stock paid for from the North Sea income.

In practice, we were not able to capitalise the North Sea income, nor to purchase an annuity. Instead it has been necessary to make appropriate borrowing or investments each year, in a way that reproduces the effect of selling the oil, buying an annuity, and receiving an income of £4.4bn p.a. (at 1986 prices).

Chart 2

ACTUAL AND PERMANENT REVENUE

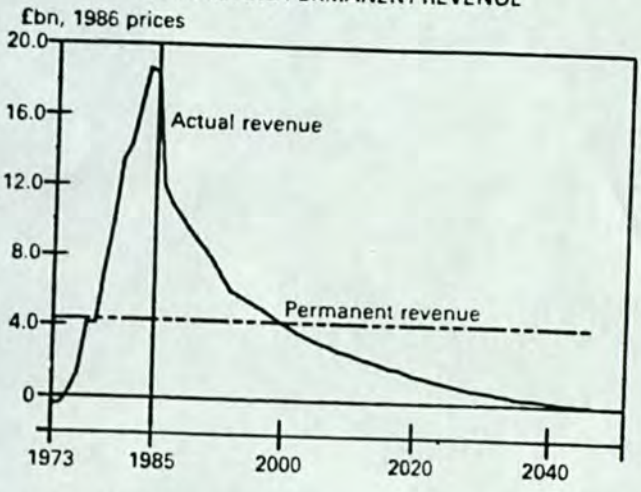


Chart 2 shows the relation between the actual revenue and the permanent income. Initially the permanent income is substantially above the actual income, and so we had to borrow. From about 1977, the actual income exceeded permanent income but, as we explain below, interest charges meant further borrowing for another three years or so until 1980. Since then actual revenues have exceeded permanent income by up to about £15bn p.a. This has allowed us to invest a high percentage of our North Sea earnings while still maintaining our increased consumption at £4.4bn p.a.

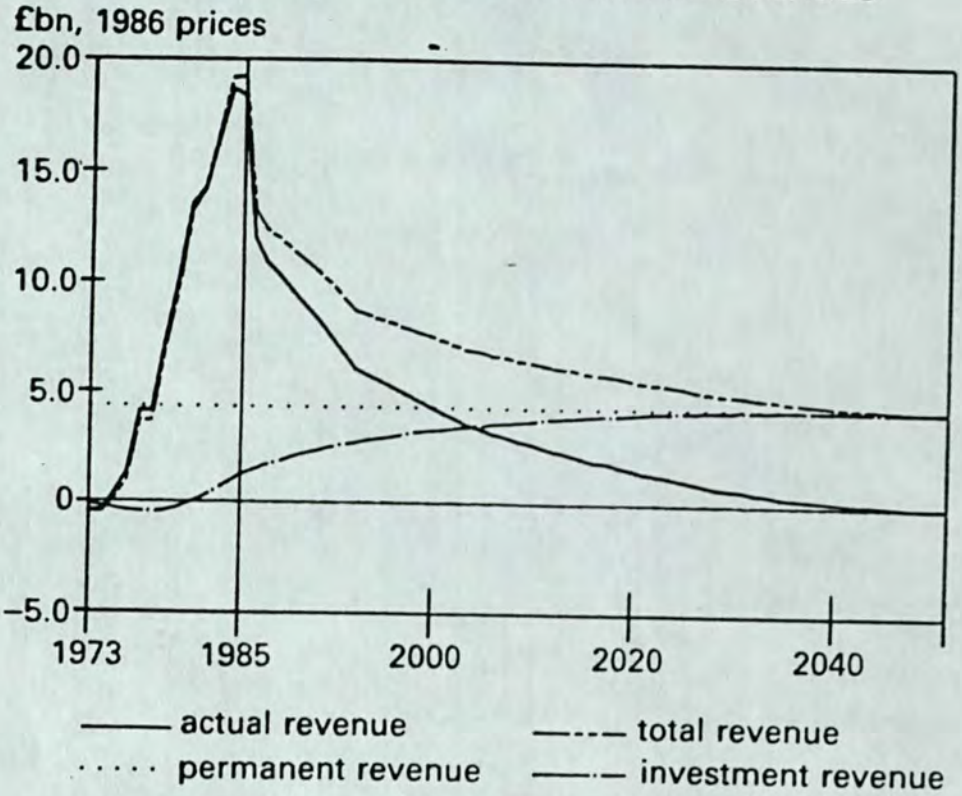
What happens from the late 1990s, when the actual revenue once again falls below the permanent income? The answer is that by then, the income from our investments (at home or abroad) will have accumulated to a substantial sum, and indeed as we look further ahead they will provide almost all of the permanent income. This is shown in Chart 3, which reproduces the lines for actual and permanent income, but also shows the income from investment. In addition, it shows the total income obtained by adding actual income from the oil to the income from investments.

For the first 8 years until 1981 we paid interest out. This is because we started spending the permanent revenue from oil in 1973, so until our actual revenue was greater than our permanent revenue we had to borrow money to finance our spending. After that interest revenues remained negative until 1981. By then actual revenues had paid off the cumulated debt. After that date they grew quickly as actual revenue was much greater than permanent revenue. By the time actual revenue falls to zero, income from investments must equal permanent revenue.

Total revenue is actual revenue plus the income from investment. Actual revenue falls quite sharply

Chart 3

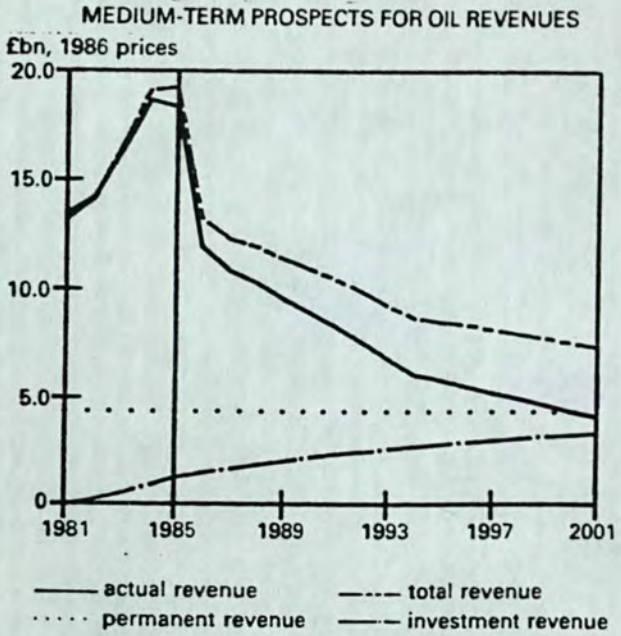
LONG-TERM PROSPECTS FOR OIL REVENUES



after 1986 whilst total revenue has a much more gentle decline until it becomes equal to permanent revenue. The difference between these lines illustrates the contrast between the simple approach of measuring oil's effect on the economy as the revenue from production, and the more complete approach which also takes into account oil's effect on investment behaviour. The importance of this over the next ten years is shown in Chart 4, which emphasises the slowness of the decline in total revenue compared to the actual revenue from oil alone.

Chart 4

MEDIUM-TERM PROSPECTS FOR OIL REVENUES



Alternative Assumptions

We now consider alternative assumptions. First, if we change the discount rate we do not change the path of the total revenue curve substantially but we do change the permanent revenue.

Table 1
Alternative discount rates

Discount rate (%)	Net present value (£bn)	Permanent revenue (£bn)
1	226	2.3
2	189	3.7
3	160	4.8
4	137	5.5
5	118	5.9

The net present value and permanent revenue of the future earnings of North Sea oil, given different discount rates (all with a base year of 1973). Figures are at 1986 prices.

Table 1 shows the effect on permanent revenue of taking a different discount rate. A higher discount rate reduces the net present value of North Sea oil but the investment earnings derived from this value is larger. The second effect dominates and so permanent income increases as the discount rate rises.

The other assumption is the choice of base year but this turns out to be less important. This is because the permanent revenue spent during the initial period (when actual revenue is below permanent income) must be paid for by borrowing

and this must be paid back with interest. If we choose a later base year, then these interest payments on borrowing are avoided but against this we lose the benefit of the high actual revenues in the period prior to the base year. There are thus two partially offsetting effects and so the choice of base year turns out to be relatively unimportant. See Table 2.

Table 2
Alternative base years

Base year	Net present value (£bn)	Permanent revenue (£bn)
1970	162	4.1
1973	174	4.4
1975	184	4.6
1980	190	4.8
1985	139	3.5

The net present value and permanent revenue of the future earnings of North Sea oil, given different base years (all with a discount rate of 2.5%). Figures are at 1986 prices.

The Evidence

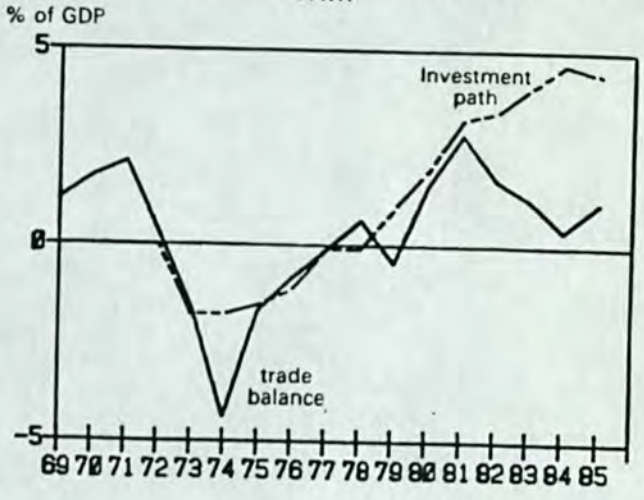
In this section we examine whether the data are consistent with the shifts in the current account and in investment that, according to our analysis, should have occurred since 1973. First we consider the implications of the theory in two extreme cases. In one case, all the investment is in overseas assets and in the other it all takes place in the UK. At the end of the section we argue that up to about 1981 the first case describes approximately what happened, and since then much of the investment has been at home. This implies hypothetical movements in the current account and in investment and we show that these are close to the events that actually took place.

Suppose that all the investment required to generate our permanent income was made abroad. Then the difference between the total revenue and permanent revenue curves on charts 3 and 4 would all be invested abroad (or, in the early years, borrowed from abroad). Net investment abroad is definitionally equal to the current account surplus and so the difference between these two lines would also be the total effect on the current account from North Sea oil. This current account effect is shown seperately in Chart 5.

According to our analysis, there was an increase in consumption as soon as oil was discovered. Initially this would have been financed by running the current account deficit shown to the left of chart 5. From about 1979 it would have been financed by the actual revenue from the North Sea, and the current account would have been approximately in balance. From about 1983 onwards, an increasing proportion would be financed by the income from investment. The total effect on the current account shown in Chart 5 is thus made up of three parts: the adverse effect of higher consumption; the actual revenue from oil; and the effect on interest, profits and dividends which is adverse initially and then favourable as overseas assets are built up.

By the time North Sea oil runs out we would have accumulated a stock of overseas assets large enough to generate interest, profits and dividends exactly equal to the permanent revenue. For the same GDP and same level of exports as we had before discovering oil, we could import £4.4bn more goods for consumption and remain in trade balance on current account. (Alternatively we could export that much less for the same level of imports.)

Chart 5
THE TRADE BALANCE AND THE EXPECTED INVESTMENT PATH



Now suppose that all the investment required to generate our permanent revenue is in the UK (in contrast to the supposition above). Then the difference between the actual and permanent revenue curves on Charts 3 and 4 would equal the change in UK capital stock caused by North Sea oil. Our domestic capital stock follows the same path as the overseas stock in the previous case.

In this case, the oil has no effect on the current account at all. Each year, the beneficial effect on our trade balance from oil (or the adverse effect in the earliest years) is exactly offset by increased imports (or exports, in the early years) of capital or consumer goods.

Starting in 1973, initially we would have had capital consumption, diverting resources from investment into consumption (and a small amount to exports). The capital stock would have been run down. With reduced productive potential, GDP would also probably fall slightly.

From about 1980 onwards, the capital stock would start to rise above the level it would have reached without oil, and there would probably be a corresponding rise in GDP. We would be importing more capital and/or consumer goods, exactly offsetting the current account gains from oil, and we would also be producing more at

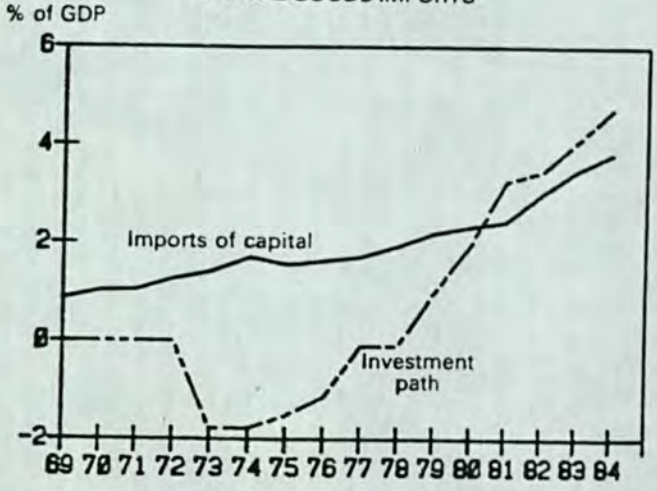
home. By 1985, the rise in capital stock should be fairly significant. It would continue to grow and eventually, when the oil finally runs out, we would have sufficient domestic capacity for GDP to be £4bn higher. We would no longer need to import extra capital or consumer goods, and we would no longer have the oil to pay for such imports.

To raise the capital stock in this way requires higher investment than would otherwise have occurred. This might be achieved either by increased imports of capital goods (which would offset the boost to the current account from oil), or by stepping up our imports of consumer goods and diverting the domestic capacity that this freed into the production of investment goods. It is thus possible that consumer goods imports could rise by more than £4.4bn. However, it seems likely that a high proportion of the capital goods would be imported. This is because the change in domestic investment is large but temporary and there are costs to switching domestic production from consumer to capital goods.

This story involves an increase in capital stock for a given workforce. It does not require that we are below full employment, although increases in output will be easier if we are starting from an under-employed labour force.

Chart 6

CAPITAL GOODS IMPORTS

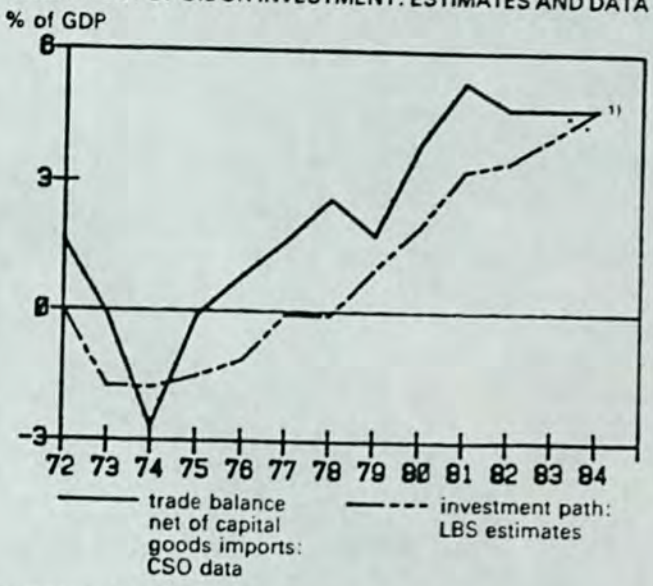


We now turn to the evidence. Chart 5, which shows the effect on the current account if all the investment had taken place abroad, also indicates that actual movements in the current account were very similar to our estimates up to 1981. Chart 6 shows the path of capital goods imports over the period since 1969. These have tended to rise over the period since 1981. This suggests that after 1981, the emphasis moved from building up capital stock abroad to an increase in domestic capital. To the extent that we have built up domestic capital stock, the current account effect of oil shown in Chart 5 is reduced. Therefore in Chart 7, we combine the evidence of the two previous charts by comparing the 'pure overseas investment' case of Chart 5 with the current account adjusted to remove capital goods imports.

The comparison is striking. It appears that our estimates follow the actual path of the current account, net of capital imports, very closely.

Chart 7

THE EFFECT OF OIL ON INVESTMENT: ESTIMATES AND DATA



1) Solid line adjusted for miners' strike, dotted line not adjusted

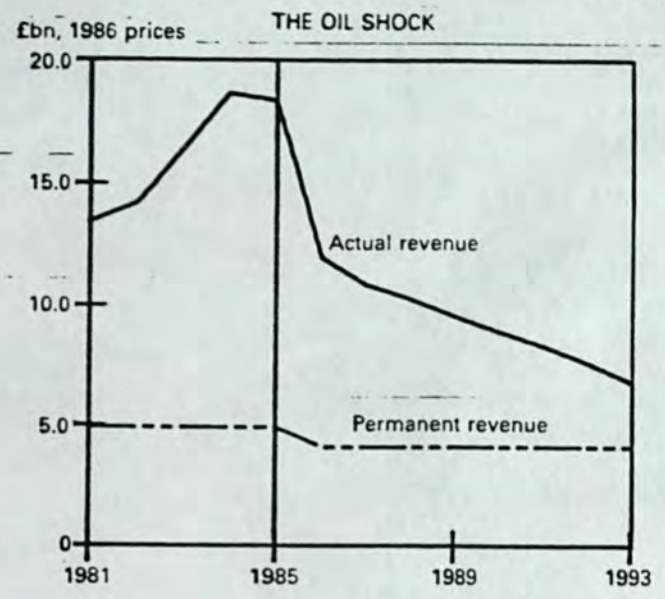
A criticism of this approach is that the current account has been subject to many other influences over the period shown. For example, exchange controls were abolished in 1979, causing a stock adjustment by pensions funds and others who wished to build up their overseas portfolios. However, an event such as the ending of controls need not lead to a stock adjustment. It can alternatively cause a shift in relative prices. If the controls had been removed in the absence of the oil effect, then the exchange rate would simply have fallen sharply to discourage purchases of overseas assets. As it was, the removal prevented an even larger appreciation in 1980.

The Oil Shock

Up to now, we have assumed that agents expected in advance that the oil price would fall to around $20 a barrel early in 1986. We now adopt an alternative assumption. We suppose that up to the end of 1985 the oil price was expected to remain at $26 throughout the 1980s. We assume that early in 1986 expectations were revised down and oil price expected to reach $20.

On this revised assumption, until 1986 we were consuming and investing as if the revenue from oil was valued at $26. This meant that we could consume almost £5bn p.a.. With the fall in the price, we realised that we had overvalued our future oil revenues and had been consuming too much and investing too little. This meant that we had to do a new permanent revenue calculation based on the new oil price. The result of this revision is a new permanent revenue of just over £4bn from 1986 onwards (Chart 8). This is less than the £4.4bn derived earlier, because that allowed for the fall to $20.

Chart 8



In both 1973-74 and 1979 there was a dramatic, and for the most part unexpected, rise in the price of oil. We should therefore adjust our analysis to take into account these two unexpected shocks. Since the price rose on both occasions, before they occurred we had been consuming too little of our North Sea oil revenue because we had undervalued the future earnings from North Sea oil. Given this the story for the first two oil shocks should be the obverse of that for the price fall discussed above.

However, these two shocks would not have as much effect as the recent shock. This is because they were much earlier. This means that we did not follow the wrong consumption path for long and so the stock of assets we had accumulated before the shock was not that much larger than would have been the case if we had anticipated the price rise. This is particularly true for the first shock of 1973-74 as we had then been investing for less than a year. The second price rise came after 6 years of investment, which is still not long compared to the 13 years of investment before the 1986 shock. This means that even if the two earlier shocks were completely unanticipated, with not even a gradual price rise being foreseen, the analysis is not greatly altered.

Conclusions

We have argued that because the approximate pattern of North Sea oil output was known when the oil was first discovered, its gradual decline will not have a destabilising effect on the economy. We use a permanent revenue approach to derive the path of investment that would have been chosen if the UK had wished to obtain a continuing benefit from the North Sea in perpetuity. We show how this could have involved either investment abroad or investment in domestic capital stock, and we present evidence (Chart 7) which supports our view that up to about 1981 this was acheived through transactions in overseas assets, and since then it has involved domestic investment as well. We note that this investment implies that the total effect of oil on the current account will decline far more slowly than the direct income from the North Sea and we conclude that no policy change is required.

Postcript. While this article and the LBS forecast on which it is based were in preparation, oil prices started to fall from about $26 a barrel, and a figure of $20 was used as a working assumption. Revising our calculations on the assumption of a $15 price reduces the permanent revenue figure to approximately £4 bn p.a., assuming this price had been anticipated. Our broad conclusions about the build up of domestic and overseas assets are unaltered.

Interest rates and asset prices

UK short-term interest rates and the exchange rate

Twelve months ago, as the pound fell rapidly towards dollar parity and DM3.50, base rates were raised from 9½ per cent at the end of 1984 to 14 per cent. The importance of the exchange rate as an intermediate target of monetary policy was confirmed in the 1985 Budget speech, when the Chancellor formally renounced a policy of 'benign neglect'. Later in 1985 the exchange rate emerged as the principal indicator of financial conditions and in the Autumn sterling M3 was officially suspended. Successive ½ per cent reductions in base rates to 11½ per cent last July were only permitted at times of currency strength.

The pound again came under severe pressure on the foreign exchanges late last year, following the collapse in oil prices. Base rates were again raised, in early January, in order to support the currency. It appeared that government policy was to hold sterling, even in the face of weakness due to falling oil prices.

Subsequently, however, and even though oil prices and sterling have moved lower, interest rates have not been raised. It therefore appears that, when domestic indicators suggest that financial policy is not lax – in the last two months sterling M3 has risen only ¾ per cent and the PSBR target of £8bn seems likely to be met – the government will accept an oil-induced reduction in the exchange rate.

We therefore expect the government to frame its policies around an exchange rate which is close to the current level (an effective rate of about 74 in mid February). This implies no tax cuts in this year's Budget. Later in the year, however, when we expect slower monetary growth and on the assumption that the uncertainties surrounding the oil price have diminished, we expect the pound to be under less pressure. This should permit interest rates to fall back from their current high (real) levels. We forecast base rates of 11 per cent by the end of the year and 9 per cent from late 1987 onwards.

Compared with our November forecast we have lowered oil prices by about one quarter and raised interest rates by 2 per cent this year and by 1 per cent in the medium term. As we show in *Economic Outlook*, the net effect of these together is to reduce the sterling index by 2-3 per cent. The lower nominal exchange rate is therefore the mechanism for the fall in the *real* exchange rate which is required to shift resources to the non-oil current account.

The gilts market

Recent developments in the gilts market are shown under the Public Sector (page). The end of overfunding, which was effectively discontinued last summer, was confirmed by the Chancellor in his October Mansion House speech. Since then

The gilts market

£ billion

	Stock 81Q1	Actual 1981/82	1982/83	1983/84	1984/85	Forecast 1985/86	1986/87	1987/88	1988/89	Stock 89Q1
Gilts purchases by sector										
Personal sector	15.4	1.7	0.7	1.7	3.3	0.1	1.5	1.1	0.8	28.5
Industrial & Commercial Companies	1.3	–0.2	0.2	0.5	–0.3	0.1	0.4	0.4	0.4	3.6
Overseas sector	6.5	0.2	0.6	1.1	1.5	2.6	0.7	–0.5	–0.5	14.9
Pensions funds and insurance companies	30.8	4.2	3.2	5.2	5.1	3.9	4.7	6.0	6.2	83.4
Monetary sector	13.8	0.5	–2.7	–1.0	–0.1	–1.1	–0.5	–0.3	–0.3	14.8
Unit and Investment Trusts	0.4	0.0	0.1	0.2	0.1	0.3	0.3	0.3	0.3	1.8
Building Societies	12.7	1.1	0.9	1.9	0.3	–1.3	–1.1	–0.9	–0.8	13.1
Total purchases	80.9	7.5	3.0	9.7	9.9	4.5	6.0	6.0	6.0	160.1
Gilts sales by government	80.9	7.5	3.0	9.7	9.9	4.5	6.0	6.0	6.0	160.1
National Savings	15.3	4.2	3.0	3.3	3.0	2.6	1.7	1.5	1.5	36.0
"Total funding"	96.1	11.8	6.0	13.0	13.0	7.1	7.7	7.5	7.5	196.1
Memorandum item: PSBR	—	8.8	9.3	9.4	10.1	8.2	9.1	8.1	6.5	—

Note: a minus indicates net sales.

gilts sales have been higher, though for 1985-86 as a whole we estimate only £4.5bn of sales, less than half the 1984-85 outturn. This has happened in spite of a higher take-up of gilts by the overseas sector and reflects a much lower take-up of gilts by the personal sector and by the pension funds and insurance companies, combined with net disposals by the monetary sector and the Building Societies. The latter continue to make net disposals because of the removal of the tax benefits from holding gilts.

The inflow into National Savings has fallen back in recent months and the government appears, in its new approach to funding, to have abandoned this year's £3bn target. We expect the outturn to reach £2.6bn. In 1986-87 and beyond, we expect a further reduction in National Savings, as the Chancellor tries to reduce pressure on the retail savings market. We assume total sales of £1½-1¾bn p.a. over the next three years.

We assume that the new policy of keeping funding close to the PSBR implies gilt sales steady at about £6bn p.a. This gives a total for financing gilts sales and National Savings that is just below the PSBR in the next two financial years and just over in 1988-89. If other funding is added (bills and certificates of tax deposit) then there is some overfunding in all three years.

Within the total of £6bn p.a. of gilts sales, the pension funds and insurance companies account for the lion's share. The Building Societies and the banks run down their holdings still further.

The volatility of short-term interest rates has had little impact on gilts prices and there have been only relatively small fluctuations in the long rate over the last three years around 10 per cent. From now on, against a background of falling short rates and much lower gilts sales than over the last two years, the gilts market should be buoyant. We forecast a steadily rising price over the next three years, with the long rate drifting gradually down below 10 per cent.

The equity market

The equity market in 1985-86 has benefitted from take-overs, and from the ending of overfunding which has increased the rate of institutional purchases. Also of great importance, the personal sector has moved from its historical pattern of substantial net disposals. There were net purchases by persons in the second calendar quarter of 1985, the first such occurrence since the bottom of the market in 1974. Although the sector resumed net sales in the third calendar quarter, we estimate that for 1985-86 as a whole it will make only modest disposals of about £0.2bn.

As a result of this increase in demand from three sectors, equity prices have been able to advance strongly despite ICC net issues estimated at £5bn for the financial year and government sales provisionally estimated at just over £3bn.

For the coming financial year, 1986-87, we are rather less optimistic. The personal sector is expected to move back to making significant net disposals, although our projection of £1.9bn sales remains low by historical standards. Corporate cash expenditure on company securities slows to £3.5bn from the peak reached in 1985-86 (note that only acquisitions for cash appear in the second row of the equity market table so successful

The equity market

£ billion

	Stock 81Q1	Actual 1981/82	1982/83	1983/84	1984/85	Forecast 1985/86	1986/87	1987/88	1988/89	Stock 89Q1
Equity purchases by sector										
Personal sector	42.3	-2.5	-3.2	-3.3	-2.6	-0.2	-1.9	-2.6	-2.9	84.1
Industrial & Commercial Companies (acquisitions)	13.4	1.3	1.5	2.5	3.8	4.5	3.5	1.6	1.4	44.8
Overseas sector	8.2	1.2	0.6	1.2	2.9	0.9	0.4	0.7	0.9	33.4
Pensions funds and insurance companies	47.8	3.2	3.4	2.5	4.0	5.2	5.2	6.4	6.7	171.9
Monetary sector	2.2	-0.1	-0.1	0.7	-0.4	-2.2	0.0	0.0	0.0	2.8
Unit and Investment Trusts	8.2	-0.3	-0.2	0.2	0.4	1.1	1.0	1.0	1.0	23.6
Total purchases	122.1	2.9	2.0	3.8	7.1	9.2	8.3	7.1	7.0	360.5
Equity sales by sector										
Government sales	0.0	0.4	0.1	-1.1	-2.1	-3.2	-4.8	-4.8	-4.8	-16.5
Industrial and Commercial Companies issues	-91.1	-3.1	-1.7	-2.2	-4.1	-5.0	-3.3	-2.1	-2.0	-275.7
Monetary sector and OFI issues	-31.1	-0.1	-0.4	-0.5	-0.9	-1.0	-0.3	-0.3	-0.3	-68.3
Total sales	-122.1	-2.9	-2.0	-3.8	-7.1	-9.2	-8.3	-7.1	-7.0	-360.5

Note: a minus indicates a sale, a plus indicates purchases.

take-overs will in aggregate be well over this figure). Institutional purchases remain high but do not accelerate further, partly because gilts sales rise in line with our expectation of a higher PSBR.

The government steps up its asset sales in 1986-87 to £4.8bn and company new issues, although slightly down on 1985-86, will still be at a high level. As a result, we expect equity prices to rise very little in 1986-87, with the boost to profits from the recent fall in the exchange rate already largely reflected in the price rises that have occurred in the last month.

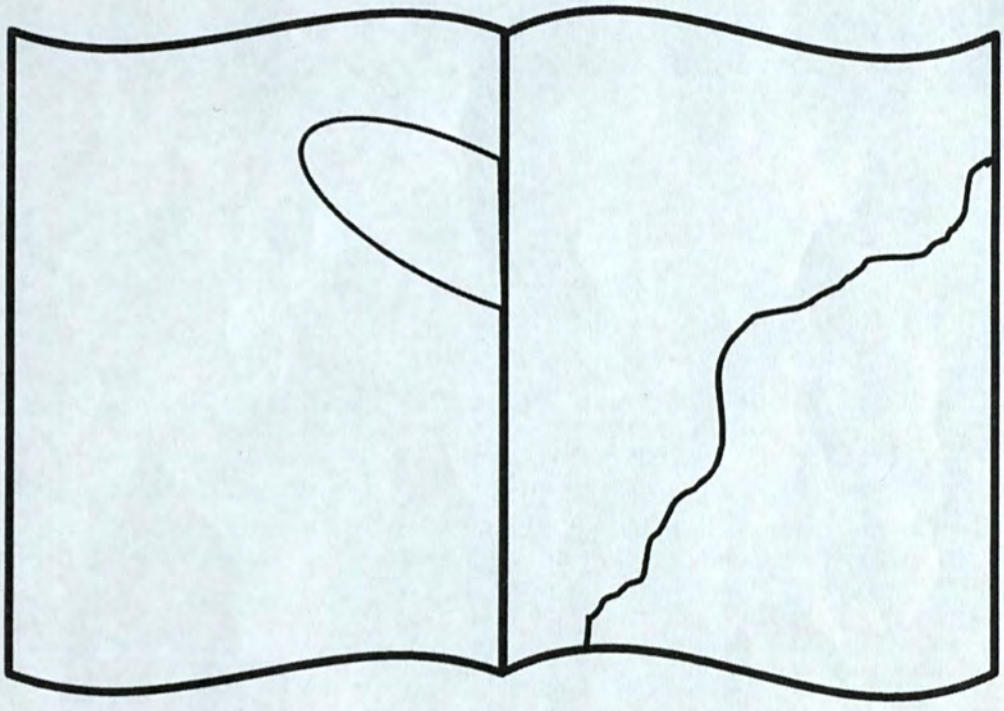
G.R.D./G.B.K.

Interest rates and asset prices

	1980/1	1981/2	1982/3	1983/4	1984/5	1985/6	1986/7	1987/8	1988/9
Interest rates – percent p.a									
UK banks base rate	15.5	13.3	11.2	9.4	10.7	12.1	11.3	9.4	9.0
Building Society deposit rate (grossed-up)	14.5	13.6	11.4	10.0	10.7	11.8	11.3	9.7	9.1
Equity yield (FT industrial ordinary shares)	7.4	5.8	5.1	4.6	4.7	4.6	4.3	4.4	4.4
20-year gilts yield	13.6	14.9	11.8	10.0	10.2	10.2	10.1	10.0	9.6
Weighted average of world 3-month interest rates*	12.0	12.6	10.5	8.5	8.7	7.3	7.0	7.0	7.0
US dollar corporate AAA bond yield	13.2	15.5	12.8	12.5	13.5	11.1	10.5	8.5	8.5
Indices – average of end quarters									
FT ~~industrial ordinary~~ all share index	282	315	363	459	545	660	725	738	770
FT government security index (dated over 15 years)	116	104	132	141	135	137	139	140	147
Exchange rate (in sterling per unit of foreign currency)**	96	116	132	146	170	159	161	166	166
US Standard and Poors composite index	128	120	131	164	164	201	217	225	233

*Weights are approximately 50 per cent US Dollar, 20 per cent DM and 10 per cent each for Swiss Franc, French Franc and Yen
**A rise in this index indicates a depreciation of sterling, a fall indicates an appreciation. The index is weighted by UK portfolio holdings overseas, giving the US dollar a higher weight than in the trade-weighted index.

SPECIAL NOTICE



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Monetary aggregates

Recent developments

The Chancellor is due to announce a new broad monetary target in the Budget, to replace the sterling M3 target whose suspension was confirmed in the Mansion House speech. Growth in sterling M3 over the last year has been particularly heavily influenced by institutional change and financial innovation in money and credit markets, with the banks re-entering the market for personal sector deposits and continued competition in the loans market. One possibility is that a very broad monetary aggregate will be used as the target. It would incorporate bank deposits, all Building Society deposits and certain other assets including certificates of tax deposit and some National Savings. This would be PSL2, expanded to include Building Society term shares. The intention is that by including all bank and Building Society deposits, such an aggregate would be unaffected by changes in market share.

On the sterling M3 table, debt sales to the UK NBPS should be added to overseas sales (on the following table) to give the total funding figure apparently used by the Chancellor. Even with this adjustment, the funding in our forecast does not move exactly in line with PSBR. There is overfunding of between about £1 bn and £3 bn in each year. Although these discrepancies are smaller than the figures of £4 bn or more recorded in some recent years it may be that the government will interpret the ending of overfunding more rigorously.

The rapid growth of sterling M3 in 1985-86 is largely the outcome of the banks' re-entry into the market for personal sector deposits. The counterpart is the rapid rise in bank loans from about £15 bn in 1983-84 to over £22 bn in 1985-86. Buoyancy in the loan market in the face of a significantly higher than average real interest rate may be the evidence of the competitive pressure on banks and finance houses to reduce their mark-up on base rate. The APRs for personal sector non-house purchase borrowing have usually implied mark-ups of the order of 10 percentage points and, for some retailers' loans, the mark-ups have exceeded 20 percentage points. There is some evidence that mark-ups are now falling as a result of the threat of new entrants into the UK retail deposit and loan markets in the form of foreign banks and the cumulative effects of deregulation of five years ago. Against this, the mark-ups applied on overdrafts without arrangement have been raised.

In contrast to this year's base drift in sterling M3, M0 fell below the lower boundary of its target range in the months to December before moving up in January.

The outlook

We predict that bank lending cannot be sustained at the record levels of 1985-86. A £2 to 3 bn fall is predicted for 1986-87 as consumer and company sector spending grow less rapidly and interest rates decline no further than 9 per cent. With the inflation rate remaining in the 3½ to 4 per cent range from 1987 onwards, real interest rates remain high.

The forecast of the overseas items is subject to great uncertainty. In 1985-86 sales of gilts to the overseas sector account for much of this item. In 1986-87, however, this will be reduced. We predict that foreign currency items (loans net of capital issues and deposits) will yield about £4bn for the banks next year. This will have a downward influence on sterling M3 and will be another contributory factor to the eventual slowing down to the predicted 7 per cent growth rate of this monetary aggregate.

S.M.M.

Narrow monetary aggregates

£ billion

	Actual				Estimate	Forecast		
	1981/2	1982/3	1983/4	1984/5	1985/6	1986/7	1987/8	1988/9
Wide monetary base MO								
Notes and coin in circulation with public	0.4	1.4	0.2	0.7	0.6	0.6	0.3	0.3
Notes and coin at banks	–0.3	–0.2	0.1	0.1	0.1	0.1	0.1	0.1
Bankers operational deposits at BoE	0.2	–0.1	0.0	–0.1	0.0	0.0	0.0	0.0
Change in M0	0.3	1.1	0.3	0.7	0.7	0.7	0.4	0.4
Stock, end year	11.9	12.6	13.0	13.7	14.4	15.1	15.5	15.9
Percentage change	2.6	9.2	2.3	5.4	5.1	4.9	2.6	2.6
Target range, March 1985 FSBR, percent	—	—	—	—				

Counterparts to sterling M3

£ billion

	Actual				Estimate	Forecast		
	1981/2	1982/3	1983/4	1984/5	1985/6	1986/7	1987/8	1988/9
PSBR	8.8	9.3	9.4	10.1	8.2	9.1	8.1	6.5
Debt sales to UK NBPS – bills	0.0	0.5	–0.1	–0.1	–0.1	–1.1	–1.2	–0.8
Debt sales to UK NBPS – gilts	–6.8	–5.1	–9.6	–8.6	–3.1	–5.8	–6.9	–6.8
Other debt sales to UK NBPS	–4.6	–3.8	–3.0	–3.7	–3.3	–2.1	–1.9	–1.9
Bank loans to UK private sector incl BoE bills	14.9	15.0	15.7	18.6	22.2	19.2	17.9	16.2
Foreign currency and external counterparts	–0.9	–3.2	–2.6	–1.7	–2.6	–4.3	–3.0	–2.7
Change in sterling non-deposit liabilities	–1.5	–1.9	–2.3	–2.6	–3.1	–2.7	–2.4	–3.2
Change in sterling M3	9.7	10.5	7.6	12.2	18.3	12.3	10.5	7.3
UK private sector deposits	9.2	8.9	7.5	11.6	17.8	11.6	10.2	7.0
Notes and coin	0.4	1.4	0.2	0.7	0.6	0.7	0.2	0.3
Total: Sterling M3	9.7	10.5	7.6	12.2	18.3	12.3	10.5	7.3
Stock, end year	84.3	94.2	102.4	114.7	133.2	145.5	156.0	163.3
Percentage change	14.4	12.2	8.2	12.0	16.0	9.2	7.2	4.7

Sterling M3 foreign currency and external counterparts

£ billion

	Actual				Estimate	Forecast		
	1981/2	1982/3	1983/4	1984/5	1985/6	1986/7	1987/8	1988/9
UK Banks £ loans to overseas net of overseas £ deposits	–0.3	–0.5	–0.8	–1.4	1.6	0.8	–1.9	–2.6
UK Banks f.c. loans net of f.c. deposits	0.3	–0.4	–0.6	1.6	–2.3	–4.0	–1.0	0.0
Public sector external finance:								
Gilts sales to overseas	–0.2	–0.6	–1.1	–1.5	–2.6	0.7	0.5	0.5
Treasury and L.A. bill sales	0.1	–0.2	0.0	–0.1	0.3	–0.4	–0.6	–0.7
Other external finance incl. f.c. bank loans and change in reserves	–0.8	–1.6	–0.2	–0.4	0.4	0.0	0.0	0.0
Total: Foreign currency and external counterparts to sterling M3	–0.9	–3.2	–2.6	–1.7	–2.6	–4.3	–3.0	–2.7

Personal Sector

Bank borrowing (excluding house loans) was £1.6bn in the second quarter of 1985 and £1.9bn in the third. The banking data suggest a further small acceleration in the months to November and possibly a slowdown in January. We have therefore revised up our projection for 1985-86 as a whole to £8.0bn. From now on, interest rates in both real and nominal terms are expected to be substantially higher and as a result we forecast some slowdown in personal sector borrowing. Our forecast for 1986-87 is £7.0bn.

For house purchase loans, we also expect little change in the flow from the peak figure of £19.6bn estimated for 1985-86. Our forecast for 1986-87 is £19.5bn. Although we expect the *flow* to decline slightly in later years our figures still represent a substantial real increase in the *stock* when compared to consumer prices or house prices.

On the uses side of the personal sector financial account, there is little change in the rate of increase of liquidity in 1986-87. Inflows to both banks and Building Societies remain high, but this projection of market shares assumes that the banks obtain benefit from another stock adjustment by launching further new savings products during the year.

Among personal sector transactions in securities, two particularly unusual items appear in recent data. First, the sector was a net purchaser of equities in the second quarter of 1985. This followed a year in which sales reached a record high in nominal terms (despite the BT sale), and is only the second quarter in which a net purchase has been recorded. (The previous instance was at the bottom of the market in 1974; the data start in 1963.) Reflecting this figure, our estimates show an unusually slow rate of equity disposals for 1985-86 as a whole, although there is some acceleration in 1986-87.

The other unusual data item shows purchases of £2.7bn of 'overseas securities' in the first half of 1985, far more than ever previously recorded. The reason is uncertain, particularly since it overlaps with the period when the weakness of sterling made foreign assets unattractive (unless a further weakening was expected). A possible explanation is a misclassification of overseas investment between sectors.

Forecast £ billion	Stock 81Q1	Actual 1981/2	1982/3	1983/4	1984/5	Estimate 1985/6	Forecast 1986/7	1987/8	1988/9	Change in base or asset prices	Stock 89Q1
SOURCES											
Saving	218.1	23.5	23.4	24.8	27.9	29.4	30.5	29.5	30.4	78.9	516.4
Net Capital Transfers	—	0.3	0.6	1.6	1.2	0.7	0.7	0.7	0.8	—	—
Bank Borrowing (excluding house loans)	14.9	4.3	4.7	4.3	4.7	8.0	7.0	7.0	7.2	1.7	63.8
House Purchase Loans; Total	54.3	10.4	15.1	14.8	16.8	19.6	19.5	18.8	19.2	0.0	188.6
Hire Purchase	4.3	0.0	0.5	0.7	0.5	0.6	0.5	0.4	0.3	–1.7	6.2
Other (net)	–4.8	0.7	1.7	2.9	6.3	2.2	–0.1	0.1	–0.3	–7.2	2.1
TOTAL SOURCES	287.0	39.3	46.0	48.9	57.4	60.5	58.2	56.5	58.2	65.2	777.2
USES											
Investment and Stocks	—	10.9	13.7	15.7	16.5	18.2	19.0	20.2	22.7	—	—
Notes and Coin	8.0	0.5	1.3	0.1	0.5	0.3	0.4	0.1	0.2	0.0	11.4
Bank Deposits	37.4	3.5	5.6	1.0	4.1	4.0	4.1	3.9	3.4	6.1	73.1
Building Society shares	51.4	7.0	10.3	11.8	12.4	13.9	13.8	13.2	12.6	0.0	146.6
Gilts and other long-term public debt	15.4	1.7	0.7	1.7	3.3	0.1	1.5	1.1	0.8	2.1	28.5
UK Debenture, Ordinary and Pref. Shares	42.3	–2.5	–3.2	–3.3	–3.6	–0.2	–1.9	–2.6	–2.9	62.1	84.1
Net Foreign Currency assets	4.5	0.2	–0.2	1.3	1.7	2.2	–0.2	–1.3	–1.7	5.5	12.0
Unit Trust Units	3.3	0.1	0.2	0.8	0.5	1.0	1.0	1.0	1.0	7.1	16.1
Nat. Saving Certificates	8.7	3.6	1.2	1.3	1.7	1.0	0.7	0.5	0.4	0.0	19.0
Other National Savings	6.5	0.6	1.8	2.0	1.4	1.6	1.0	1.0	1.1	0.0	17.0
Trade Credit (net)	2.1	0.0	0.8	1.3	1.7	–0.4	0.2	0.2	0.2	0.0	6.0
Equity in Pension Funds and Insurance Cos.	106.5	13.2	13.6	14.6	16.6	17.5	18.5	19.2	20.4	119.0	359.1
Accruals Adjustment	0.7	0.4	0.1	0.5	0.8	1.3	0.1	0.1	0.1	0.0	4.3
TOTAL USES	287.0	39.3	46.0	48.9	57.4	60.5	58.2	56.5	58.2	65.2	777.2
MEMORANDUM ITEMS											
Financial balance	218.1	12.9	10.3	10.7	12.6	11.9	12.3	10.0	8.5	209.1	516.4
House Purchase Loans by Sector.											
(a) From Banks	3.1	3.1	4.8	3.9	2.5	3.9	3.6	3.4	3.6	0.5	32.4
(b) From Building Soc's	44.4	5.9	9.6	11.1	14.6	15.4	15.1	14.5	15.0	0.0	145.6
(c) From Other	6.8	1.4	0.6	–0.2	–0.2	0.4	0.8	0.9	0.6	–0.5	10.6

Overseas sector

Recent developments

The current account is provisionally estimated to have recorded a surplus of £3.6 bn in 1985. This reflects a £2 bn trade deficit which was more than offset by a £5.6 bn invisible surplus. On the trade side oil contributed an £8.2 bn surplus (compared with £7.1 bn in 1984) while non-oil trade recorded a deficit of £10.3 bn (£11.2 bn in 1984). Thus the £2.4 bn improvement in the current balance was evenly distributed between oil, which improved after the end of the miners' strike, and non-oil exports, which benefited from the large fall in the exchange rate at the beginning of the year.

The current account surplus for the first three calendar quarters of 1985 was £1.6 bn (unadjusted). However a balancing item of £1.6 bn meant that the recorded capital account deficit was twice as large, at £3.2 bn. Official reserves rose by £0.6 bn in the first three quarters, but this was largely cancelled by other official transactions and so the net outflow from the private sector at £3.1 bn was almost equal to the recorded capital account deficit. On a quarterly basis, the outflow of £2.3 bn in the third quarter was the largest figure since the end of 1983.

The reserves fell sharply in the fourth calendar quarter of 1985, reflecting intervention to support the pound after the G5 agreement. In January the reserves rose by £45m. This was unexpected given the government's apparent desire to support the pound without raising interest rates, following the dramatic fall in oil prices. Though the reserves were boosted by a large EEC rebate which was paid into the reserves in January, it is possible that support of the pound has not been as great as expected.

The outlook

The reduction in oil prices combined with falling production contributes to a steady decline in the current balance from this financial year until 1990.

The main capital account counterparts to this are a slower build up of overseas assets by the private sector and an increase in bank deposits by the overseas sector. Moving against this trend are overseas holdings of gilts which will peak in 1985-86 and then level out. This reflects our view that the overseas sector has now acquired its desired stock of gilts.

F.J.B.

	1985				1985					
	Q1	Q2	Q3	Q4	Jul	Aug	Sep	Oct	Nov	Dec
Current account, £m s.a.	–408	1435	1162	1359	491	333	338	400	268	691
Visible trade, £m s.a.	–1283	–222	–543	–7	–56	–195	–200	0	–132	125
of which:										
oil	1862	2367	1932		663	626	644	760	675	652
non-oil	–3145	–2589	–2475		–740	–862	–873	–759	–807	–528
Investment and other capital transactions, £m, n.s.a.	–1625	850	–2309							
Official reserves, £m, n.s.a. (drawings on +)	90	–607	–49							

Forecast £ billion	Stock 81Q1	Actual 1981/2	1982/3	1983/4	1984/5	Estimate 1985/6	Forecast 1986/7	1987/8	1988/9	Stock 89Q1
ACQUISITION OF FINANCIAL ASSETS										
Foreign Currency deposits net of loans, at UK banks	–5.8	2.4	1.9	0.5	6.1	–3.4	–1.5	0.7	0.1	–2.6
Bank deposits net of loan	2.8	0.3	0.5	0.8	1.4	–1.6	–0.8	1.9	2.6	7.5
Wholesale Deposits	0.5	–0.1	0.2	0.0	0.1	–0.3	0.4	0.6	0.7	2.1
Overseas Securities & net Direct Investment	–23.1	–5.7	–7.5	–6.3	–9.6	–8.2	–5.5	–3.5	–4.2	–143.2
Net Trade Credit	0.1	0.6	0.2	0.2	0.3	0.0	0.1	0.1	0.1	1.7
Gilts and other long-term public sector debt	6.5	0.2	0.6	1.1	1.5	2.6	0.7	–0.5	–0.5	14.9
UK Debentures, Ordinary and P Share Holdings	8.2	1.2	0.6	1.2	2.9	0.9	0.4	0.7	0.9	33.4
Other assets including balancing item	—	–2.9	–1.3	0.0	–2.3	4.0	0.5	0.4	1.5	—
TOTAL										
Net acquisition of financial assets	–10.9	–4.0	–4.7	–2.5	0.3	–5.9	–2.7	0.3	1.2	–86.2

Industrial and Commercial Companies

Lower world commodity prices and a higher exchange rate reduced manufacturing input prices in the third quarter of last year. With output prices increasing at 5.6 percent per annum, profit margins widened. These developments have enabled profits to be maintained at a quarterly rate of £12.9 bn after the rapid growth of the last two years. Following the surge at the end of 1984-85, investment has now stabilised. Given marginal increases in tax, dividends and interest payments, savings reached £8 bn (see Recent Developments table) and the NAFA £2.2 bn in the third quarter of 1985.

One of the recent features of company behaviour has been the exceptionally high level of bank borrowing. Data indicate that over the last year this has reached a peak and that ICCs are beginning to show a preference for equity finance. Companies are continuing to take advantage of the buoyant equity market to float a large number of new issues but the switch towards equity finance also reflects the changes in corporation tax announced in the 1984 Budget. Prior to this the relative advantage of debt financing was considerable with a corporation tax rate of 52 per cent and an imputed basic income tax rate of 30 per cent. From April 1986 the relief on debt finance will be down to 35 per cent and despite the possibility of a small reduction in income tax rates over this period the comparative advantage of debt financing is greatly lessened. These changes are an important element in our forecasts.

On the uses side individual firms have run down their liquid asset holdings to finance a spate of merger and takeover activity but companies in aggregate are still improving their liquidity.

Data available after the forecast was finalised indicate that the large unidentified item for 1984-85 has been considerably reduced. The main counterparts to this are changes in the figures for financial transactions, rather than savings and investment.

For 1985-86 as a whole we expect a marginal improvement in savings to £33.1 bn. However investment is relatively sluggish and the NAFA rises to £8.2 bn. In this period ICCs raise a total of £6.9 bn net from external sources with more being raised on the equity market than through bank borrowing. Compared to our last forecast the latter is lower reflecting higher interest rates. On the uses side the portfolio is evenly split between bank deposits, equity and net overseas investment. Although the exchange rate for 1985-86 on average will be marginally stronger than the previous year, net overseas investment falls slightly from the exceptional level of 1984-85.

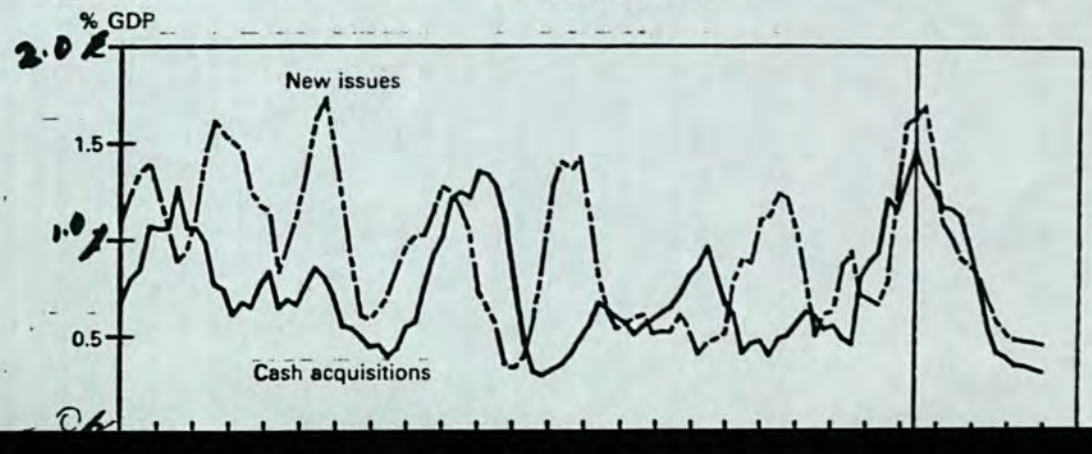
In the current quarter and over the next two years the recent weakening of the oil price and the decline in North Sea oil production reduce oil sector profits. Despite a subsequent improvement in the finances of other companies, the overall profitability of the ICC sector is reduced. This trend is enforced by unfavourable movements in unit labour costs and consequently our outlook for profits and saving is more pessimistic than in November. Despite these developments the NAFA is little changed in 1986-87 at £8.3 bn. With external borrowing of £7.9 bn, ICCs have considerable resources to acquire assets. We expect a rise in fixed investment to almost £30 bn, plus a cash expenditure of £3.5 bn on domestic acquisitions, which are now at a record level even as a percentage of GDP (solid line on chart). We also expect a further build up of liquid assets and a slight reduction in the rate of overseas investment. The latter is still high compared to previous forecasts and reflects expected capital gains which offset the risk adjusted interest rate differential. Note that this category also includes net direct investment and may be related to factors such as the recent instability of the pound.

Over the medium term we are forecasting a decline in the NAFA to £6.1 bn. Bank borrowing is flat and new issues decline. The rate of increase in liquidity slows down considerably with the bulk of funds going overseas and relatively less into UK equities.

K.M.W.

	Q4	Q1	Q2	Q3	Q4
Fixed investment (£bn)	5.1	5.7	5.3	5.5	
(% change in brackets)	(21.4)	(28.4)	(14.3)	(18.5)	
Savings (£bn)	7.9	8.7	7.6	8.0	
(% change in brackets)	(21.0)	(15.6)	(5.0)	(-1.9)	
Stockbuilding (£m)	349	-476	358		
Bank deposits (flows)					
Sterling sight	843	-504	-446	816	
Sterling time	-14	1043	523	1537	
Foreign currency	1410	-209	355	577	
Net new issues	287	1035	1385	1101	573
Bank loans and acceptances in sterling. Banking quarters (£m)					
Total manufacturing	1594	466	121	414	523
Wholesale distribution	308	-100	254	159	435
Retail motor trades	280	573	205	-102	55
Other retail distribution	10	73	32	85	63

COMPANY EQUITY ISSUES AND CASH ACQUISITIONS
(4-qtr moving average)



Sources and uses of funds: Industrial and Commercial companies

£ billion

	Stock 81Q1	Actual 1981/2	1982/3	1983/4	1984/5	Estimate 1985/6	Forecast 1986/7	1987/8	1988/9	Change in base or asset prices	Stock 89Q1
SOURCES											
INTERNAL FUNDS TRANSFERS ETC											
Saving	-101.1	18.0	21.0	26.5	32.0	33.1	37.9	40.7	41.8	-361.2	-211.2
Net Capital Transfers	—	0.7	0.7	0.3	0.4	0.3	0.2	0.2	0.2	—	—
ACQUISITION OF FINANCIAL LIABILITIES											
Bank Borrowing (including BoE bill purchases)	30.5	5.7	3.3	4.0	7.5	4.1	4.6	4.4	4.4	1.9	70.4
Medium dated bills	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
UK Debenture, Ordinary and Pref. Share Issues	91.1	3.1	1.7	2.2	4.1	5.0	3.3	2.1	2.0	161.1	275.7
Net Trade Credit	1.4	1.8	0.6	1.1	1.3	-0.7	0.2	0.2	0.2	0.0	6.1
Net Foreign Currency short-term borrowing	2.7	1.2	-0.1	-1.5	3.5	-1.1	-1.9	-0.3	0.1	1.1	3.6
Accruals Adjustment	6.2	1.4	0.2	0.1	-0.1	-1.1	0.2	0.3	0.3	0.0	7.6
Other (net)	3.3	-6.1	-4.1	-3.2	-10.3	0.7	-2.7	-5.7	-6.7	21.2	-12.6
TOTAL SOURCES	34.0	25.8	23.3	29.5	38.5	40.3	41.7	41.9	42.3	-179.0	139.5
USES											
INTERNAL & TRANSFERS											
Investment & Increase in BV of Stocks	—	18.7	17.2	21.0	24.5	25.2	29.8	34.0	35.9	—	—
ACQUISITION OF FINANCIAL ASSETS											
Notes and Coin	1.9	-0.1	0.1	0.1	0.2	0.3	0.3	0.2	0.1	0.0	3.0
Bank Deposits											
(a) Sight	4.4	0.3	0.4	2.1	1.6	1.1	0.7	0.4	0.4	0.3	11.7
(b) Time incl. C.D.s	8.7	2.8	0.7	0.7	2.4	4.0	3.3	1.6	0.5	0.8	25.6
Medium dated corporate bills	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other short-term assets	1.0	0.0	0.1	0.8	0.2	0.3	-0.8	-0.1	0.5	0.0	1.9
Gilts	1.3	-0.2	0.2	0.5	-0.3	0.1	0.4	0.4	0.4	0.6	3.6
UK Debenture, Ordinary and Pref. Share Holdings	13.4	1.3	1.5	2.5	3.8	4.5	3.5	1.6	1.4	11.3	44.8
Overseas Securities & Net Direct Investment to or by Overseas Sector	3.5	2.4	3.1	2.0	6.2	4.8	4.3	3.8	3.0	13.8	48.0
Hire Purchase	-0.1	0.6	0.1	-0.2	-0.1	0.0	0.0	0.0	0.0	0.6	0.9
TOTAL USES	34.0	25.8	23.3	29.5	38.5	40.3	41.7	41.9	42.3	-179.0	139.5
MEMORANDUM ITEM											
Financial balance	-101.1	0.0	4.5	5.9	7.9	8.2	8.3	6.9	6.1	-157.9	-211.2

Monetary sector

Demand for new lending by the UK private sector was stronger than we expected in the months to December, although the provisional January figure shows a sharp slowdown. Personal sector demand is the main reason for the high rate of lending, with corporate borrowing relatively depressed. Lending to the personal sector in 1985-86 as a whole is expected to be £12.2 bn with a third of this being for house purchase. In addition the banks are estimated to take up some £2 bn of Building Society debt, which is in effect on-lent to persons, and about another £¾ bn reaches the personal sector via the finance houses. This gives a figure of £15 bn in total, including loans to unincorporated businesses which were about £1 bn in the third quarter of 1985.

Personal sector deposits continue to benefit from the attractiveness of the new high interest accounts, although data for personal sector inflows suggest that this effect was less powerful in the latter part of 1985. Deposits by firms have continued to grow reflecting their highly liquid position.

The outlook

Although borrowing in 1985-86 seems to have been well above our estimated figure, we expect a slowdown over the next two years towards the levels that we forecast last November. Higher interest rates compared to our last forecast will tend to reduce loans but offsetting this competition is cutting margins and the APRs actually charged are in some cases significantly lower than six months ago. Loans to the UK private sector recorded in the monetary sector table are between £1 bn and £3 bn less than those in the sterling M3 table, because overfunding is not completely eliminated in the later years of the forecast.

Substantial inflows are expected to continue from both persons and firms during 1986-87 with a decline in later years as companies build up liquidity less rapidly. Further net inflows of £2 bn in sterling from the overseas sector in the later years of the forecast provide extra revenue for maintaining lending growth.

P.N.S

£ million, unadjusted	Q4	1985 Q1	Q2	Q3	Jul	Aug	Sept	Oct	Nov	Dec
UK private sector £ bank deposits	3936	1636	3903	5317	-344	2079	1941	1151	2473	423
Overseas £ bank deposits	951	4304	-412	792	421	291	-15	-199	-540	67
UK private sector £ lending (exc. BoE bills)	4178	9729	4589	4049	4293	71	501	3733	-306	-1114
Overseas £ lending	1651	890	-382	-391	-479	-672	210	-1	28	1600
Memorandum item: UK private sector £ lending (including BoE bills)	4943	7120	4446	4447	3103	1110	414	3440	1198	1020

Forecast £ billion	Stock 81Q1	Actual 1981/2	1982/3	1983/4	1984/5	Estimate 1985/6	Forecast 1986/7	1987/8	1988/9	Stock 89Q1
LENDING										
£ Lending to UK private sector	54.7	10.7	15.8	12.1	21.4	21.7	17.9	15.8	13.0	187.0
Lending in £ to overseas	9.1	3.4	3.6	3.9	5.5	2.2	3.2	0.5	-0.2	31.9
Lending in £ to public sector	16.6	0.1	-3.3	-0.9	-4.5	-0.4	-0.3	-0.1	-0.1	13.6
Net f.c. loans to all sectors (excl non-deposit liabilities)	1.2	0.3	-0.4	0.0	5.9	-0.5	-3.5	-0.5	0.5	7.9
TOTAL lending	81.6	14.6	15.6	15.0	28.0	23.2	17.3	15.6	13.1	240.4
Financial balance	-0.9	1.2	2.1	3.1	3.6	3.6	2.3	1.0	1.6	18.8
Equity and deb. issues	13.9	0.0	0.4	0.4	0.4	0.7	0.2	0.2	0.2	25.4
Purchases of equity & debs.	-2.2	0.1	0.1	-0.7	0.4	2.2	0.0	0.0	0.0	-2.8
Foreign currency non-deposit liabs.	0.3	0.0	0.0	0.5	4.3	1.8	0.5	0.5	0.5	3.7
Other sterling non-deposit liabilities	0.0	0.1	-0.7	-0.6	-1.8	-3.5	0.2	1.2	1.3	1.8
UK private sector sterling deposits	57.3	9.2	8.9	7.5	11.6	17.8	11.6	10.2	7.0	148.7
Overseas Sterling deposits	11.8	3.7	4.5	4.2	9.1	0.6	2.4	2.4	2.3	41.7
Public sector deposits	1.4	0.2	0.3	0.3	0.4	0.2	0.1	0.1	0.1	3.1
TOTAL	81.6	14.6	15.6	15.0	28.0	23.2	17.3	15.6	13.1	240.4
Of which: non-deposit liabilities:										
in sterling	—	1.5	1.9	2.3	2.6	3.1	2.7	2.4	3.2	—
in foreign currency	—	0.0	0.0	0.5	4.3	1.8	0.5	0.5	0.5	—
total	10.7	1.5	1.8	2.8	6.8	5.2	2.6	2.7	3.1	43.2

Building Societies

Recent developments

Although interest rates fell in the second half of last year, they remained high in real terms (retail price inflation also fell) and have risen again in the first quarter. The personal sector appears to have responded to this incentive to save, and the savings ratio is estimated at 13 per cent for the second half of the current financial year – extraordinarily high given the low actual and prospective rate of inflation.

Building Societies have been facing stiff competition from the banks – all the major clearers are now offering special high-interest instant-access accounts as well as free-if-in-credit banking. But though Building Societies have lost market share, the buoyancy of personal savings has kept inflows at healthy levels. Since the Societies have also been successful in the current financial year in raising money on the eurobond market (taking advantage of rule changes allowing gross interest payments from later this year) and in other unconventional ways, the inflow of money from their traditional sources has left them in an unusually liquid position, as the liquidity ratio reveals.

The immediate prospect is that these inflows will slow. Quite apart from the usual seasonal influences, the Building Societies are once again a step behind the banks in the interest rate dance, and have not matched the January increase in bank base rates. Our forecast is that this interest rate handicap will persist for the first half of the year. We expect the authorities to survive the recent pressure on sterling without further base rate increases, but bank rates will not get back to fourth quarter levels until the second half of the year. During this period we expect the Building Societies to attract a smaller proportion of new savings. Since mortgage demand remains strong, the Societies will continue to meet it by running down liquid balances, notably bank deposits. Some of the recent increase in money supply can be attributed to the build-up of Building Society deposits, and the preliminary figures for January, which suggest a slowdown in monetary growth, could be partly explained by the Building Societies drawing on their cash reserves to meet new commitments.

The outlook

House prices have been advancing substantially faster than general inflation, and we expect this to continue. Mortgage demand is thus forecast to remain strong despite high real rates of interest. In recent years, rising demand for new mortgages has outstripped the rise in deposits, and the Societies have bridged the gap by recourse to the wholesale money markets. From now on we expect the demand for new mortgages to stabilise, and to remain significantly above the flow of new deposits. The Societies will thus continue to be regular borrowers on the wholesale money market. However we do not expect them to raise as much in 1986-87 as in the current financial year. Moreover their cash flow will be worsened next year by the move to quarterly payment of Composite Rate Tax. Under these circumstances it is unlikely that the Building Societies will add to their cash reserves at the massive rate they achieved in 1985-86. The money supply figures should react accordingly.

P.W.R.

£ million	1985 Q4	Q1	Q2	Q3	Q4	1985 Jul	Aug	Sep	Oct	Nov	Dec
Net increase in shares & deposits outstanding	3380	3088	3467	3342	3160	1138	1335	869	818	1094	1248
Mortgages											
new commitments	5939	6064	6390	7021	8027	2163	2301	2557	2753	2785	2489
net advances	3462	3344	3514	3270	4190	1076	1045	1149	1254	1492	1444
Liquidity ratio, percent	17.5	16.8	16.8	16.9	17.2	17.1	17.1	16.9	16.8	16.7	17.2

Forecast

£ billion	Stock 81Q1	Actual 1981/2	1982/3	1983/4	1984/5	Estimate 1985/6	Forecast 1986/7	1987/8	1988/9	Change in base or asset prices	Stock 89Q1
SOURCES											
Financial balance	7.7	0.2	–0.2	0.9	0.7	1.3	1.1	1.0	1.3	0.2	14.2
Building Society Shares	51.4	7.0	10.3	11.8	12.4	13.9	13.8	13.2	12.6	0.0	146.6
Wholesale funds incl CDs	0.3	0.1	0.2	1.7	1.0	2.7	2.0	2.0	2.0	0.0	12.0
Other	–0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	–0.5
Accruals Adjustment	1.1	0.2	–0.2	0.3	0.3	0.7	–0.7	0.1	0.1	0.0	1.9
TOTAL SOURCES	60.1	7.5	10.2	14.8	14.4	18.6	16.2	16.3	15.9	0.2	174.2
USES											
Notes & Coin and bank deposits	1.7	0.6	0.2	1.7	–0.5	4.5	1.6	1.8	1.2	0.0	12.8
Treasury & LA bills	1.3	0.0	–0.5	0.1	–0.1	0.0	0.5	0.9	0.5	0.0	2.7
Gilts	12.7	1.1	0.9	1.9	0.3	–1.3	–1.1	–0.9	–0.8	0.2	13.1
House Purchase Loans	44.4	5.9	9.6	11.1	14.6	15.4	15.1	14.5	15.0	0.0	145.6
TOTAL USES	60.1	7.5	10.2	14.8	14.4	18.6	16.2	16.3	15.9	0.2	174.2

Pension Funds and Insurance Companies

The bank borrowing (mostly by insurance companies) built up during 1984-85 is estimated to have been partly run down in 1985-86. In the second calendar quarter of 1985, there were net repayments of loans and in the third quarter, net transactions were roughly zero. For the financial year as a whole we expect a small repayment of £300m. Equity and debenture issues by insurance companies are expected to be about £100m, a third of their size in the previous year. Net inflows in 1985-86 are expected to be £17.5 bn, an increase of only 5 per cent over the previous year. This is partly because inflows in 1984-85 were boosted by pre-Budget concerns about alterations to the tax treatment of pension schemes. In addition during 1985-86 there have been some reductions in employer contributions and increases in pension benefits in the light of the actuarial surpluses currently being experienced by pension funds. Further, the annual premium life business remains depressed following the withdrawal of tax relief in the 1984 Budget. A number of life companies have introduced their own unit trusts but this does not affect the figures shown here. On the other hand, dividend receipts continue to be strong. The combined effect of these factors is to reduce total sources available for investment from £17.8 bn in 1984-85 to £17.4 bn in 1985-86. With companies continuing to take action to remove pension fund surpluses, the inflows to the combined sector are again depressed in 1986-87. They rise by 7 per cent to £18.6 bn, against growth in total wages and salaries of 7.6 per cent.

On the investment side, there was a dramatic slowdown in gilts purchases in the third quarter when overfunding was officially ended. For example, the pension funds net investment in gilts fell from £1112m in quarter 1 to £257m in quarter 3. The main counterpart was an increase in the purchases of UK equities reaching £2.3 bn in the third quarter for the combined sector. For 1985-86 as whole equity purchases exceed gilts purchases, the first time that this has occurred since 1972. Overseas investment has continued to decline in 1985-86. Many institutions appear to have completed their portfolio adjustment following the ending of exchange control. In addition, the low exchange rate provides a disincentive to investment overseas. Property purchases appear to be more robust than in previous years and in the third quarter the pension funds spent almost as much on property as they did on gilts.

In later years equity purchases are expected to remain strong up till the end of the forecast period. This reflects both the acceleration in government asset sales and our forecast of substantial new issues by the industrial and commercial sector. Gilts purchases are also expected to recover from their 1985-86 low but are not expected to exceed equity purchases.

Note: Property and other assets

Data for this category are determined as a residual and so may incorporate errors and omissions from other asset categories. An example is given by the data for 1984-85. The figure of £16.6 bn for net inflows is taken from the national income accounts. The figures for uses are taken from the investment tables of Financial Statistics (or Business Monitor MQ5). For 1984-85, Financial Statistics suggest that property and other assets purchases came to £3.9 bn whereas the figure in our table, computed as a residual, is £3.6 bn. There is thus a small residual error of £300m. Within the £3.9 bn total property (and property unit trusts) accounted for £1.4 bn (37 per cent) while other assets (unit trust units, loans excluding house purchase loans, agents' balances, local authorities' mutual investment trust, and other investments) accounted for the remainder. With property accounting for less than 40 per cent of the total, the forecasts of around £3.5 bn for this asset category over the rest of the decade imply property purchases of around £1¼ to £1½ bn p.a.

D.P.C.B

	1985 Q1	Q2	Q3
		£ million	
Investment in:			
UK equities* –			
pension funds	655	1270	914
insurance companies	817	912	1391
Gilts –			
pension funds	1112	786	257
insurance companies	491	653	195
Overseas securities –			
pension funds	825	382	554
insurance companies	279	125	321
Short-term assets –			
pension funds	–80	–242	394
insurance companies	62	34	445
UK land and property –			
pension funds	113	23	238
insurance companies	199	375	119

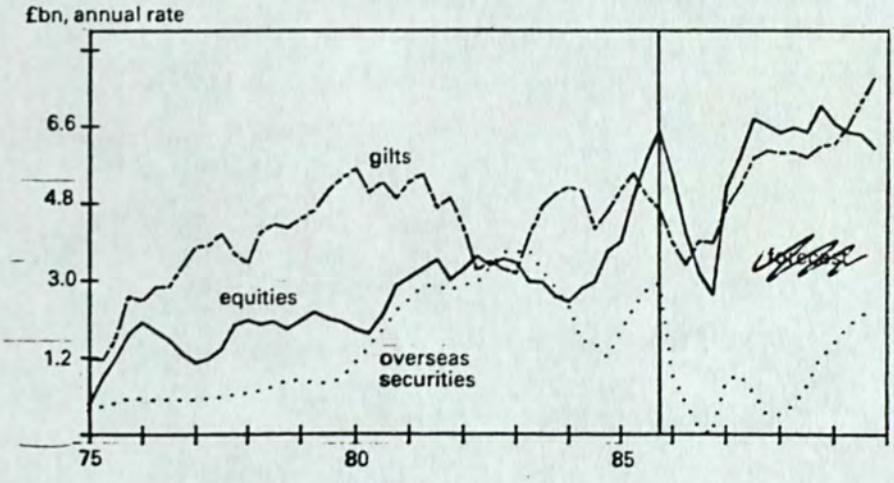
* including holdings of unit trusts or Local Authority Mutual Investment Trusts.

Sources and uses of funds: Pension funds and insurance companies

£ billion

£ billion	Stock 81Q1	Actual 1981/2	1982/3	1983/4	1984/5	Estimate 1985/6	Forecast 1986/7	1987/8	1988/9	Stock 89Q1
SOURCES										
Bank Loans	–0.4	0.1	0.4	0.5	0.9	–0.3	0.0	0.0	0.0	1.2
Insurance co. equity and deb. issues	11.8	0.1	0.0	0.0	0.3	0.1	0.0	0.0	0.0	22.1
Net inflow into Pension Funds and Insurance Co's	106.5	13.2	13.6	14.6	16.6	17.5	18.5	19.2	20.4	359.1
TOTAL SOURCES	117.9	13.4	13.9	15.1	17.8	17.4	18.6	19.3	20.5	382.4
USES										
Bank Deposits	2.7	1.2	1.0	1.7	2.4	2.9	1.1	1.7	0.3	15.1
Gilts	30.8	4.2	3.2	5.2	5.1	3.9	4.7	6.0	6.2	83.4
UK Debenture, Ordinary and Pref. Share Holdings	47.8	3.2	3.4	2.5	4.0	5.2	5.2	6.4	6.7	171.9
Foreign Currency Shorts	0.2	0.1	0.0	0.1	0.1	0.0	0.1	0.1	0.1	1.1
Treas. & LA Bills, B. Soc CDs	0.7	0.2	0.1	0.3	0.3	0.5	1.7	0.8	1.7	6.4
Overseas Securities	7.9	2.9	3.7	2.4	1.8	0.8	0.7	–0.1	1.5	49.1
House Purchase Loans	2.1	0.1	0.0	0.2	0.2	0.5	1.0	0.9	0.6	5.7
Property and other assets	25.7	1.5	2.6	2.7	3.6	3.5	4.2	3.5	3.4	49.8
TOTAL USES	117.9	13.4	13.9	15.1	17.8	17.4	18.6	19.3	20.5	382.4

PENSION FUNDS AND INSURANCE COMPANY INVESTMENT FLOWS
(4-qtr. moving average)



Public Sector

The forecast was completed in January at which time data on the PSBR was available for the first nine months of the current financial year (April-December). The cumulative total to December was officially estimated at £7.8bn which suggested a full-year outturn of £8bn. This is because in the last two years public borrowing in February-March has been more-or-less exactly offset by a surplus in January due to the onset of the corporate tax-paying season. On this basis we forecast a PSBR in 1985-86 of £8bn, in line with the Autumn Statement and unchanged from our previous forecast last October.

However, in January the public sector made a net repayment of £4½bn, so that the cumulative total is currently only £3.2bn (see chart opposite). Even though borrowing in March will be raised by lower oil tax receipts (reflecting the first weakness in the oil price late last year), the full-year total is not now likely to reach the £8bn shown in our table. The Treasury's Budget forecast of £7.1bn may therefore be closer to the mark.

The improvement in public sector finances has taken place in spite of lower oil tax receipts, which we estimate at £10.7bn this financial year, a shortfall of nearly £3bn compared with the Budget forecast. This in turn is due to the appreciation of sterling against a falling dollar – the Treasury calculation was based on $1.10 to the pound against a likely outturn of $1.37.

The oil shortfall has been offset by non-oil tax receipts – Consolidated Fund revenues were £14.9bn in January, £2½bn higher than a year earlier, compared with expenditure of only £9.1bn which was little changed over 12 months. The buoyancy of non-oil revenues stems largely from company tax payments – not only have profits recovered strongly, but also the effects of the 1984 restructuring of corporation tax are now boosting receipts.

The outlook for public sector finances is dominated by the uncertainties associated with the oil price. For forecasting purposes we have assumed that North Sea oil prices average $20 a barrel in 1986-87 which implies total North Sea tax revenues of £6.3bn, over £5bn below last year's Budget forecast. This effectively removes the scope for cutting taxes in this year's Budget and, on the basis of unchanged policy (Rooker-Wise indexation of tax allowances and bands and re-valorisation of indirect taxes in line with inflation in 1985), we expect the PSBR in 1986-87 to reach £9.1bn, £1½bn above the 1985 Budget guideline. In 1987-88 and again in 1988-89, on the basis of buoyant tax receipts, we forecast that tax cuts of about £1bn will be possible.

The £9.1bn PSBR projection for 1986-87 comprises a fiscal deficit of £14bn with £5bn of favourable financial items. In addition to asset sales, which we assume will meet the government's revised £4¾bn target, there is a favourable accruals item of £0.6bn as the Building Societies begin to pay tax on a quarterly basis. In the two following years accruals revert to being unfavourable and net financial transactions are £3¾bn each year. The reduction in the PSBR is therefore due to a lower fiscal deficit.

We assume that the government continues throughout the forecast period with its new policy of keeping funding much closer to the PSBR than in the last four years. This policy was confirmed in last year's Autumn Statement. With the PSBR declining slightly in nominal terms, and from 2½ per cent to 1½ per cent of GDP at market prices, this reduces the funding requirement and is consistent with interest rates falling back from current high levels.

We estimate that national savings will account for £2.6bn of funding this year. This is below the original target of £3bn, but that target was announced before the change in overall funding policy. In 1986-87 and beyond we expect the lower overall funding requirement to be reflected in a reduction in the target for national savings. Also we expect slower growth of notes and coin (reflecting lower overall inflation) and tax instruments. Thus gilts and other long-term debt sales to the non-bank private sector and overseas, which essentially are the residual funding element, remain fairly stable at a little over £6bn p.a.

G.R.D.

£ million, s.a.	1985 3 months ending Mar 20	June 19	Sept 18	Dec 11	1985 month ending Nov 20	Dec 11	1986 Jan 15
CGBR	2334	2053	3953	2915	1905	115	54
net contribution from rest of public sector	163	106	–1167	–1289	–1089	460	–356
purchase of central government debt by NBPS	3782	2281	1159	2045	707	349	–360
of which: stocks (n.s.a.)	2972	1361	410	1479	671	296	106
national savings	459	854	886	439	184	58	20
	Q1	**Q2**	**Q3**	**Q4**	**Nov**	**Dec**	**Jan**
PSBR, n.s.a.	–118	2618	2958	2091	674	1712	–4501

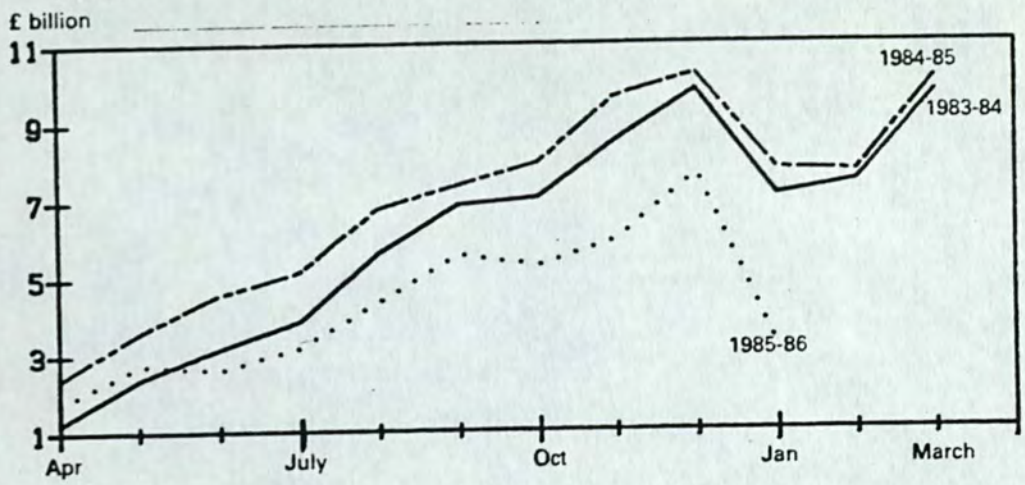
Revenue and expenditure are Consolidated Fund figures. Gilts and National Savings figures are in banking months and gilts data refer to marketable debt (stocks)

Sources and uses of funds: Public sector

£ billion

	Stock 81Q1	Actual 1981/2	1982/3	1983/4	1984/5	Estimate 1985/6	Forecast 1986/7	1987/8	1988/9	Change in base or asset prices	Stock 89Q1
Financial balance	102.3	5.8	9.1	12.2	15.1	10.5	14.1	11.9	10.2	–3.2	188.0
UK Debenture, Ordinary and Pref. Share Holding	0.0	0.4	0.1	–1.1	–2.1	–3.2	–4.8	–4.8	–4.8	3.6	–16.5
House purchase loans	4.6	0.8	0.6	–0.4	–0.4	–0.2	–0.2	0.0	0.0	0.0	4.9
Trade credit	–0.8	1.1	–0.4	–0.5	–0.6	–0.3	–0.1	0.0	0.0	0.0	–1.6
Other	–12.5	–0.9	–0.4	–0.4	–0.9	1.8	0.7	0.7	0.7	18.2	6.9
Accruals	7.0	1.3	–0.1	–0.1	–0.4	–0.3	–0.6	0.3	0.3	0.0	7.5
PSBR	100.6	8.6	8.9	9.8	10.6	8.2	9.1	8.1	6.5	18.6	189.1
Bank Deposits	–1.4	–0.2	–0.3	–0.3	–0.4	–0.2	–0.1	–0.1	–0.1	0.0	–3.1
Notes and Coin	11.4	0.1	1.2	0.3	0.8	0.7	0.8	0.3	0.4	0.0	15.9
Gilts and other long-term debt sales to NBPS and overseas	67.1	7.0	5.7	10.7	10.1	5.7	6.5	6.3	6.3	19.9	145.2
National Savings	15.3	4.2	3.0	3.3	3.0	2.6	1.7	1.5	1.5	0.0	36.0
Reserves and other f.c.	–7.1	0.8	1.6	0.2	0.4	–0.4	0.0	0.0	0.0	–3.9	–8.4
Issue Department purchases of ICC and overseas (ECGD) bill	–2.8	–4.2	0.3	–3.1	0.4	–0.4	–1.3	–2.1	–3.3	0.0	–16.5
Bill and other debt sales to banks	15.1	0.4	–3.0	–0.9	0.2	–0.6	–0.4	–0.3	–0.2	6.6	16.9
Bill sales to UK NBPS	2.6	0.0	–0.5	0.1	0.1	0.1	1.1	1.2	0.8	0.0	5.5
Bill sales to overseas	0.5	–0.1	0.2	0.0	0.1	–0.3	0.4	0.6	0.7	0.0	2.1
Net indebtedness to BoE	0.0	0.1	–0.1	–0.1	–4.9	0.1	0.1	0.1	0.1	0.0	–4.6
Tax instruments	—	0.4	0.8	–0.3	0.7	0.8	0.4	0.4	0.5	—	—
PSBR	100.6	8.6	8.9	9.8	10.6	8.2	9.1	8.1	6.5	18.6	189.1

PSBR
(Cummulative total, within financial years)



Unit and Investment Trusts

The sharp rise during 1985 in total net sales of Unit Trusts noted in the previous *Financial Outlook* has continued to the end of the year. The fourth quarter saw net sales of almost £1bn compared with only £244 million in the fourth quarter of 1984. These figures reflect both internal growth and the launching of new trusts, especially by the Insurance Companies. As a result of these recent trends we have revised upwards our forecast of sales for 1985-86 onwards.

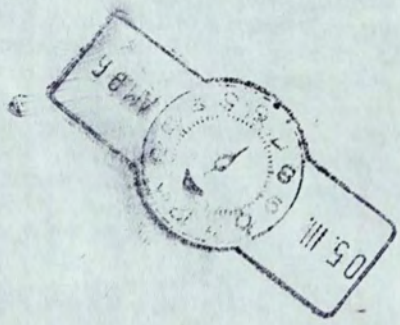
On the investment side the volatility of the purchases of overseas securities continues. In 1985 first quarter investment and unit trusts between them acquired £574 million of overseas securities. Purchases then dipped to £75 million and £115 million in quarters 2 and 3 respectively. We forecast that the recent pattern of overseas, UK equity and gilts investment will continue with domestic equity investment around one to two times the level of gilts. It is of interest to note that investment trusts continue to be net sellers of listed equities – partly reflecting recent liquidations – but net buyers of unlisted equities.

P.L.L.

£ million	1984 Q1	1984 Q2	1984 Q3	1985 Aug	1985 Sep	1985 Oct	1985 Nov	1985 Dec	Estimate 85/86	Estimate 86/87
Net sales of Unit Trust units*	511	415	718	185	361	308	361	225	n.a.	
of which: to the personal sector	-201	-178	-308			n.a.			1021	1000
Investment Trust equity issues	-48	-55	-11						95	50
Investments:										
UK equities – ***										
Unit Trusts	149	273	281							
Investment Trusts	-72	20	-96							
Gilts –						n.a.			n.a.	
Unit Trusts	19	0	39							
Investment Trusts	12	-7	101							
Overseas company securities ****										
Unit Trusts	323	108	173							
Investment Trusts	189	-27	-96							

* excluding property unit trusts
** LBS forecast
*** listed ordinary shares.
**** ordinary shares.

Forecast £ billion	Stock 81Q1	Actual 1981/2	Actual 1982/3	Actual 1983/4	Actual 1984/5	Estimate 1985/6	Forecast 1986/7	Forecast 1987/8	Forecast 1988/9	Change in base or asset prices	Stock 89Q1
SOURCES											
Financial balance and sales of unit trust units to OFIs	1.3	0.3	1.0	1.2	0.8	2.1	2.1	2.1	2.3	2.0	15.2
Bank Loans	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Unit Trust Units sold to the personal sector	3.3	0.1	0.2	0.8	0.5	1.0	1.0	1.0	1.0	7.1	16.1
Investment Trust Equity Issues	5.3	0.0	0.0	0.1	0.2	0.1	0.0	0.0	0.0	15.0	20.8
TOTAL SOURCES	10.0	0.4	1.2	2.1	1.4	3.2	3.1	3.1	3.3	24.1	52.0
USES											
Bank Deposits	0.1	0.1	0.0	0.5	0.6	0.7	0.7	0.7	0.9	0.0	4.3
Gilts	0.4	0.0	0.1	0.2	0.1	0.3	0.3	0.3	0.3	-0.1	1.8
UK Debenture, Ordinary and Pref. Share Holdings	8.2	-0.3	-0.2	0.2	0.4	1.1	1.0	1.0	1.0	11.1	23.6
Foreign Currency short-term assets	-0.1	0.0	0.1	0.4	0.1	0.5	0.5	0.5	0.5	-0.4	2.0
Overseas Securities	1.4	0.5	1.1	0.9	0.3	0.6	0.7	0.7	0.7	13.5	20.3
TOTAL USES	10.0	0.4	1.2	2.1	1.4	3.2	3.1	3.1	3.3	24.1	52.0



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Covering SECRET

QU

EMP X/12

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DATE: 3 March 1986

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THE RESERVES IN FEBRUARY 1986

The reserves announcement for February will be made on Tuesday 4 March at 2.30 pm. This month's announcement reports a rise in the reserves of $250 million and an underlying rise of $112 million. I attach for the Economic Secretary's approval a draft of the press notice, together with Q and A briefing.

D McSharry

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THE RESERVES IN FEBRUARY 1986

The UK official reserves rose by $250 million in February. Accruals of borrowing under the exchange cover scheme amounted to $190 million; repayments of such borrowing amounted to $50 million. Capital repayments on assignments to HMG of other public sector debt taken out under the exchange cover scheme amounted to $2 million. At the end of February, the reserves stood at $15,810 million (£10,900 million*) compared with $15,560 million (£11,046 million+) at the end of January.

Note to Editors

2. After taking account of foreign currency borrowing and repayments, the underlying rise in the reserves during February was $112 million. The underlying change in the reserves is the result of a variety of transactions, both debits and credits including, for example, transactions for Government departments and with other central banks, and interest receipts and payments. The underlying change should not therefore be taken as an indication of market intervention during the month. The above figures can also be obtained from the Reuters Monitor (Code TREA).

3. Accruals of borrowing under the public sector exchange cover scheme were as follows :

South of Scotland Electricity Board, $161 million; West Midlands County Council, $19 million; Merseyside County Council, $10 million.

---

* When converted at the closing market rate on Friday 28 February £1 = $1.4505

\+ When converted at the closing market rate on Friday 31 January £1 = $1.4086

Repayments of such borrowing were:

National Coal Board, $25 million; British Steel Corporation, $12 million; South of Scotland Electricity Board, $5 million; British Telecommunications plc, $3 million; British Airways, $2 million; British Railways Board, $1 million; North West Water Authority, $1 million; Others, $1 million.

THE RESERVES IN FEBRUARY 1986 : PRESS BRIEFING

Factual : Main features of markets in February

	£ ERI	$/£	DM/£	$ ERI	DM/$	Yen/$
3 February	73.5	1.3870	3.3267	123.7	2.3985	191.41
7 February	74.4	1.4020	3.3739	123.3	2.4065	190.92
20 February	74.7	1.4540	3.3515	118.9	2.3050	180.60
28 February	73.2	1.4505	3.2368	117.0	2.2315	180.70

Sterling began February sharply lower as oil prices weakened, but unexpectedly good money supply and reserves figures helped the pound to strengthen. Sterling strengthened further as the dollar declined and oil prices firmed on the back of rumours that some Middle Eastern producers were contemplating reductions in output. As the dollar continued to weaken, particularly against the deutschemark, sterling briefly kept pace but fell behind at the end of the month, as oil prices weakened again, falling to an all-time low of DM 3.2335 on 28 February.

Positive

Second month in succession that underlying increase has been registered [IF PRESSED: last month's statement noted special factor of EC abatement - part of the payments connected with the abatement was taken off-market to minimise risk of market disruption].

Defensive

Q1. **Underlying increase implies intervention against pound**

Underlying change not a good guide to market intervention. Reflects a large number of other transactions, for example, government departments and interest receipts and payments.

Not practice to discuss detailed reserve transactions, especially those involving the Bank's customers.

Q2. **Exchange and interest rate policy**

Government policy unchanged. No exchange rate target, but rate taken into account in assessing monetary conditions. Priority is to maintain firm downward pressure on inflation. While no one likes high interest rates, government has shown that it will not hesitate to take action if necessary.

Q3. **Effect of oil price falls on exchange rate**

Markets have been naturally disturbed by recent falls in oil prices. But the actual relationship is complex and uncertain.

Q4. **Weakness of sterling in December-February**

Well known that sterling can react to oil market developments in a way which other leading currencies do not. Some grounds to believe that some market operators exaggerate significance of oil to UK economy. Effect of fall in oil price on output and inflation expected to be broadly neutral, if anything slightly beneficial.

Q5. **ERM**

Position unchanged. Matter kept under continuous review. Government views most recently stated by Economic Secretary in HC debate on 29 January (Hansard vol. 90 no. 46 cols 979-1009).

Q6. **Intervention details/tactics**

General practice of governments not to comment on market tactics.

Q7. **Exchange rate and competitiveness**

Depreciation not way to improve competitiveness. Recent fall in sterling due to fall in oil price. Vital that British companies do not regard lower exchange rates as an easy option. Key is realistic pay deals and better

productivity. Government providing best environment by pursuing responsible domestic policies.

Q8. **Exchange rate stability**

Greater stability clearly desirable. But markets bound to be affected by recent sharp fall in oil prices.

Q9. **UK reserves dangerously low**

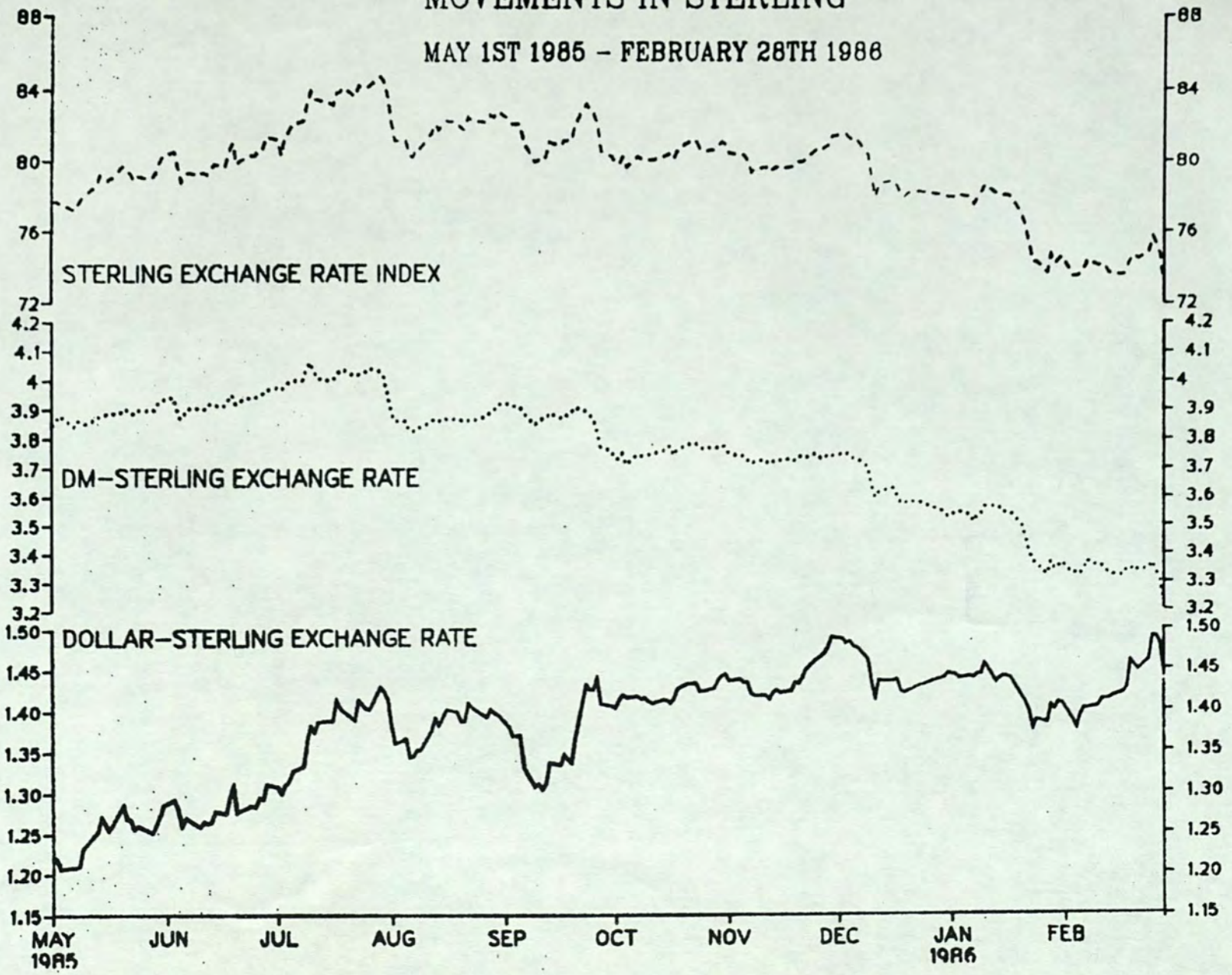
No. Rose this month and last. UK reserves at end-February higher than 12 months earlier (end-Feb 1985 : $15.4 billion). Valuation differences affecting gold and non-dollar reserves make precise comparisons difficult.

Q10. **SSEB commercial paper programme increase suggests change in borrowing strategy**

No. Planned for some time. New borrowings and repayments under the exchange cover scheme tend to net out over time but individual months can show large increases or decreases in net borrowing, ie timing of borrowings and repayments do not necessarily coincide.

MOVEMENTS IN STERLING

MAY 1ST 1985 – FEBRUARY 28TH 1986



Prime Minister 2

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

FROM: B H KNOX

DATE: 27 February 1986

CHANCELLOR

cc: PS/Prime Minister
CST
FST
EST
Minister of State
Sir P Middleton
Mr Cassell
Mr Peretz

INVESTIGATION OF VAT GOLD FRAUD

Our Investigation Officers have been looking into a gold smuggling ring whereby gold bars minted in Switzerland have been sold through a chain of suppliers to final purchasers who have paid VAT to their suppliers but these suppliers have gone missing not accounting for VAT. JMB who were a final purchaser of gold have been visited to obtain evidence of the purchases on which they paid VAT to the absconding suppliers. A team of 50 investigators have visited 27 sets of premises in Birmingham, Preston and London to obtain evidence on the suspected irregularities, 13 persons have been arrested and will be charged tomorrow and 2-1/2 kilos of smuggled gold have been seized.

2. Our investigators are assessing the voluminous evidence obtained but we will not be in a position to give an informed assessment of the extent of the involvement of various parties until next week.

Bryce Knox
B H KNOX

Internal distribution:

CPS Mr Jefferson Smith Mr Teller

Ms/24

CONFIDENTIAL

CCBG

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

24 February 1986

The Rt Hon Paul Channon MP
Secretary of State for Trade and Industry
Department of Trade and Industry
1 Victoria Street
LONDON SW1

NBPN.

Dear Paul

REGULATION OF THE WHOLESALE MONEY, FOREIGN EXCHANGE AND BULLION MARKETS

The Governor has expressed to me his concern about important gaps in the proposed regulatory framework which the financial services, banking and building societies legislation will form. In a nutshell, he is concerned that the Bank's present non-statutory surveillance of the wholesale money, foreign exchange and bullion markets could well prove an insufficient backing for the Bank's authority in the future, when the bulk of the financial services industry will be statutorily regulated. I have to say that, having looked into this, I agree with the Governor, and believe we should provide statutory backing for the Bank's role in these markets.

At present, the Bank of England oversee the wholesale foreign exchange and currency deposit markets through the British Bankers Association (BBA) and the Foreign Exchange and Currency Deposit Brokers Association (FECDBA), and have a non-statutory system of "recognition" in these markets, and a Code of Conduct. The bullion market is subject to less formal supervision and there is no written Code. The Bank's regulation of the sterling money markets is also less formal, and is exercised through a joint standing committee of principals and brokers in the sterling deposit market, with an appropriate Code of Conduct for all participants.

The Bank's specific proposals are as follows:-

(a) Wholesale foreign exchange and bullion markets
The Bank seeks statutory powers

(i) To enable them to deem banks and licensed deposit-takers (a distinction to be abolished in the new banking legislation), also to be authorised to conduct a business in the wholesale foreign exchange and/or bullion markets;

(ii) To authorise directly brokers and other non-bank principals conducting a business in the foreign exchange/bullion markets;

(iii) To issue conduct of business rules to govern transactions in these markets.

(b) The Bank regard the following as those instruments dealings in which constitute the wholesale money market:-

- Certificates of deposit up to 5 years original maturity (traded in London)

- Other sterling or foreign currency debt liabilities of UK recognised banks, LDTs and building societies of up to five years original maturity (as defined in Section 18 of Schedule 1 of the Financial Services Bill);

- Treasury Bills; local authority bills; local authority bonds of up to one year; commercial paper of up to one year; short-term (up to one year) corporate bonds; sterling deposits and commercial bills (notwithstanding their exclusion from the scope of the Financial Services Bill). Equivalent non-sterling instruments would also be covered.

One route our officials have explored at an earlier stage is the exclusion of some or all of these instruments from the definition of invetment in the Financial Services Bill. The Bank does not now propose exclusion, but suggests as a preferable route that it should be given powers:-

(a) To deem banks and licensed deposit-takers, authorised as deposit-takers under the Banking Act, to be similarly authorised to participate in the money markets.

(b) To authorise directly brokers participating in the money markets.

(c) To issue conduct of business rules for banks and brokers.

In the case of the money markets, however, the Bank do not wish to authorise other non-bank or non-broker participants. Under the Bank's scheme, the SIB or the relevant SRO would authorise participants who were neither banks nor brokers, and would issue identical rules of conduct to those issued by the Bank.

I am not wedded to the detail of the Bank's scheme, which clearly needs to be thought through further. In particular, there is an awkwardness about divided responsibility for authorisation in the money market, and it may be that the price of giving statutory backing to the Bank's traditional authority is a responsibility for authorising all those conducting a business in that market.

CONFIDENTIAL

The position of the wholesale money markets under the Financial Services Bill has been under discussion between our officials for some months. I entirely accept that it is unfortunate that the Bank have brought this new proposal to our attention at such a late stage, when the Financial Services Bill is already in Committee. But these provisions do fit logically into the conceptual framework of the Financial Services Bill. On the model of the reciprocity provisions, already included in the Bill, I might be given parallel powers to yours to designate an agency - the Bank of England - in respect of the foreign exchange, bullion and money markets. The Bank would then have similar powers to the SIB in relation to those markets which it supervised, and those provisions of the Financial Services Bill which were appropriate would apply to institutions operating in those markets.

I hope that our officials can discuss this soon, and report to us urgently.

I am copying this letter to the Prime Minister, the Lord Privy Seal, the Chief Whip and Governor of the Bank of England.

NIGEL LAWSON

SECRET

5

COPY NO 51

FROM: H P EVANS
DATE: 30 January 1986

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
PCC Members
Mr Fitchew
Mr Monger
Mr Peretz
Mr Odling-Smee
Mr Turnbull
Mr S Davies
Mr Mowl
Miss Peirson
Mr Riley
Mr Cropper
Mr Lord
Mr H Davies
Sir L Airey (IR)
Sir A Fraser (C&E)

Prime Minister 2

I suggest paragraphs 1-33 and, particularly the thorough discussion of employment prospects in paragraphs 112-120. There is a forecast assuming $18 oil on the back.

DHS
10/2

TREASURY ECONOMIC FORECAST

I attach a copy of our report on the internal forecast. While we base the main case on an oil price of around $20 a barrel, we look at the possible consequences of a $15 oil price.

2. Miss Peirson's report on Public Sector Finances is being circulated separately. It provides chapter and verse for our view that the lower oil revenues in the main case remain consistent with a sizeable, but reduced, fiscal adjustment in 1986.

3. With oil and financial markets so volatile, there is a somewhat greater than usual risk of changes to the forecast when we carry out the usual updating exercise next month for final decisions in the Budget and for the FSBR.

HPE

H P EVANS

SECRET

TREASURY ECONOMIC FORECAST

JANUARY 1986 REPORT

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(ii) fiscal prospects	8-12
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Annex: Comparison with outside Forecasts

SECRET

TREASURY ECONOMIC FORECAST: JANUARY 1986

Report by EA

Introduction

This is the report on the internal January exercise. Detailed reports are being circulated as follows:

Public finances, Miss Peirson (PSF).

Oil production and revenues, Mr Hacche (EA2).

Financial forecast, Mr Mowl (EA2).

World economic prospects, Mr Matthews (EF2).

2. In general, we follow the policy framework of the last MTFS. The forecast covers the next two years, in summary pages 2-15, and in detail pages 21-59. Pages 16 to 20 outline the consequences of yet lower oil prices.

3. The **world economy** is now in a period of moderate growth and low inflation. The steep fall in oil prices in recent weeks will bring benefits to consumers in the form of lower inflation and higher growth of real incomes.

SUMMARY

4. The forecast makes broadly the same assumptions as the MTFS: that monetary and fiscal policy together will be set so as to bring about a decline in the growth of nominal GDP.

5. From 1986-87 onwards, the PSBR is as in the MTFS, although the composition (especially higher asset sales and lower oil revenues) has changed. This suggests that fiscal policy is a little easier than in the MTFS. To compensate for this and for the tendency of money GDP growth to be a little faster, monetary policy has to be somewhat higher than was implied by the projections underlying the MTFS.

6. Indeed monetary policy is already tighter. The exchange rate is higher, and interest rates are very high, in real terms, in relation to other countries and relative to the MTFS.

Oil prices

7. The main uncertainty in this forecast is the level of oil prices and the consequences of the recent fall in prices for the world economy and the UK. Ever since 1982, successive forecasts allowed for falls in real oil prices as a consequence of the growing imbalance between supply and demand - but these falls did not begin until 1985.

8. We have assumed that North Sea prices average $20 for the rest of this year and in 1987, 25 per cent below last year. A bigger fall is likely if OPEC does not reduce its output. Even if the price does average $20 for 1986, there are liable to be sharp fluctuations: one possibility is that prices will fall further before recovering later in the year.

Exchange rates and interest rates

9. This forecast was completed against the market background of a falling pound and upward pressures on interest rates. Thus far the exchange rate has fallen no more than would be expected given the fall in oil prices. Fears of further oil price falls, and some uncertainty over policy, may explain the current market pressures. The situation is, however, different from a year ago, when there was only a modest fall in oil prices in relation to the fall in the exchange rate, and a larger rise in UK interest rates. Last year these factors led to a sharp recovery in the exchange rate, though with some delay.

10. We assume that the exchange rate fall attributable to oil prices (using a ratio of about 1:4) is accommodated with only a moderate rise in interest rates - because the net effect on inflation is probably small. We also assume that, whatever the immediate fluctuations, the lure of high UK rates will serve to steady the exchange rate once the uncertainties over oil prices and over policies are reduced.

	Exchange rates		North Sea Oil price		Short-term Interest rates, per cent		
	Effective index	$/£	$	£	UK	UK-world differential	UK "real"
1984 Q4	75	1.22	28½	23½	10	1	5½
1985 Q4	80	1.44	29	20	11½	3½	7
1986 January 29	74	1.39	18½	13½	13	5	9½
1986 Q4	75	1.44	20	14	11½	4½	7½
1987 Q4	73	1.48	21½	14½	10¾	4½	6½

The financial forecast

11. MO growth has slowed down this financial year, probably in response to higher interest rates. The growth of MO remains around 4 per cent in 1986-87 and 1987-88 as the growth of personal incomes stays high and interest rates decline slowly. We judge that rapid growth in £M3 is consistent with low inflation: there is every reason to expect further falls in velocity. A chart on page 59 shows that in successive versions of the MTFS (the same is true in internal forecasts) there has been a pronounced tendency to over-forecast £M3

velocity. (Forecasts of money GDP have been much more accurate than forecasts of £M3.) The scale of financial liberalisation, and probably somefall in the price of financial services, is continuing to encourage both companies and persons to hold more financial assets and liabilities. The forecast is summarised and compared with the MTFS in the following table:

Monetary Policy Targets and Indicators

(per cent changes on a year earlier for M0 and £M3)

	Sterling Index		M0		£M3		UK short Interest Rates	
	Forecast	MTFS	Forecast	MTFS range	Forecast	MTFS range	Forecast	MTFS
1984-85	76	76	5½	4-8	9½	6-10	11	11
1985-86	79	74	4½	3-7	13	5-9	12¼	12
1986-87	75	74	3½	2-6	13	4-8	11¾	10
1987-88	73	72	3½	1-5	12	3-7	10¾	9

Inflation

12. Inflation, as measured by the RPI, is now set to fall quickly. Even with a rise in mortgage rates, the RPI should be a little below 4 per cent in the second quarter, on the assumption that indirect taxes are indexed in the budget. By the fourth quarter the RPI rate may be about 4 per cent: the slight deterioration compared with the Autumn Statement reflecting adverse movements in the mortgage rate and local rates. The broader measure of inflation, the GDP deflator, is expected to rise by 5½ per cent in 1985-86, and 4 per cent in 1986-87: both figures would be 1-1½ per cent higher without the steep decline in sterling oil prices. Most measures of inflation are not expected to change much in 1987: lower increases in wages and profits should offset the faster growth of import prices.

Income and spending

13 Rising output and falling commodity prices should provide companies (except those in the North Sea) and households with substantial rises in real incomes; we expect real incomes of industrial and commercial companies to rise a further 7 per cent in 1986, while persons' real incomes, after tax, may rise by about 5½ per cent. This includes ½ per cent from the assumed fiscal adjustment.

14. Judgments about private sector spending also take into account the high level of interest rates and the availability of finance. The forecast gives greater weight to the high level of interest rates than to the availability of finance. Even so, private sector spending is likely to rise strongly this year, and, though perhaps more slowly, in 1987.

Constant prices, per cent changes on a year earlier

	level in 1984 £ bn	1985	1986	1987
Company sector spending	27	4	4	3½
Personal sector spending	152	2½	4	4
Government spending on goods and services	62	1	½	0
Total domestic demand	241	2	3½	3

Activity

15. Both 1984 and 1985 saw strong rises in **exports**: for manufactures export growth was probably 1-2 percentage points above the growth in world trade. We have assumed that this good performance will not be repeated: even so, export growth in 1986-87 may not be much short of that in world markets. In the home market too 1985 was a good year for domestic manufacturers, with only a slow rise in import penetration.

16. The fastest period of (underlying) growth in the economy was probably in the second half of 1984 and first half of 1985: some 4 per cent at an annual rate. There was some slowing down in the course of 1985: our forecast, which seems consistent with the January CBI Trends survey, suggests that underlying growth will be around 2½ per cent in 1986 and 1987.

Per cent changes on a year earlier

	1985	1986	1987
Domestic demand	2	3½	3
Exports (non-oil)	6	3	3
Imports (non-oil)	4	5½	4
GDP: non-oil output	3½(3)	3 (2½)	2½
GDP: total output	3½(3)	3 (2½)	2

Figures in brackets are after adjustment for the effects of the coal strike

Unemployment

17. The continuing rise in activity is probably still creating new jobs, though the statistics are not adequate to measure the scale of increase with any accuracy. Unemployment has risen only a little in the past nine months. The increasing effect of special employment measures (this forecast assumes extra spending out of the reserve of £150 million net in 1986-87), the re-structuring of National Insurance Contributions, and the slow down in the growth of the labour force may well make for a slow fall in unemployment. But at the aggregate level, there is no sign of any downward adjustment of real wage growth in the UK.

Current account of the balance of payments

18. The current account has been in sizeable surplus for some years now, and we expect another substantial surplus to be earned in 1986, despite the decline in oil prices. The deficit on manufactures may increase, with the surplus on invisibles growing. 1987 may see a smaller surplus, partly because of a smaller contribution from oil.

Nominal income: the policy framework and the impact of falling oil prices

19. The forecast is for the growth of money GDP to slow down, though by rather less, mainly in 1987-88, than in the MTFS:

	per cent			
	1984-85	1985-86	1986-87	1987-88
MTFS	6¾	8½	6½	5¾
January forecast	7(8½)	9(7½)	6½(6½)	7

Figures in brackets are adjusted for the estimated effects of the coal strike. Growth in nominal GDP this year is turning out very close to that in the MTFS.

The composition of money GDP growth in the forecast is as follows:

	per cent			
January forecast	1984-85	1985-86	1986-87	1987-88
GDP Deflators total	4½	5½(5)	4 (4½)	4½(3½)
non-oil	3½	7	5½	4½
oil	+ 15	- 18	- 28	+ 1
output (strike adjusted)	3½	2½(2½)	2½(2)	2 (2)
Nominal GDP (strike adjusted				
: total	8½	7½(7)	6½(6½)	6½(5¾)
non-oil	7½	9	8½	7½

Figures in brackets are from the 1985 MTFS

20. Even though oil output represents only 5-6 per cent of total GDP, the big price falls mean that its contributions to changes in nominal GDP are significant. The bottom line shows that there is a declining trend in non-oil nominal incomes in both of the forecast years. This mainly reflects the trend in prices: the fall in oil and other commodity prices working their way through to wages and profits. The fall in nominal GDP brought about by lower oil prices is at least partly offset by a faster rise in output in the non-oil sector.

Risks and uncertainties

21. Errors from past forecasts are reminders of the scope for error:

	Forecast	Average error from past forecasts
GDP growth 1985 to 1986	3	1
Balance of payments on current account, £billion, 1986	4	2½
RPI: per cent increase to fourth quarter, 1986	4	1*
Fiscal adjustment 1986-87, £ billion	2	2½**

* Average error calculated from budget forecasts since 1979

** Average error calculated from PSBR errors in budget forecasts (since 1981)

The fiscal prospect

22. On **Public expenditure**, (full details are set out in Miss Peirson's note) we start with the plans in the 1986 PEWP, though for years after 1986-87 the plans look increasingly unrealistic in some key areas. We attempt to forecast whether the Reserves will be over or under spent, and by how much. For 1986-87, we make the following crucial assumptions:

(i) There will be no major policy changes increasing expenditure. But the pressures on programmes are nearly always upwards.

(ii) There will be no major unexpected calls on the Reserve - such as a coal strike.

(iii) Economic developments will be as in our main forecasts.

23. The new style Reserve covers all spending over and above programmes. By calculating the difference between outturn and programme plans for the year immediately ahead we see the size of reserve that was actually needed in recent years:

	£ billion					
	1981-82	1982-83	1983-84	1984-85	1985-86 Forecast	1986-87 Forecast
Reserve needed	1.5	1.4	2.2	6.1 (3.5)	4.7 (3.6)	4½
Allowance in Budget forecast	1.6	2.4	- 0.1	2.8	5.0 (4.5)	4½*

Figures in brackets exclude the costs of the coal strike.

* 1986 PEWP

24. The increasing difficulties of public expenditure control are reflected in the top line. For 1986-87, it is sensible to make a comparison with the strike adjusted figures for earlier years. Except for 1983-84, the allowance made in the FSBR for the year ahead was about right, if the coal strike effects are excluded.

25. Our central estimate of the **Reserve** required is £4½ billion in 1986-87. It is a coincidence that this is the same figure as in the PEWP.

26. For later years the Reserves have usually been seriously inadequate: the same is likely to be true of current plans, by perhaps £2½ billion in 1987-88 and perhaps double that in 1988-89. The increase in the Reserve (from £4½ billion in 1986-87 to £6¼ billion in 1987-88 to £8 billion in 1988-89) is barely enough to cover the likely increases needed for local authorities alone, and there will be other claims (such as social security) increasing over the period.

27. **Revenues** are buoyant, except for oil revenues which are forecast to fall from £11½ billion this financial year to £8 billion in 1986-87 and £6½ billion in 1987-88. This is based on a North Sea price of $20 a barrel.

The table below analyses the forecasts of central government revenues from taxes and National Insurance contributions.

CG revenues (excluding oil taxes) from taxes and NICs, as proportion of nominal income (less oil), per cent

		1983-84	1984-85	1985-86	1986-87**	1987-88**
(1)	Actual/forecast	33.4	33.3*	32.8	33.2	34.0
(2)	Line (1) adjusted to remove effects of changes in tax rates and allowances in 1984 and 1985 Budgets	33.4	33.3*	33.4	33.7	34.4

* adjusted for effects of coal strike (because the net effect on revenues was small)

** before fiscal adjustment

28. The rise of more than one percentage point between 1984-85 and 1987-88 in the adjusted proportion mainly reflects the effect of real fiscal drag on personal income tax (worth about £¾ billion). Receipts from corporation tax rise rapidly because of the lagged reaction of onshore company taxes to the rapid rises in profits in earlier years. A further factor is the forecast shift in the distribution of income from 1985-86 in favour of employment incomes and away from onshore company profits (reversing the shift seen up till then). This will tend to raise taxes for given total nominal incomes because the average tax rate on employment income is higher than on company income.

29. Since the 1985 MTFS, the forecasts have changed as follows:

£ billion	1985-86		1986-87	
	MTFS	Jan 86	MTFS	Jan 86
Oil revenues	13½	11½	11½	8
Non-oil revenues	136½	138	147½	150
Total	150	149½	159	158

30. The increase in non-oil revenues in both years reflects mainly a 2 per cent increase in the level of non-oil nominal income, as well as some increase in the yield for given incomes and expenditure. With no change in the planning total for 1986-87 (higher asset sales offsetting higher programme expenditure), the scope for fiscal adjustment has been reduced by the fall in oil revenues -but by much less in absolute terms because of the extra revenues elsewhere, some of which are already evident in 1985-86.

31. The 1985-86 PSBR which we revised up to £8 billion in the Autumn Statement we have now revised down to £7 billion: that estimate is likely to change further in the run-up to the Budget.

at 208 p.6,

32. Our best estimate of the annual fiscal adjustments, with a PSBR at £7½ billion, are £2 billion for 1986-87 and £4 billion in 1987-88. There have been major changes to asset sales and to oil revenues in particular:

Asset sales, £ billion

	1985-86	1986-87	1987-88
MTFS	2½	2¼	2¼
PEWP/January forecast	2½	4¾	4¾

Oil revenues, £ billion

	1985-86	1986-87	1987-88
MTFS	13½	11½	9½
January forecast	11½	8	6½

33. The PSBR is one measure of the fiscal position. The **public sector financial deficit** - the net acquisitions of financial assets by the public sector - excludes from the PSBR financial transactions such as asset sales and net lending. In contrast to the PSBR, the financial deficit has increased in recent years.

	£ billion	
	PSBR	**Financial deficit**
Average: 1980-81 to 1982-83	10	9
Average: 1983-84 to 1985-86	9	12
1986-87	7½	11½
1987-88	7	11½

SUMMARY TABLE AND COMPARISON WITH THE FSBR AND AUTUMN STATEMENT

	FSBR/MTFS MARCH 1985	AUTUMN STATEMENT NOVEMBER 1985	JANUARY 1986
1. World GNP (major 6)			
(% change on year earlier)			
1984	4½	4½	4½
1985	3½	3	2½
1986	3	3	3
1987	3½	-	3
2. Effective Exchange Rate			
(1975=100)			
1984 Q4	75	75	75
1985 Q4	74	81	80
1986 Q4	74	81	75
1987 Q4	72	-	73
3. Oil prices, $ North Sea spot			
1984	29½	29½	29½
1985	27	27½	27½
1986	26	25	20½
1987	26½	-	20½
4. Nominal GDP (mp)			
(% change on year earlier)			
1984-85	6¾	7	7
1985-86	8½	9	9
1986-87	6½	7	6½
1987-88	5¾	-	6½

	FSBR/MTFS MARCH 1985	AUTUMN STATEMENT NOVEMBER 1985	JANUARY 1986
5. GDP Volume (% change on year earlier)			
1984	2½	2½	2½
1985	3½	3½	3½
1986	2	3	3
1987	2	-	2
6. RPI (% change on year earlier)			
1985 Q4	5	5½	5½
1986 Q4	3¾	3¾	4
1987 Q4	3	-	4¼
7. Unemployment (UK s a excluding school leavers, millions)			
1985 Q4	3.1	3.18	3.17
1986 Q4	3.0	3.2	3.10
1987 Q4	3.0	-	3.10
8. Current Balance (£ billion)			
1984	0	1	1
1985	3	3	3½
1986	2½	4	4
1987	1½	-	1½
9. PSBR, £ billion (% of GDP in brackets)			
1984-85	10½(3¼)	10 (3)	10 (3)
1985-86	7 (2)	8 (2¼)	7 (2)
1986-87	7½(2)	7½(2)	7½(2)
1987-88	7 (1¾)	-	7 (1¾)

	FSBR/MTFS MARCH 1985	AUTUMN STATEMENT NOVEMBER 1985	JANUARY 1986
10. Fiscal Adjustment (annual not cumulative)			
1986-87	3½	[3]	2
1987-88	3	-	4
11. Interest Rates Short-term (per cent)			
1985 Q4	11½	11½	11¾
1986 Q4	10	10¼	11½
1987 Q4	9¼	-	10¾
12. Money Supply £M3 (% change)			
1984-85	9½	9½	9½
1985-86	8½	13½	13
1986-87	7½	12	13
1987-88	6½	-	12
13. Money Supply M0 (% change)			
1984-85	4¾	5½	5½
1985-86	4½	4½	4½
1986-87	4½	4	3½
1987-88	5½	-	3½

OIL PRICE VARIANT

34. The main forecast assumes that world oil prices in 1986 and 1987 remain at about $20 per barrel, close to the current spot level. There is great uncertainty over this, and as a variant we have investigated the effect on the world and UK economies of assuming that there is further fall in the price of oil of $5 (25 per cent) at the beginning of the second quarter of 1986. Oil prices are then assumed to remain about $5 per barrel lower than in the base throughout the forecast period.

Effects on World Economy

35. The fall in oil prices will tend to reduce inflation, boost consumer spending and reduce government expenditure in the oil importing countries. The ultimate effect on world economy will depend crucially on the policy reactions of governments in both the industrialised and oil-exporting countries. In the former it is assumed that governments in the major seven countries keep monetary growth rates unchanged by lowering interest rates; and that countries with historically high budget deficits (US, France, Italy and Canada) allow the operation of automatic stabilisers to reduce their deficits in relation to nominal GDP, while deficits in Japan, Germany and the UK remain broadly unaffected by the lower oil price. The net effect is to reduce nominal GDP in the major 7 countries by up to 0.8 per cent, policy not being sufficiently expansionary to offset the effects of the fall in oil prices on the price level. The oil exporting countries, some of whom face severe balance of payments difficulties even in the base case, are assumed to cut imports and invisible payments (eg. payments to expatriate workers) by as much as possible to avoid exhausting their reserves of useable overseas assets too quickly.

36. Largely because we have no clear idea of the precise consequences, the variant makes no allowance for major changes in economic behaviour. Such a sharp fall in oil prices could pose problems for the banking system, eg. from the increased likelihood of default on debt repayments by an oil-dependent countries such as Nigeria or Mexico, or from failures of banks in the US which are heavily exposed in the energy sector. We have not attempted to make specific allowances for these risks.

37. Within this policy framework and under these assumptions, real GDP in the major seven countries could be 1¼ per cent higher after two years, and world import volumes perhaps 1¾ per cent higher in part due to greater world oil trade. The price level in the major 7 is forecast to fall by about 1 per cent after about a year. This effect increases to about 2 per cent after 2 years, but then stabilises because of higher world activity.

Effects on UK Economy

38. In the face of lower oil prices we have assumed that the PSBR ratio is unchanged, and that lower oil revenues lead to a smaller fiscal adjustment. This contrasts with the assumption in the Powell/Horton Working Paper where the PSBR was allowed to rise. We have assumed no change in interest rates. This is consistent with little effect on monetary growth.

39. The forecast variant is shown in levels terms in the table on page 19 and as differences in the table on page 20.

40. Unlike other OECD countries, whose balance of payments benefit, lower oil prices lead to a deterioration in the UK current account. Furthermore, if the lower oil price is expected to persist, the value of North Sea oil reserves, and future export earnings, are reduced. In the forecast variant the sterling effective rate falls by nearly 4 per cent in 1986, slightly less in 1987. This is less than our previous relationship - a 10 per cent fall in oil prices leading by itself to a 3 per cent fall in the effective rate - might suggest. This is because the effect on the exchange rate depends on the absolute (not the percentage) fall in oil prices: and a 25 per cent fall starting from $20 per barrel would have about two thirds the effect of a 25 per cent fall starting from $30 per barrel.

41. The fall in the exchange rate and some rise in UK exports in line with higher world activity is not sufficient to prevent a deterioration in the current account of about £1 bn in 1987. This compares with the fall in the value of oil exports of £2¾ bn in the same year. By 1987 it seems likely that North Sea production would be adversely affected, and a small allowance for this has been made of 4½m tonnes (4%).

42. The variant suggests that there would be virtually no change in GDP. However UK real incomes (measured by Real National Disposable Income) fall by nearly one half of 1 per cent compared with the forecast. Within unchanged GDP there is:

- higher non-oil net exports because of higher world trade, and an improvement in competitiveness,

- a small rise in fixed non-North Sea investment and stockbuilding caused by higher private non-oil output,

- lower consumers' expenditure, mainly because the smaller fiscal adjustment reduces real personal disposable income.

43. Unlike other industrialized countries which clearly benefit, UK inflation, as measured by the RPI, is virtually unchanged as a result of lower world oil prices in 1986 and 1987. This is because higher import prices and wage costs offset the effect of lower sterling oil prices. The GDP deflator, which excludes the effect of higher import prices and in which oil prices have about a 5 per cent weight, is lower than in the main forecast, by about ½ per cent, and consequently Money GDP is also lower in the first year, by about the same.

44. The assumed fall in the dollar price of oil of about 25 per cent leads to a reduction in sterling oil prices of about 23 per cent. This, coupled with lower production, reduces North Sea Revenues by £1¼ bn and £2¼ bn in 1986-87 and 1987-88 respectively, and gives levels of North Sea revenues of £6¼ bn and £4 bn in the two years. The fall in revenue is proportionately larger than the fall in prices because, in broad terms, taxes are levied on the surplus over operating costs.

45. The variant suggests that the fiscal adjustment would be £1½ bn and £2 bn lower than in the forecast in 1986-87 and 1987-88. The main changes in the public sector accounts are set out below:

£bn	Fiscal Adjustment	Income Taxes ex FA	North Sea Taxes	Total Receipts	Total Expenditure
1986-87	-1.4	0.2	-1.6	0	0
1987-88	-2.0	0.4	-2.3	-0.2	-0.2

SUMMARY TABLE JANUARY 1986 FORECAST

		MAIN FORECAST	LOWER OIL PRICES
1.	World GNP (major 7 excluding UK) (% change on year earlier)		
	1986	3	3½
	1987	3	3½
2.	Effective Exchange Rate (1975 = 100)		
	1986 Q4	75	72
	1987 Q4	73	70
3.	Oil prices, $ Brent spot		
	1986 Q4	20	15
	1987 Q4	21½	16½
4.	Nominal GDP (mp) (% change on year earlier)		
	1986-87	6.7	6.2
	1987-88	6.8	6.7
5.	GDP Volume (% change on year earlier)		
	1986	2.7	2.8
	1987	1.7	1.8
6.	RPI (% change on year earlier)		
	1986 Q4	4.1	4.0
	1987 Q4	4.3	4.2
7.	Current Balance (£ billion)		
	1986	4¼	3¾
	1987	1½	½
8.	Fiscal Adjustment (annual not cumulative) £bn		
	1986-87	2¼	¾
	1987-88	4¼	2¼

LOWER OIL PRICE VARIANT

% change from base

Year	Major 7 excl. UK GDP	Major 7 excl. UK Consumer Price Index	Real GDP	RPI	Nominal GDP	Real National Disposable Income	£ Effective exchange rate
1986-87	+0.6	-1.1	+0.1	-0.1	-0.5	-0.3	-3.8
1987-88	+1.1	-2.2	+0.1	-0.1	-0.6	-0.4	-3.7
1988-89	+1.3	-2.3	0	+0.1	-0.2	-0.2	-3.2
1989-90	+1.2	-2.0	0	+0.1	0	-0.2	-2.8

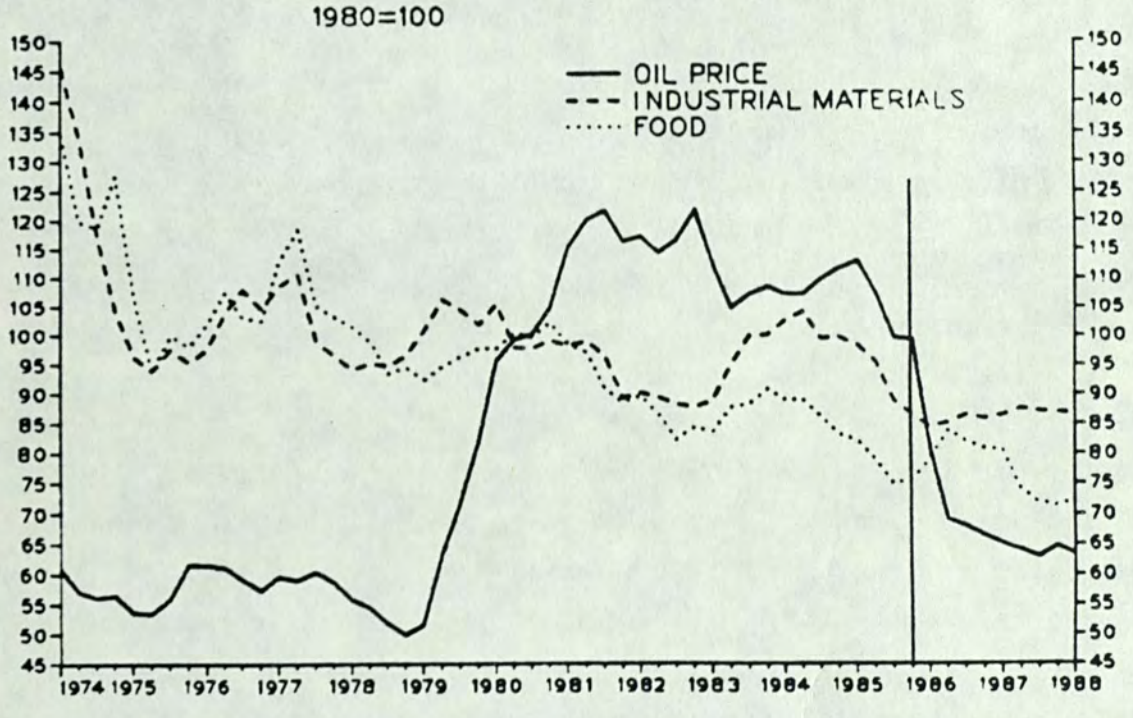
Year	Labour cost competitiveness	Earnings	Employees in employment (000s)	North Sea Revenues (£bn)	Fiscal Adjustment (£bn)	World Trade in manufactures (UK weighted)
1986-87	-3.8	+0.2	+10	-1.6	-1.4	+0.7
1987-88	-2.9	+0.3	+70	-2.2	-2.0	+1.5
1988-89	-2.9	+0.6	+70	-2.1	-1.6	+1.5
1989-90	-3.2	+1.0	+10	-1.9	-1.2	+1.4

SECRET

THE WORLD ECONOMY

46 For some time we have been forecasting falls in **world oil prices**, but not big or fast enough. For this forecast we have assumed that world prices are $20 a barrel in 1986. This is not very different from the current (January 28) spot and forward price for West Texas Intermediate. The implications of a bigger fall were examined earlier in this report. For 1987 we have assumed no change in the dollar oil price, but a continuing fall in the dollar, and hence in the real oil price. Real oil prices are now close to their pre 1979 levels. With a few exceptions like coffee, other **world commodity markets** provide evidence of plentiful supplies relative to demand. Prices are likely to remain weak.

REAL COMMODITY PRICES *



* IN RELATION TO PRICES OF MANUFACTURES

47. These big falls will stimulate oil demand and reduce supply from non-OPEC countries. But these effects build up only slowly (we have not yet seen the full effect of the 1979-80 price rises); and the present level of output in OPEC is likely to remain a long way below potential for some years. Hence any major strengthening of prices seems unlikely before the early 1990s.

48. Falling commodity prices provide a favourable background for industrial countries, enabling inflation to fall without squeezing profit margins or reducing real wages.

Per cent changes on a year earlier

	1983	1984	1985	1986	1987
World GNP (major 7)	2½	4½	2½	3	3
Consumer prices (major 7)	4½	4½	4	3	3
World imports: total	3	9	3	5	4

49. In the **United States** the slowdown in economic growth has been accompanied by lower interest rates. Short rates are now around 8 per cent, tax-deductible for business and consumers, and no longer look high in relation to an inflation rate of 3 per cent or so. The dollar has fallen (in effective terms) by over 20 per cent since its peak in February 1985, but the potential effect on inflation is being partly offset by lower importers' margins and the fall in oil prices. For 1986 as a whole, US import prices may be no more than 4 per cent higher than in 1985.

50. If confidence in financial markets does not break, the US should be able to continue with some growth and low inflation for a time. But the speed of adjustment to the deficits looks very slow indeed. The external deficit, in particular, is unlikely to decline much - even with some further dollar depreciation - until domestic demand growth in the US is appreciably slower than in other OECD countries. This could come about either through a speeding up of domestic demand growth elsewhere, and there is an element of this in our forecast for Japan and Europe, or by a further slowing down in the US. A US recession could be induced by tighter policies if a faster adjustment to the deficits is required. Domestic demand growth in the US and other countries is summarized in the following table:

Domestic demand at constant prices
per cent changes on a year earlier, at annual rates

	US	Japan	Europe	UK
1982-84	7	2½	1½	3½
1984-87	3	4	2½	3

51. With some further appreciation of the yen and DM, and with falls in commodity prices, we expect falling interest rates and broadly stable prices in **Japan** and **Germany** for the two or three years. In terms of both deutschmarks and yen, world oil prices are currently roughly half their level of eighteen months ago. But with some further tightening of fiscal policy in Japan, the expansion of domestic demand may not fully compensate for a slower growth of Japanese exports, leaving GDP growth in the 3-4 per cent range, compared with the 4-5 per cent of recent years. The potential for faster growth is greater in Europe and we expect the 2 per cent growth rates of the last two years to be succeeded by growth nearer to 3 per cent in 1986 and 1987.

52. Most **developing countries** will benefit from continued expansion in OECD, and from the big fall in oil prices, even though their own export prices may be weak. Oil exporters face the prospect of further large cuts in imports, as well as running down their reserves. Heavily indebted oil producers such as Mexico and Nigeria are likely to face particular difficulties and to seek greater debt relief from their creditors.

EXCHANGE RATES AND COMPETITIVENESS

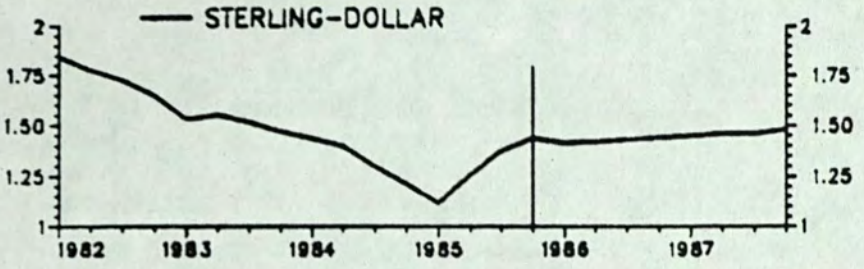
53. Forecasts made a year ago underestimated the level of sterling in 1985. One factor was an initial underestimate of the interest differential in favour of sterling (see table), which averaged 4 points, compared with less than 1 in the two previous years; another was a larger than expected fall in the dollar. But for most of the explanation we have to resort to the tendency of financial markets to overshoot in the short run. In the present forecast we have made some allowance for this, but have taken the assumed improvement in sentiment partly in the form of a fall in interest rates from their current level and partly a small rise in sterling.

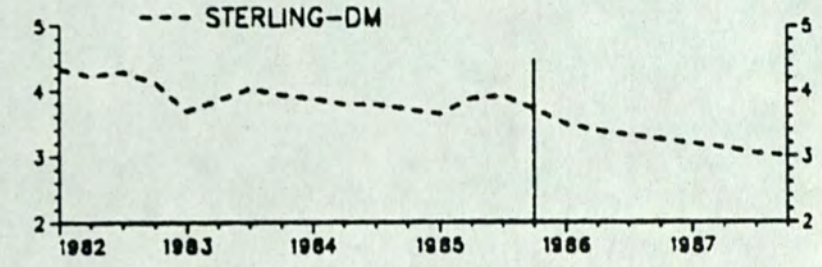
	Forecasts for 1985 made in:				
	January 1985	**Budget 1985**	**Autumn Statement 1985**	**1985 Outturn**	**Current Forecast for 1986**
Sterling Index	72	73	78½	78¼	75½
Short term Interest rates	11½	12½	12¼	12¼	12¼
Interest differential	2¾	3½	4	4	5
Oil prices:					
$	26½	27	27	27	20½
Real*	101	109	103	105	71
Dollar effective	142	148	141	141	122

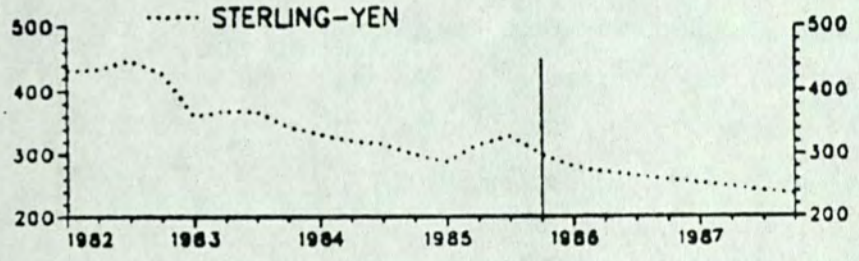
* 1980=100

54. Recent market expectations, as implied by the interest differential reflected in the forward rate, have been for sterling to depreciate about 5 per cent over the next year. The forecast has a slower fall because we assume a revised market assessment if oil prices stabilise as forecast, the dollar continues to weaken and the economic indicators (inflation, current account) are favourable. UK short rates in 1986 are forecast to be 5 per cent above the average of the major 6.

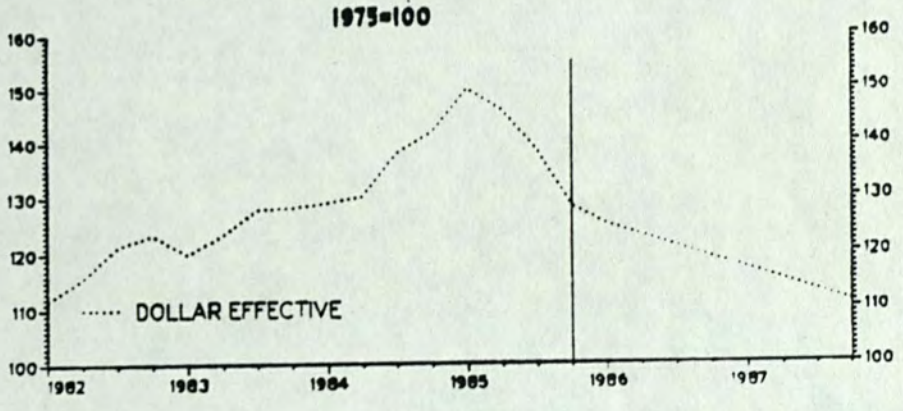
BILATERAL RATES FOR STERLING

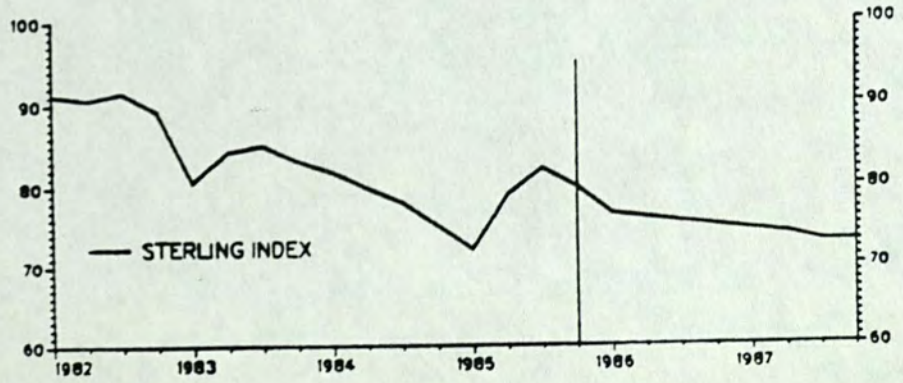






STERLING AND DOLLAR EXCHANGE RATES
1975=100





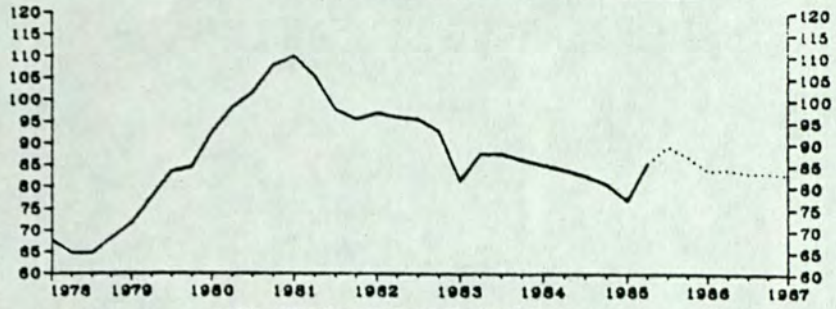
55. With the effective exchange rate at the bottom end of, or slightly below, the 75-85 range of the last four years, there should be a slight improvement in UK manufacturing competitiveness.

Price and Cost Competitiveness 1980=100

	Effective Rate	Relative export prices	Relative Unit Labour Costs
1983	83½	90	85½
1984	78½	88½	83
1985	78	92	85
1986	75½	91	83½
1987	73½	90½	82

56. While all the measures show an improvement in cost and price competitiveness since 1980, the last few years - and the next two years on our forecast - exhibit little change. This is despite a falling trend in the exchange rate, and reflects the tendency of labour costs in the UK to rise more than in our main competitors. The fluctuations in measured competitiveness in recent years (which are mirrored in the CBI balances - see next chart) are not likely to be contributing much to the UK's trade performance.

RELATIVE ACTUAL UNIT LABOUR COSTS



RELATIVE EXPORT PRICES

PROPORTION OF RESPONDENTS IN C.B.I. SURVEY CITING PRICES (COMPARED WITH OVERSEAS COMPETITORS) TO BE A CONSTRAINT ON EXPORT ORDERS

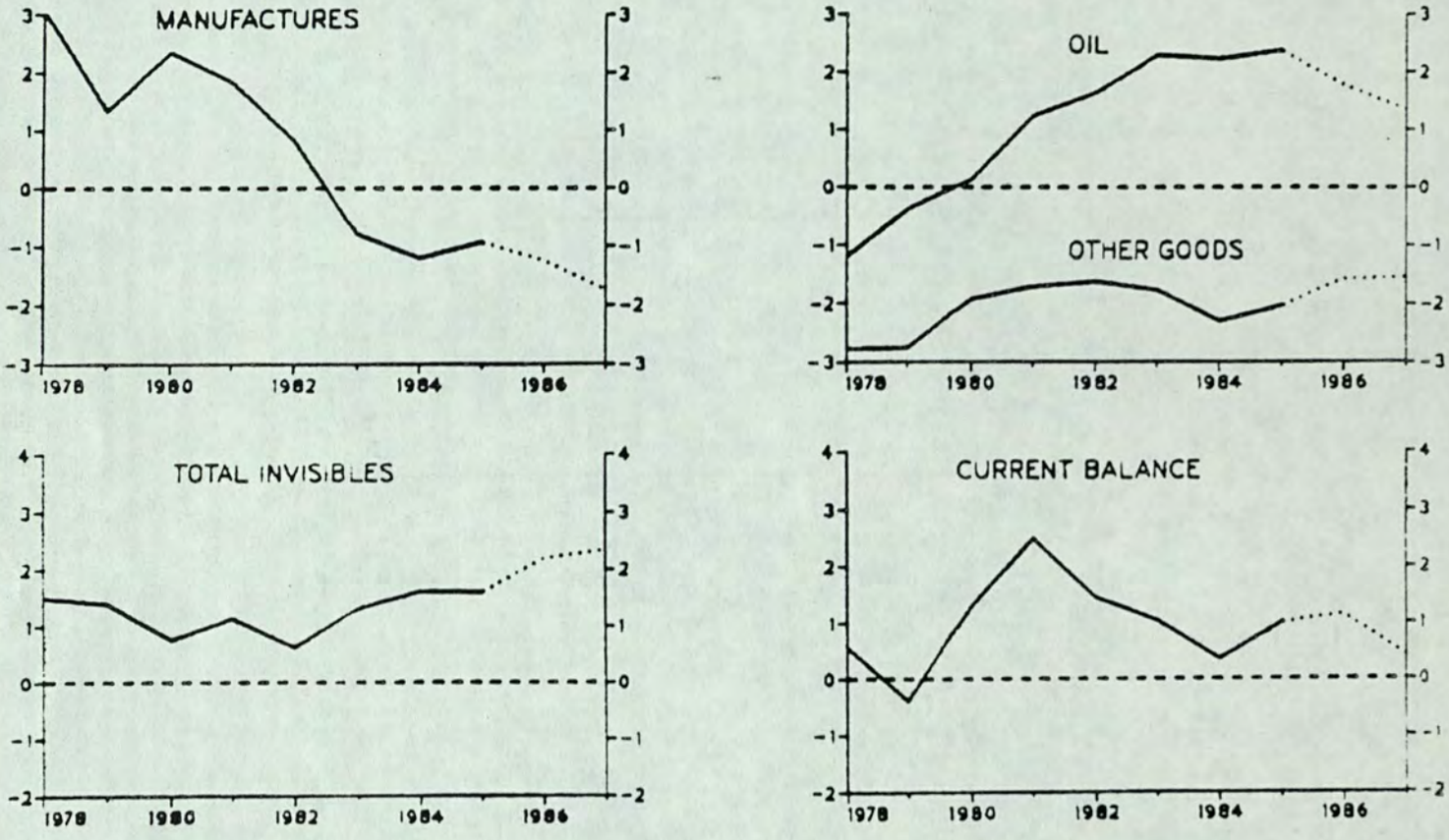
Trade and the balance of payments

57. The UK is expected to continue to run a substantial balance of payments surplus in 1986, as it has done since 1980. The contribution of manufacturing has tended to fall since 1979, more than offset by rising surpluses elsewhere. The chart below sets out recent trends and prospects.

58. Over the forecast period the oil surpluses fall with oil prices. The deficit in manufacturing was steady in 1984 and 1985, reflecting a combination of good growth in world trade, a strong trade performance - in terms of market share - by the UK, and in 1985 improving terms of trade.

59. We assume that trade performance will continue to be strong by the standards of the past 10-15 years, but not to the same extent as in 1984-85.

TRADE BALANCES AS SHARE OF GDP



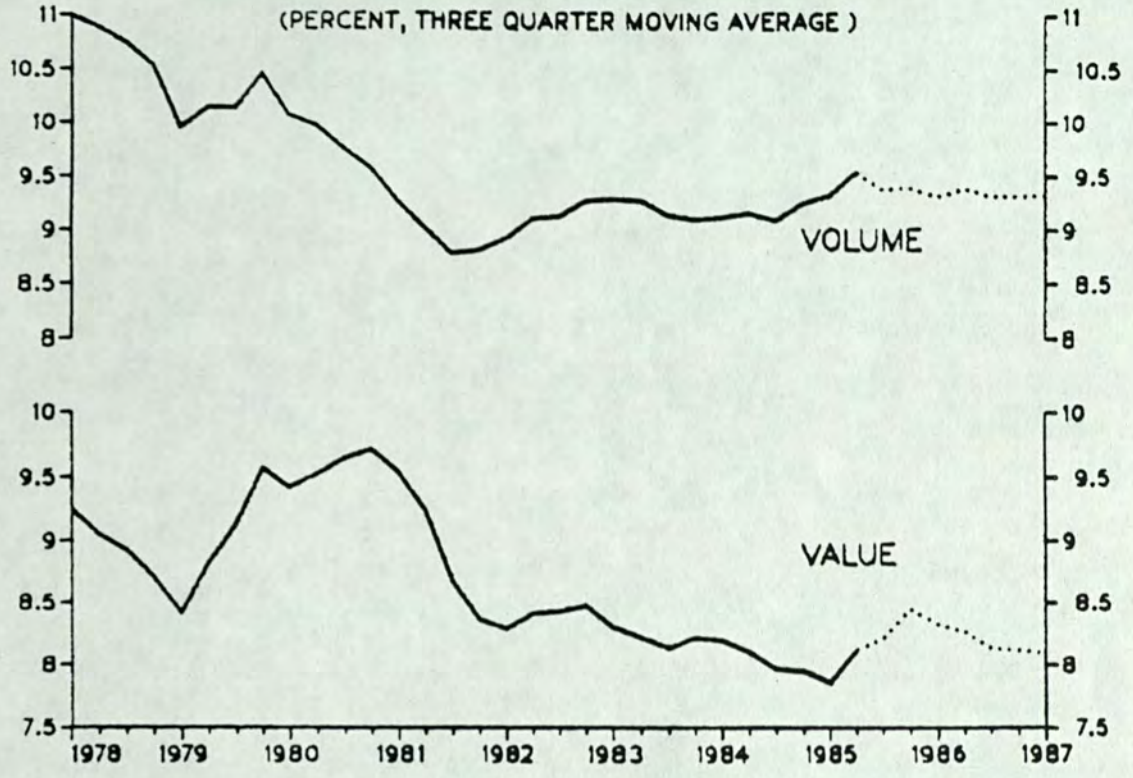
60. The improvement in the balance on other goods (food, drink and tobacco and basic materials) is largely the result of the 9 per cent improvement in the terms of trade that has recently taken place.

Trade in Manufactures

61. Short term movements in manufactured goods trade, which account for 70 per cent of total trade, are dominated by world trade and domestic demand.

62. Exports were higher than forecast in both 1984 and 1985 and exporters improved their share of world trade in volume terms - this is unusual in a period of substantial growth in world trade. The chart below shows the UK share of world trade in both volume and value terms.

SHARE OF U.K EXPORTS IN MAIN MANUFACTURING COUNTRIES EXPORTS OF MANUFACTURES



63. Recent information on exports suggest that we have once again experienced an increase in the last quarter of the year - although DTI statisticians claim that the seasonal adjustment is not at fault.

64. The forecast of exports is for slower growth of 3-3½ per cent in 1986 and 1987, partly because of some slowdown in world trade in 1987, but also because we have allowed for only part of the recent good performance to be repeated. Even so, any fall in the UK share of world trade is likely to be very modest.

65. In the last three years, the growth in demand has been shared by importers and domestic producers, with importers continuing to increase their share. We expect domestic demand for manufactures to grow a little more slowly in 1986 and 1987, partly because growth in the economy is less investment and more consumption orientated. Nevertheless with consumer durables spending rising strongly, especially in 1986, import growth is likely to be substantial: we put it at 8 per cent in 1986, 6 per cent in 1987.

Trade in Manufactures

per cent changes (except for last line), annual averages

	1974-1982	1982-1985	1985-1987
Volumes			
World trade	3	4½	4
UK exports	1	5	3½
Domestic demand	- 2	5½	3
UK imports	6	10	7
Terms of trade	+ 2	0	1
Balance of trade in manufactures level, as per cent of GDP	2½	- 1	- 1½

Invisibles

66. The balance of trade in **services** has more than doubled since 1982, and recent revisions by the CSO confirm that 1985 was an exceptionally good year for services - partly because the strengthening of the pound in the spring led to an improvement in the terms of trade without much effect on volumes. Any further improvement in the services balance in 1986 and 1987 is liable to be small. The balance on transfers was low in 1985 because most of the EC rebate for 1984 was deferred into 1986. Net payments to the EEC are expected to remain low in 1987.

67. Earnings from **Interest, Profits and Dividends** have been rising strongly in recent years as the stock of overseas assets has risen. There was a setback in 1985 because UK interest rates and other rates of return rose relative to those overseas, and because of BP's 0.6 billion write-off on Sohio. In 1986 and beyond, oil debits will fall, reflecting lower profits in the North Sea, and the non-oil balance, though still held down by high UK rates, should resume their rise as the stock of overseas assets rises. The invisible balance and its main components are set out in the following table.

Invisibles balances £ billion

	1984	1985	1986	1987
Services	4	6½	6½	6½
IPD	3½	3	4½	5½
Transfers	- 2½	- 3½	- 2½	- 3
Total	5	5½	8	9

The sterling value of the total stock of overseas assets has benefitted from rising stock markets but has been reduced by the rise in the sterling/dollar rate (a high proportion of our overseas assets are denominated in dollars). The table below gives past and forecast levels of our stocks of overseas assets. Of the rise estimated at £77 billion between 1979 and 1985, the cumulative current balance accounts for £20 billion, the remainder is accounted for by revaluations, including currency and stock market changes.

Net overseas assets

End year	£ billion	per cent of GDP
1979	12	6
1984	76	24
1985	90	26
1986	99	26
1987	105	26

68. The current account surplus is set out in the following table, with some of the special factors which distort the trends:

£ billion

	Current account						
	1981	1982	1983	1984	1985	1986	1987
Actual/forecast	6	4	3	1	3½	4	1½
i)coal strike effects	-	-	-	2½	1½	-	-
ii) Shift of EC rebate	-	-	-	-	½	- ½	-
iii) Sohio write-off	-	-	-		½	-	-
Current balance allowing for i) and ii) and iii)	6	4	3	3½	6	3½	1½
Memo Net oil exports less NS IPD debits (this item is adjusted for the coal strike)	1	2	4	6½	6½	4½	3½

69. Once again, despite some allowance for upward revisions of early estimates, the current account for 1985 is turning out a little better than in the forecasts. Except for oil, there now appears to be little tendency for the UK current account to deteriorate, when the UK and the world economy are growing at similar rates. The sharp deterioration between 1981 and 1983 reflected mainly the faster growth of domestic demand in the UK: 7 per cent, as against 2½ per cent in the major 6.

INFLATION

Producer Prices

70. As recent data and responses to the CBI survey show, manufacturers' ability to raise their prices remain very limited, mainly as a result of falling prices of competing manufacture imports. Even with little change in the growth of wage costs, the increase in total costs including imported materials and fuels may be no more than 3 per cent from now on. The main influences on producer prices are set out in the table below:

Manufactures
per cent changes on a year earlier
(annual averages)

	Unit Labour costs	Import costs	Total costs	Prices of imported manufactures	Domestic output prices
1984	1½	10	4½	7½	5½
1985	4	4	4	6½	6½
1986	4½	- 7½	1	4	4
1987	4½	2	3½	6½	4

71. The table shows costs again rising faster than more slowly than domestic output price so that margins rise in 1986.

RETAIL PRICES

72. **Nationalised Industry** prices in 1986 are being set early in the year, and provide for increases close to (a backward looking estimate of) the inflation rate. In consequence the growth of nationalised industry prices for the rest of 1986 looks high in relation to prices in general. By 1987, however, nationalised industry prices should rise at a slower rate than prices in general. We have allowed for the effects of lower oil prices on coal, gas and electricity, though more on industrial than domestic prices. **Petrol prices** are forecast to fall to 175p a gallon by the end of 1986.

Retail Prices Index, per cent changes on a year earlier

	Food	Housing	Nationalised industries	Petrol	Other	Total
Weights	19	15	8	5	53	100
1984 Q4	3.3	10.6	4.2	3.2	4.1	4.8
1985 Q4	3.2	9.3	5.4	1.6	5.5	5.5
1986 Q2	2½	8	5	- 10	4	3¾
1986 Q4*	3	9	5	- 10	4	4
1987 Q2*	3½	3	2½	- 7	5	4
1987 Q4	3½	5	3	- 2	5	4½

* Forecasts for these periods are normally published in the FSBR, but without the split between petrol and other.

73. **Housing** prices will be affected by a sharp increase forecast for local authority rates in April; and by movements in the mortgage rate: we have assumed a rise of 1 per cent in March, which is reversed in August. Details of the housing index are set out in the next table:

Housing prices in the RPI, percentage change on a year earlier

	Mortgage Interest payments	LA rates	Other (rents, insurance, repairs etc)	Total
Weights	32	25	43	100
1985Q4	12	9	7	9
1986Q2	9	12	5	8
1986Q4	12	13	4	9
1987Q2	- 3	9	4	3

74. RPI inflation slows to under 4 per cent over the next few months as the big increases in early 1985 drop out of the annual comparisons. The monthly figures may look as follows:

RPI

per cent changes on a year earlier

December 1985	(published)	5.7
January 1986		5.6
February		5.0
March		4.6
April *		3.9
May		3.8
Q3		4
Q4		4

This assumes specific indirect tax rates are raised by 5.7 per cent in the budget, in line with December outturn. The consequence for the level of the total index is ½ per cent, which is allowed for in these figures. If there were no rise in the mortgage rate, then the figures for March to May would be lower by 0.4 per cent.

75. By Q4 1986 the inflation rate is put at 4 per cent, ¼ per cent higher than the forecast in the Autumn Statement; the effects of lower oil prices have been more than offset by a lower exchange rate, a higher mortgage rate, and a higher forecast of local authority rates.

76. In 1987, there may not be much change in the inflation rate, as the growth of unit wage costs slows, but there is less gain on commodity and oil prices.

GDP Deflator

77. This measures the price of UK "value added". It is not affected directly by import prices nor by mortgage rates, and so tends to be more stable than the RPI (though subject to revision, usually upwards). Its main components are wages and profits per unit of output.

78. The MTFS profile showed only a very muted rise in 1985-86 and a slow fall thereafter. Our latest assessment is very similar.

GDP deflator, per cent change on a year earlier

	1984-85	1985-86	1986-87	1987-88
MTFS	4½	5	4½	3½
January forecast: total	4½	5½	4	4½
: total less oil	3½	7	5½	4½

79. The GDP deflator measures domestically generated inflation. It is affected by world prices only when world prices affect domestic profits, earnings, or other domestic incomes. Neither the rise in non-oil import prices during 1984-85 nor their subsequent fall has had the impact on the GDP deflator that it has had on other price indices. In 1985-86 and 1986-87 the fall in world oil prices pushes down North Sea prices and profits: the deflator for non-oil GDP rises by about 1½ points a year more than the whole economy GDP deflator.

Pay

80. Earnings growth in the private sector has been broadly constant at an annual rate of 7½-9 per cent since late 1982. Price inflation has fluctuated around an average of 5 per cent. Each of the last three pay rounds has led to a substantial increase, some 3 per cent a year on average, in real earnings before tax. This was a little higher than anticipated by wage bargainers, because of the tendency for price forecasts to be pessimistic except in 1985. There has been little or no tendency for the high level of unemployment to restrict the growth of wages. The ability of employers to pay, as substantial productivity gains have been made, has increased over this period.

Factors influencing private sector earnings, pay rounds

	1982-83	1983-84	1984-85	1985-86	1986-87
Inflation, per cent					
(i) At start of round, Q3	8	4½	4½	6½	(4)
(ii) Outcome on inflation, Q3	4½	4½	6½	(4)	(4)
Unemployment level at start of round, per cent	11	12	12½	12¾	(12½)
Profit share, per cent (non-North Sea ICCs)	8¾	10	12	(12¾)	(12½)
Earnings growth per cent change on a year earlier	8¼	7¾	8½	(8)	(6¾)

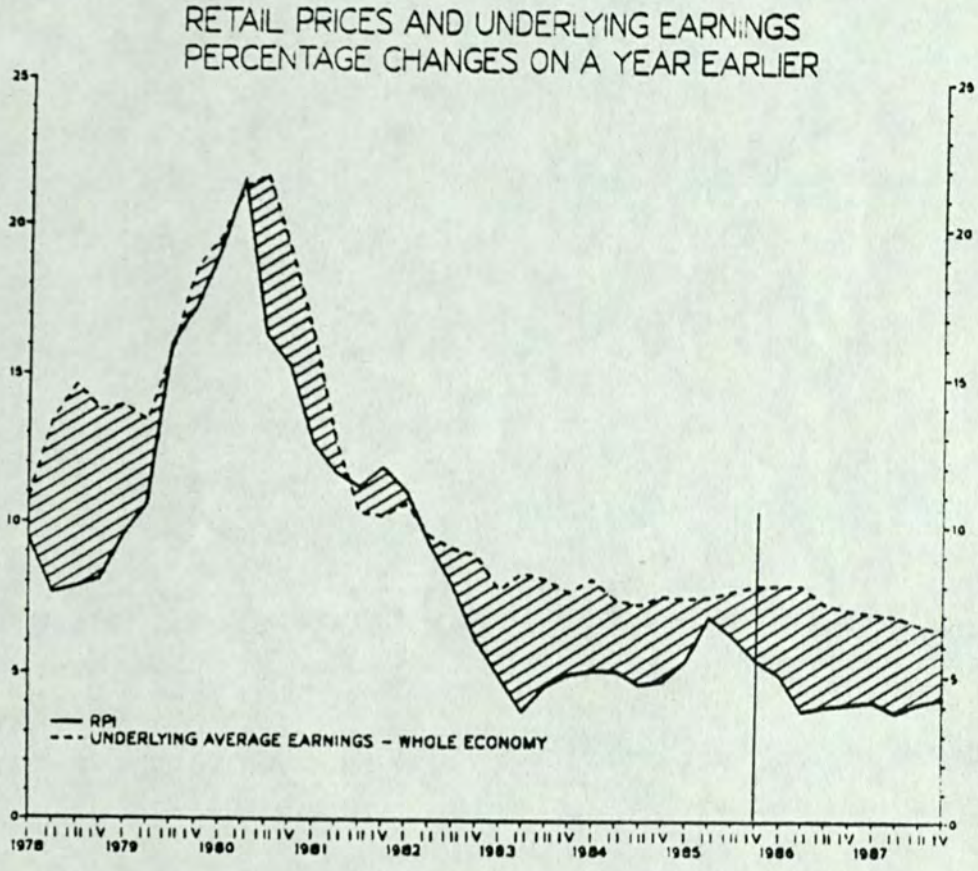
Figures in brackets are forecast; pay rounds run approximately from September to August

81. With both employers' and employees' real incomes rising strongly, wage bargains have been concluded with little difficulty. Short-term fluctuations in price inflation - often not fully anticipated - have had little impact on wage settlements and earnings growth. But a clear and sustained shift in the rate of inflation is likely to be reflected in wage settlements, though not immediately.

82. Current pay settlements are much as forecast: we expect earnings growth in the pay round as a whole to be about 8 per cent in the private sector. By the spring, inflation is likely to be down to below 4 per cent, and any pick-up later in the year likely to be small. By mid year, the average employee may have seen his take home pay up by some 6 per cent in real terms. (This includes a contribution of 1 per cent from the fiscal adjustment of £2 billion in the 1986 budget, assumed to be wholly in the form of income tax cuts).

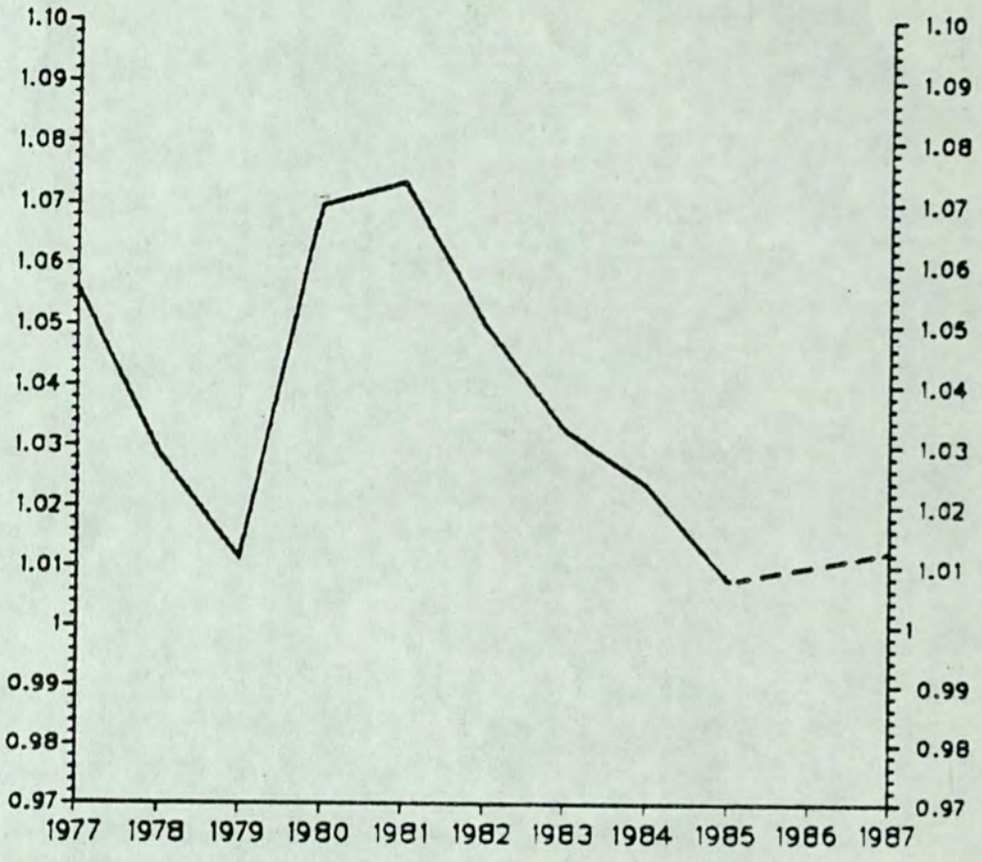
83. At mid 1986, employers will continue to see their ability to raise prices as limited: without lower wage settlements, profit shares and rates of return would be liable to decline. Taking into account both employers' and employees' position - and tending to give rather more weight to the former, though it is not crucial to the outcome - we think that earnings growth in the private sector may slow to 7 per cent or below in the course of 1987. Even this - with the help of another large fiscal adjustment in the 1987 budget -could deliver another 4-5 per cent growth in real take-home pay.

84. The overall picture for earnings growth and price inflation is shown in the next chart:



85. Public service pay presents more difficulties to both pay bargainers and forecasters. We interpret the offers made to local authority manuals, teachers and civil servants as evidence that pay will no longer rise more slowly in the public services than in the rest of the economy. We have assumed that from now on, earnings in the public services will in general rise at the same rate as earnings elsewhere: this will often mean higher settlements in the public services because of lower drift. The teachers we treat as an exception: as well as getting a late settlement of their 1985 pay claim (too late to be paid in financial year 1985-86) they get the extra £1¼ billion spread over 4 years. The resulting ratio of public service to whole economy earnings is shown in the chart below:

RELATIVE EARNINGS IN PUBLIC SERVICES
TO WHOLE ECONOMY EARNINGS (UNDERLYING)
(JAN 1980=1)



Labour costs

86. The table below shows the composition of unit labour costs (recent fluctuations in the monthly statistics for unit wage costs, around an average of some 5 per cent, are probably of little significance):

Private sector, per cent changes on a year earlier

	Earnings (underlying)	Taxes on labour and employers' contributions	Total labour costs	Productivity	Unit Labour costs
1983	8½	4	8	5	3
1984	8	- 2½	6½	3	3½
1985	8	0	7	2½	4½
1986	8	3	7½	2½	5
1987	7	4	6½	2	4½

NIS reductions, and reductions in employers' contribution to pension funds, account for low figures in the second column.

COMPANY INCOME AND SPENDING

87. 1985 saw a further recovery in the profitability of industrial and commercial companies taken as a whole. However, the fall in sterling oil prices - and the flattening out of North Sea output - meant that North Sea companies' profits went into reverse after the first quarter of the year; while non-North Sea profits benefited from the lower price of oil and other inputs. North Sea profits may fall by about a third in 1986; but non-North Sea profits should again rise as the economy continues to expand and costs grow slowly.

Industrial and Commercial Companies' Profits (per cent)

	As a Share of Total Income		Rate of return on assets, non-North Sea
	Oil	Non-oil*	
1973-1983 average	2.5	10.3	5.3
1984	6.9	11.2	6½
1985	6.2	12.2	8
1986	3.9	12.7	8½
1987	3.3	12.1	8

* Net of stock appreciation; adjusted for privatisation.

88. Data revisions are reducing the size of the discrepancy in the company sector accounts for 1984 and the first half of 1985. The financial accounts now give a rather healthier picture for the position of ICCs than previously - one that is much more consistent with the buoyancy of ICCs profits. The financial accounts are also now more consistent with the results of surveys which suggest quite a comfortable liquidity postion. Our forecast suggests that ICCs liquidity should remain at around present levels in relation to sales over the next two years.

Business Investment

89. Business investment now appears to have fallen back rather more sharply after the first quarter of 1985 than we had thought at the time of the Autumn Statement. For 1985 as a whole we now expect that manufacturing investment will rise by about 6 per cent (including assets leased from finance lessors), and non-manufacturing investment by a similar amount.

90. These rates of investment imply that the ratios of capital to output have continued to fall in both manufacturing and non-manufacturing over the last year. Although manufacturing output is only about 4 per cent below its 1979 average, manufacturing investment is still almost 20 per cent below its 1979 level. As measured by the CSO, the gross capital stock in manufacturing is rising at around ½ per cent a year; although the true growth rate may be a little higher than this (perhaps up to 1½ per cent) if there has, in the past, been substantial - but unrecorded - premature scrapping of the capital stock.

91. Despite the 3 per cent rise in manufacturing output over the past year, the number of firms quoting capacity as a potential constraint on output is the same as a year ago. While some industries such as textiles have been reporting capacity constraints approaching 1973 levels, overall the proportion is well below levels experienced in 1973 and at cyclical peaks during the 1960s.

92. The level of capacity utilisation and the much improved rate of profit now being earned on the existing capital stock both point to a further rise in investment during 1986. But the latest DTI Intentions Survey again suggests weak business investment this year. Part of the explanation for this weakness may be that investment has been brought forward into 1985 to forestall the reduction in capital allowances due in April 1986; but it is likely that most of the investment brought forward will occur in the first quarter of 1986, so that the total for investment in the calendar year is unlikely to be greatly affected by forestalling. Possibly high interest rates are part of the explanation, though with the stock market strong throughout 1985, the cost of equity finance has not risen as much as real interest rates.

93. In the forecast we have written up the DTI Intentions Survey figures for both 1986 and 1987: the forecast for 1986 is not much changed from the Autumn Statement.

	Percentage Increase by Volume in		
	1985	1986	1987
Manufacturing* (£6.4 billion in 1984)			
DTI Survey	6	- 2	0
HMT Forecast	6	0	3
Non-manufacturing** (£14.4 billion in 1984)			
DTI Survey	6	2	3
HMT Forecast	6	4	4

* Including leased assets

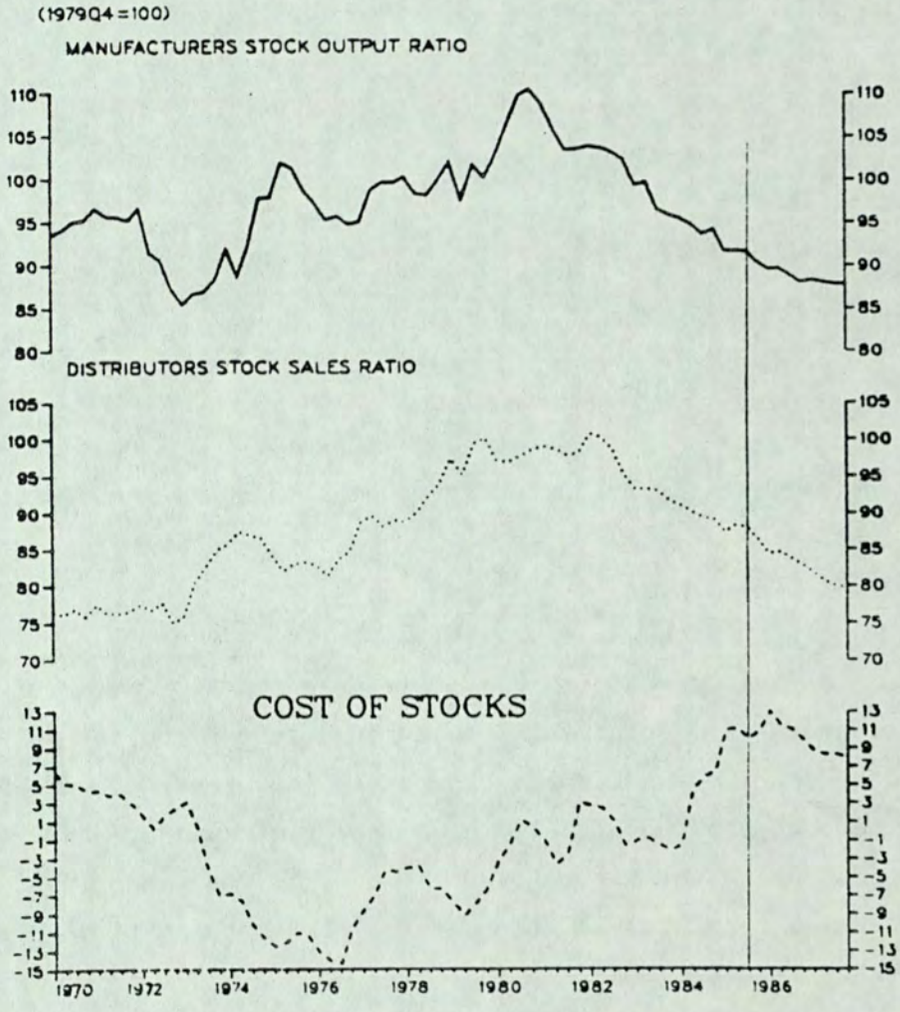
** Adjusted for privatisation and excluding assets leased to manufacturers.

Stockbuilding

94. There seems to have been little overall change to the level of stocks held by manufacturers and distributors during the course of 1985: manufacturers' stocks are currently some £5 bn (14 per cent) lower in real terms than they were at the end of 1979. We interpret much of the rise in stock output ratios during the latter part of the 1970's and much of the subsequent reversal as attributable to changes in the cost of financing holdings of stocks - see next chart.

95. High real interest rates, and the abolition of stock relief in the 1984 Budget mean that the cost of holding stocks is now much higher than at any time in the last ten years. The implication is that stock output ratios are likely to continue to fall; and this receives further support from recent Surveys. A positive balance of both distributors and manufacturers still say that their stock levels are too high; and replies to the CBI's January Trends Survey indicate that manufacturers are expecting to reduce stocks from current levels.

AGGREGATE STOCK RATIOS



PERSONAL INCOME AND SPENDING

96. For some time now we have been forecasting an exceptionally large rise in personal disposable income in 1986, and with it the re-emergence of consumer spending as the main area of growth in demand. This pick up in consumption has already started and is now evident in the figures for 1985; the CSO's preliminary estimates of consumers' expenditure for the fourth quarter (which we expect will be revised up a little) show 3 per cent growth in total consumers' expenditure between the second halves of 1984 and 1985, compared with 1½ per cent in 1984; and a 9 per cent rise in spending on durable goods over the same period.

97. The rise in spending so far has been rather larger than might have been expected given the recorded change in personal disposable income: the personal savings ratio may have fallen by about a point between the second half of 1984 and the second half of 1985. There seems to have been an improvement in consumer confidence over this period: perhaps the outcome of the coal strike has had something to do with this.

98. We now expect real personal disposable incomes of persons to rise by about 5½ per cent in 1986, and by about 3½ per cent in 1987: this compares with rises of just under 2½ per cent a year in the three years to 1985. The main contributions to the much higher growth rates in real incomes come from:

(i) a fall in consumer price inflation, which may average a little under 4 per cent in 1986, compared with 5 per cent in the previous three years;

(ii) the slight pick up in wage settlement rates during the 1984-85 pay round, higher public sector settlements during the present pay round, and a large chunk of back pay for teachers, which together mean that growth in average earnings is about ¾ per cent higher in 1986 than in 1985;

(iii) the forecast fiscal adjustment of £2 bn in 1986 and £4 bn in 1987 which adds about ½ per cent to disposable income growth in 1986, and 1½ per cent in 1987;

(iv) employment growth of about 1 per cent a year over the next two years, helped by the 1985 Budget measures, and by an assumed further employment package in the 1986 Budget.

These are partly offset by:

(v) a reduction in employers' pension fund contributions in response to the present large (£10-12 bn according to GAD estimates) actuarial surpluses of pension funds.

99. We do not expect consumers' expenditure quite to keep pace with the growth of personal income in 1986. The saving ratio normally rises during periods of fast personal income growth; and as durables spending seems during 1985 to have anticipated the pick up in incomes growth due for 1986, it may grow correspondingly less this year. Our forecast also allows for some impact of the current high level of interest rates on consumer spending. On the other hand the fall in inflation in 1986, and the reduction in employers' pension fund payments - which will depress measured income but probably not expenditure - will tend to reduce the personal saving ratio.

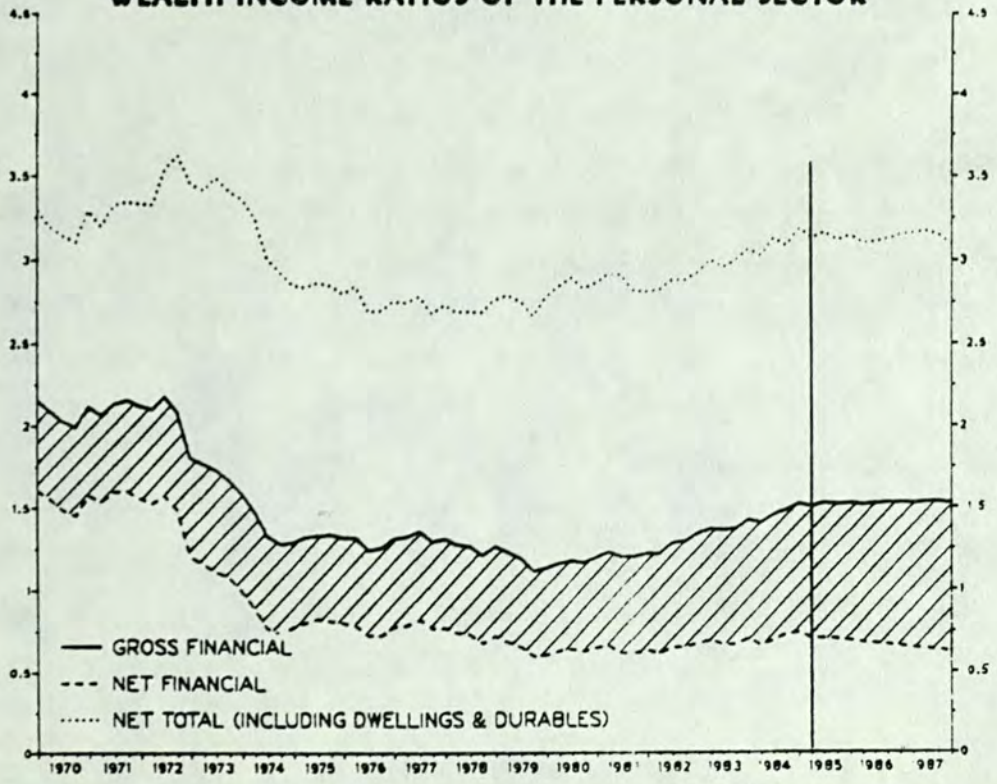
100. On balance we now expect consumers' expenditure to rise by about 4 per cent in 1986; and by a similar amount in 1987. The personal saving ratio is forecast to rise by a bit over one point in 1986, and to fall back a little in 1987.

101. We also expect persons' investment in housing to pick up in 1986. Private housing starts have been on an upward trend throughout 1985, although housing completions and investment in new dwellings have fallen. This rise in housing starts was not expected at the beginning of 1985; and the two increases in mortgage interest rates in the first four months might have been expected to lead to a still less favourable outturn. But the housing market managed to cope with these interest rates increases - the freer availability of mortgages clearly helped - and in the more prosperous parts of the country house prices have been rising fast enough to stimulate housebuilders to increased activity.

102.We expect therefore to see both completions and investment in new dwellings picking up again by the middle of 1986. Investment in improvements, now recognised as about half of total housing investment, was low between mid-1984 and early 1985 following the extension of VAT and the reduced availability of improvement grants. It recovered in the third quarter of 1985 and we expect it to continue rising roughly in line with growth in personal incomes.

103. The slowdown in inflation, the strength of the stock market, and (more recently) of house prices has meant that although the personal saving ratio has fallen from about 15 per cent in 1980 to around 12 per cent on average in the last three years, net personal wealth has been rising in relation to income. At first sight it may seem surprising, in view of the high level of interest rates, that the increase in the value of physical assets (included in the top line of the Chart) has been greater than the rise in net financial assets. But this is a consequence of asset revaluations and the programme of council house sales which have reduced persons' net financial wealth but not their total wealth (including dwellings). Persons' net financial wealth (which includes the net worth of life assurance and pension funds) is forecast to fall a little in relation to income in 1986 and 1987, as pension funds reduce their current actuarial surpluses. The forecast high level of durables purchases and housing investment is reflected in a gradual rise in the ratio of total net personal wealth to incomes.

WEALTH INCOME RATIOS OF THE PERSONAL SECTOR



Income and spending: the private sector in total

104.We expect a combination of rapid growth in real incomes and very high interest rates to keep saving high in 1986 (except of course for companies with North Sea interests). By 1987, companies will be finding it more difficult to raise profits. We assume that the rate of return falls a little in 1987: wage increases come down only moderately and productivity growth slows a little; while price increases continue to be restrained by very low inflation in the world. Calls on company incomes are likely to increase, with another large rise in the tax bill, reflecting profit growth in 1985 and 1986, and spending on capital assets rising further. In consequence the financial surplus of companies is forecast to fall in 1987, from the high levels of 1985 and 1986:

Financial surpluses £ billion

	1984	1985	1986	1987
Personal sector	12	12	15	15
Companies: i) North Sea	3	1	- 3	- 1
ii) Other	5	10	10	5
Total private sector	20	22	22	19

(Financial deficits are being run by the public sector, and by the overseas sector - corresponding to the surplus on the current account of the balance of payments.)

105.In successive forecasts we have been expecting the rate of profit to level off, but companies, by securing faster productivity growth and in other ways, have achieved further increases in profitability. The two most obvious routes to lower costs are higher productivity and lower (real) wage settlements: our forecasts have tended to be low on both productivity and real wage increases.

DEMAND AND ACTIVITY (SUMMARY)

106. The prospects for domestic demand (at constant prices) are summarised in the table below:

	per cent changes on a year earlier				
	1983	1984	1985	1986	1987
Personal Consumption	4	1½	2½	4	4
Public Consumption	2	1½	0	½	0
Total Investment	4½	8	2	4	1½
Change in stockbuilding (as per cent of level of GDP)	1	- ½	0	0	0
Total Domestic Demand	4½	2½	2	3½	3

107. The balance of trade made a substantial contribution to growth in 1985, because of the strong performance by UK manufacturers in both overseas and domestic markets. Domestic demand growth takes up the running this year and next.

108. The table below tries to split the growth of output into the contributions of domestic demand, external demand and trade performance. The numbers are only very approximate:

Contributions to growth of (non-oil) output, per cent

	1984	1985	1986	1987
Domestic demand less normal import content	1¾	¾	2	2
External demand	1½	1	¾	¾
Trade performance	- ¼	1¼	- ¼	0
Other	- ¼	- ¼	0	- ¼
GDP less oil and adjusted for coal strike	3¼	2¾	2½	2½

109. A positive figure for "Trade performance" measures the extent to which (a) exports gained share of the overseas market and (b) importers' share of the domestic market rose more slowly than usual. The 1¼ per cent figure for 1985 combines a strong export performance with a slower than expected rise in import penetration.

110. The estimated effects of the coal strike and of North Sea oil and gas production on total GDP can be seen in the following table:

	1980 = 100, and per cent changes on a year earlier				
	1983	1984	1985	1986	1987
GDP Average Measure	103.7	106.1	109.9	112.9	115.2
	(3.3)	(2.3)	(3.6)	(2.8)	(2.0)
Contribution of North Sea production to GDP changes	+ 0.4	0.2	0	- 0.1	- 0.5
Effects of coal strike	0	- 1.2	0.8	0.4	0
GDP less contribuiton of both oil and coal strike	2.9	3.2	2.8	2.4	2.5

111. The growth of oil production has accounted on average for half a per cent a year of the growth of GDP between 1980 and 1984. Oil production is now forecast to peak in 1986 and fall 5 per cent in 1987.

PRODUCTIVITY, EMPLOYMENT AND UNEMPLOYMENT

112. Recent CSO revisions to the figures for manufacturing output in 1985 (including the introduction of a bias adjustment to figures for the most recent six months) mean that we now see less of a slowdown in productivity growth over the last year. Output per head in manufacturing in 1985 probably rose by about 3½ per cent (on the published definition which includes an allowance for growth in self-employment in manufacturing): this is very close to the average growth rate in manufacturing productivity since 1979.

113. Although continuing high growth in real wages and low materials prices will encourage substitution away from labour over the next few years, we expect somewhat lower manufacturing productivity growth in 1986 and 1987, reflecting the gradual slowdown in output growth.

114. Outside manufacturing, productivity growth is affected by a number of special factors. The continuing shift towards part-time work is reducing growth in output per head by about ¾ per cent a year. The effect of the 1985 Budget measures (SEMS and NIC restructuring) and a further SEMS package assumed for the 1986 Budget reduce productivity growth by around ½ per cent a year on average in 1986 and 1987. On the other hand, the collapse of the coal strike and the outcome of the British Rail guards dispute mean that the way is open for substantial long overdue productivity gains in some nationalised industries. Exceptional productivity improvements in the two industries named (and also in the post office) are assumed to add almost ½ per cent a year to non-manufacturing productivity growth on average in 1986 and 1987.

Productivity Growth

	Manufacturing		Non-manufacturing*		
	Trend	Actual	Trend per full-time worker	Trend per head	Actual output per head
1973-79	1.6	0.7	1.6	1.0	0.5
1979-84	3.3	4.0	1.9	0.9	1.0**
1984-87	3.5	3.3	2.3	1.5	1.3**

* Private sector and nationalised industries (excluding steel). (These productivity estimates differ from published figures in attributing all self employment growth to non-manufacturing. They thus tend to overstate productivity growth in manufacturing a little, and understate productivity growth in non-manufacturing.)

** Adjusted for coal strike.

115. The implications for employment are set out in the table below. The last reasonably firm estimate for employment is for the second quarter of 1984.

	Employment, 000s, changes		
	1981 Q2 - 1985 Q2 (Annual average)	1985 Q2 - 1986 Q2	1986 Q2 - 1987 Q2
Employees	- 165	+ 75	+ 145
Self-employed	+ 125	+ 125	+ 125
Total employment	- 40	+ 200	+ 270
of which: full-time	- 245	+ 10	+ 15
part-time	+ 205	+ 190	+ 260
Full-time equivalent	- 145	+ 105	+ 145

116. Our projections for labour supply growth start off from the projections published in the July 1985 Employment Gazette. As compared with the Department of Employment's figures, we have allowed for rather higher female activity rates; and a continuing fall in activity rates for men near to retirement age.

Labour Supply, 000s, changes

	1983 Q2 - 1985 Q2 (Annual average)	1985 Q2 - 1986 Q2	1986 Q2 - 1987 Q2
Males	90	45	35
Females	340	115	140
Total	430	160	175
(of which population effect)	160	120	110

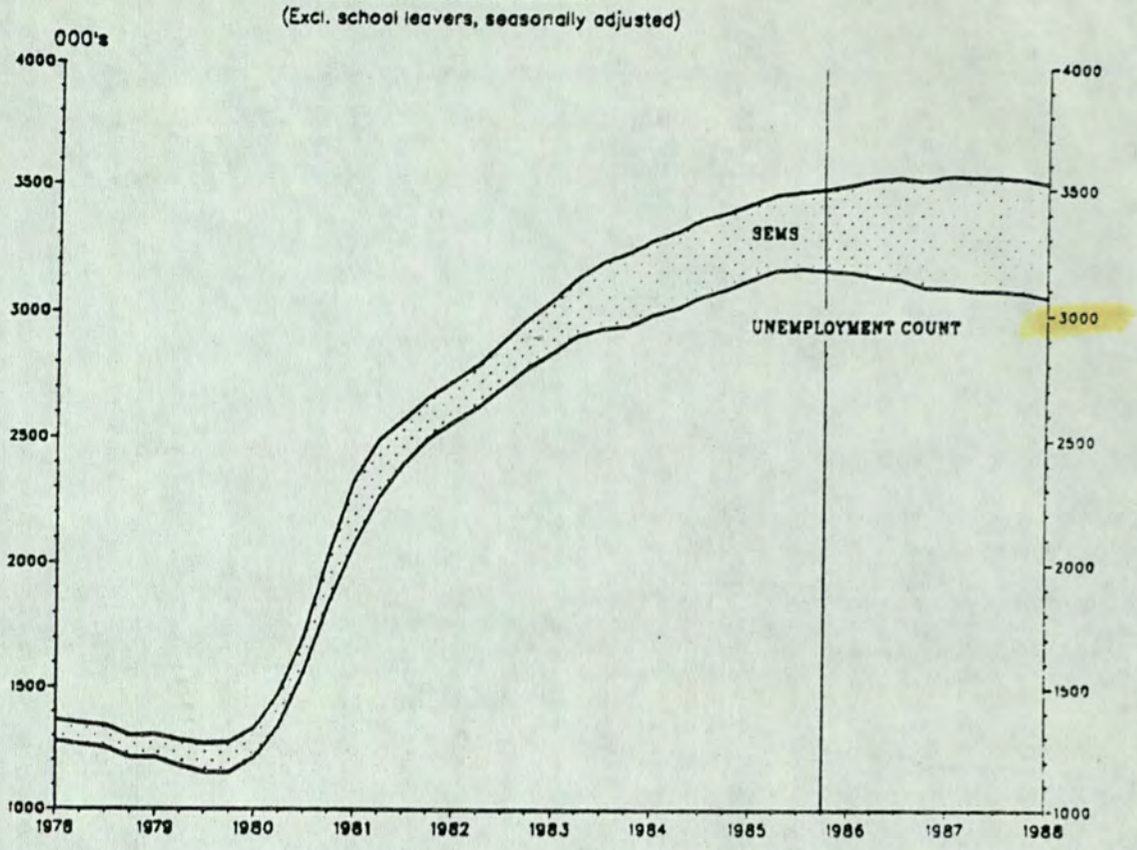
117. The trend in unemployment changed markedly for the better between the second and fourth quarters of 1985. We had been expecting some improvement during the course of the year, but the extent of the improvement (and the deterioration in the most recent months) was not expected and is at present not easy to explain. Maybe when the 1985 LFS arrives it will help to clarify the reasons for the improvement.

118. The latest employment statistics show a 120,000 smaller increase in the employed labour force in the first three quarters of 1985 than in the corresponding period of 1984. There was a 14,000 bigger fall over the more recent period in the number of employees in the production industries, (manufacturing, energy and water supply): industries where the employees are mainly full-time male workers with a high propensity to register as unemployed. The unemployment figures do show a rise in inflows onto the register in 1985; but this has been more than offset since the spring by a larger rise in outflows off the register. It is possible that this evidence of increased inflows and outflows means that the downward bias in the employment statistics - which reflects a failure of the statistics to keep pace with changes in the labour market - will have increased recently.

119. Our forecast does not make much allowance for a continuation of the unexplained part of the improvement in unemployment trend. Nevertheless we do expect unemployment to fall over the next two years as a result of lower growth in labour supply and the effects of the 1985 Budget measures. We have also allowed for a further package of employment measures in the 1986 Budget, which reduce (adult) unemployment by 60,000 by the first quarter of 1987. The chart shows the actual path of unemployment in the forecast, and also the growing impact of SEMS on the count.

UK UNEMPLOYMENT

(Excl. school leavers, seasonally adjusted)



120. As in previous forecasts we assume in constructing our unemployment forecast that:

(i) changes in the number of manufacturing employees feed one for one into claimant unemployment;

(ii) changes in part-time female employment have little effect on the number of claimant unemployed. Thus, taking account of the relative importance of this type of employment outside manufacturing, claimant unemployment might fall by only about 40 for every 100 extra jobs in the private sector outside manufacturing and by 60 for every 100 extra jobs in the public sector;

(iii) additions to labour supply from higher female activity rates do not have much impact on claimant unemployment, because most women joining the labour force will not have the insurance records that enable them to claim benefit.

The forecast for unemployment is set out below.

	Changes		
	1981Q2-1985Q2 (Annual average)	1985Q2-1986Q2	1986Q2-1987Q2
Unemployment:			
Total including school leavers.	+ 230	- 35	- 95
Narrow definition excluding school leavers.	+ 230	- 25	- 55
Memo: SEMS effect on unemployment			
- Total	- 30	- 85(-15)	- 90(-45)*
- Adult	- 15	- 85(-15)	- 60(-45)*
SEMS effect on employment statistics.	0	85(15)	0 (50)*

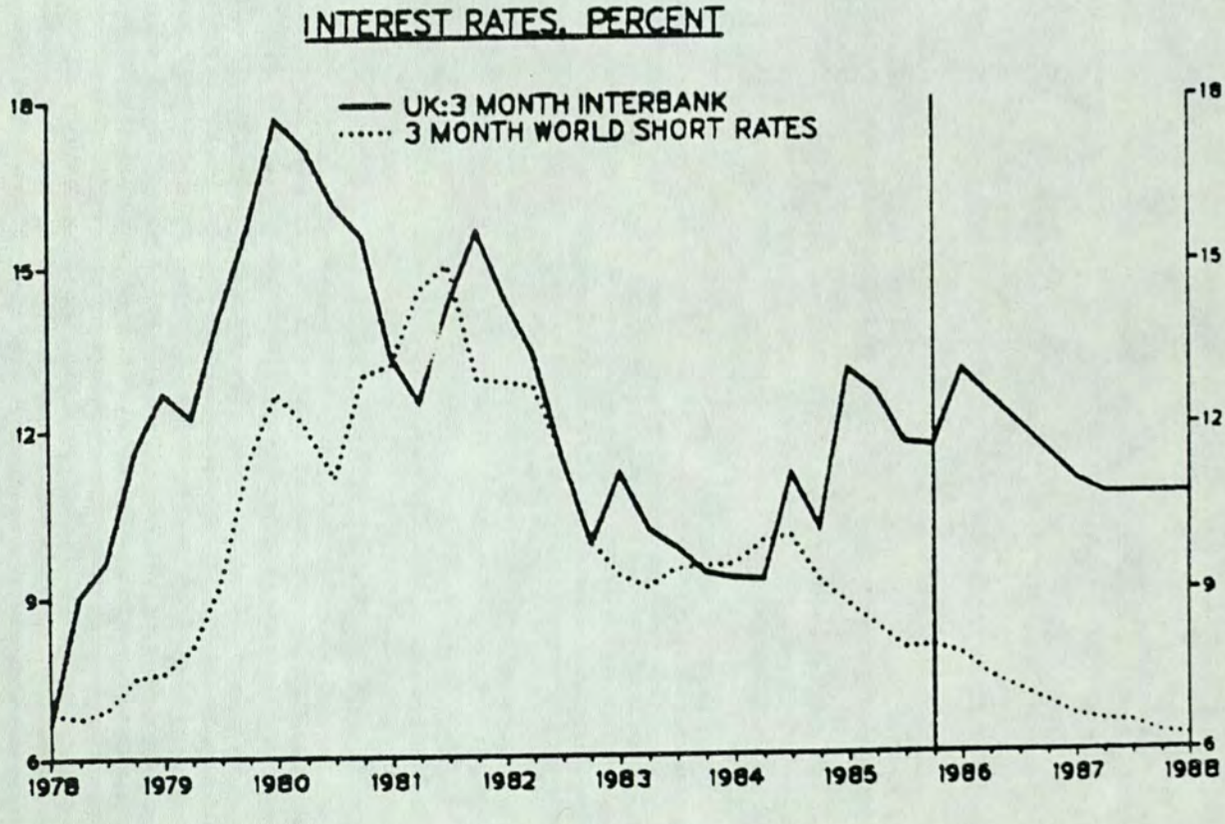
* Figures in parentheses show contribution of assumed 1986 SEMS package.

Financial forecast

121. As a result of the steep fall in oil prices and market pressures we have once again revised up our forecast of short-term interest rates. With overseas rates likely to fall at least outside the US (the recent fall in oil prices should help that process), we think that UK rates should be able to drift slowly downward once the immediate crisis is past. Even so sterling interest rates stay 4-5 per cent above the average of overseas rates through 1986 and 1987. Long rates, which have changed little in response to changes in money market rates, may not change much from current levels.

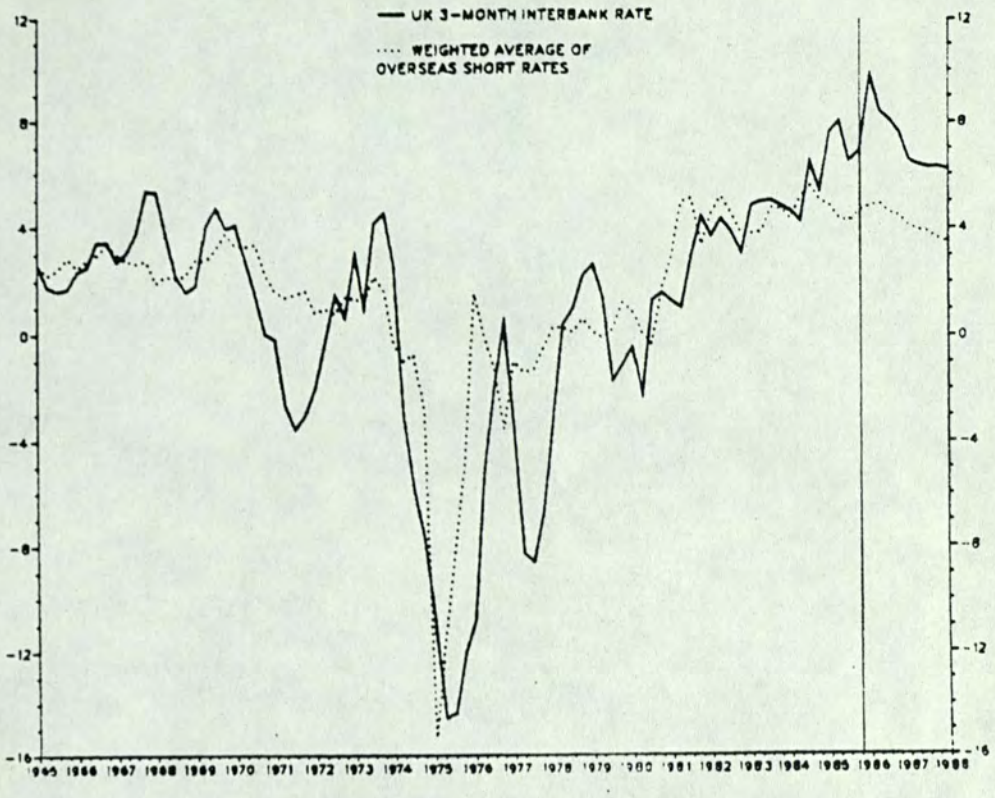
	World basket short rate	UK rates 3 month	UK rates mortgage rate*
1985 Q4	8	11½	12¾
1986 Q4	7	11½	12¾
1987 Q4	6½	11	12

* with a rise to 13¾ per cent assumed by March and a fall in Q3.



122. **Real rates** in the UK are higher than in most other countries:

REAL INTEREST RATES AT HOME AND ABROAD

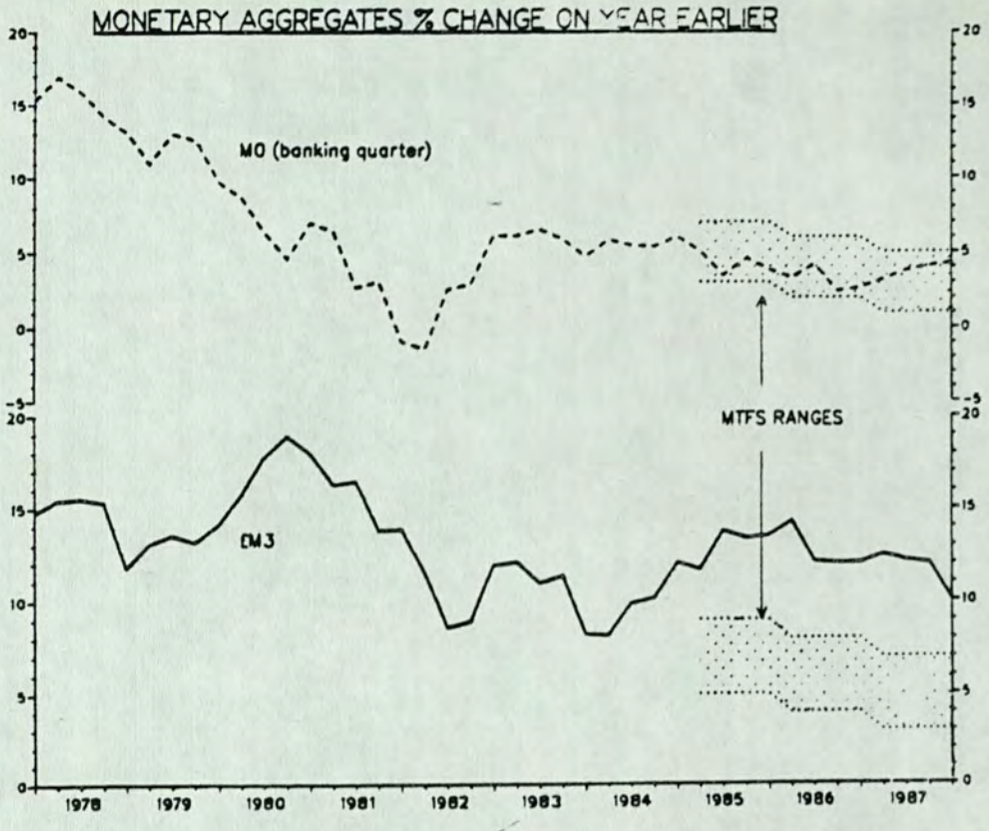


Monetary aggregates

123. The forecast is summarised and compared with the MTFS ranges in the following table and in the chart:

Average Percentage growth rates in financial years

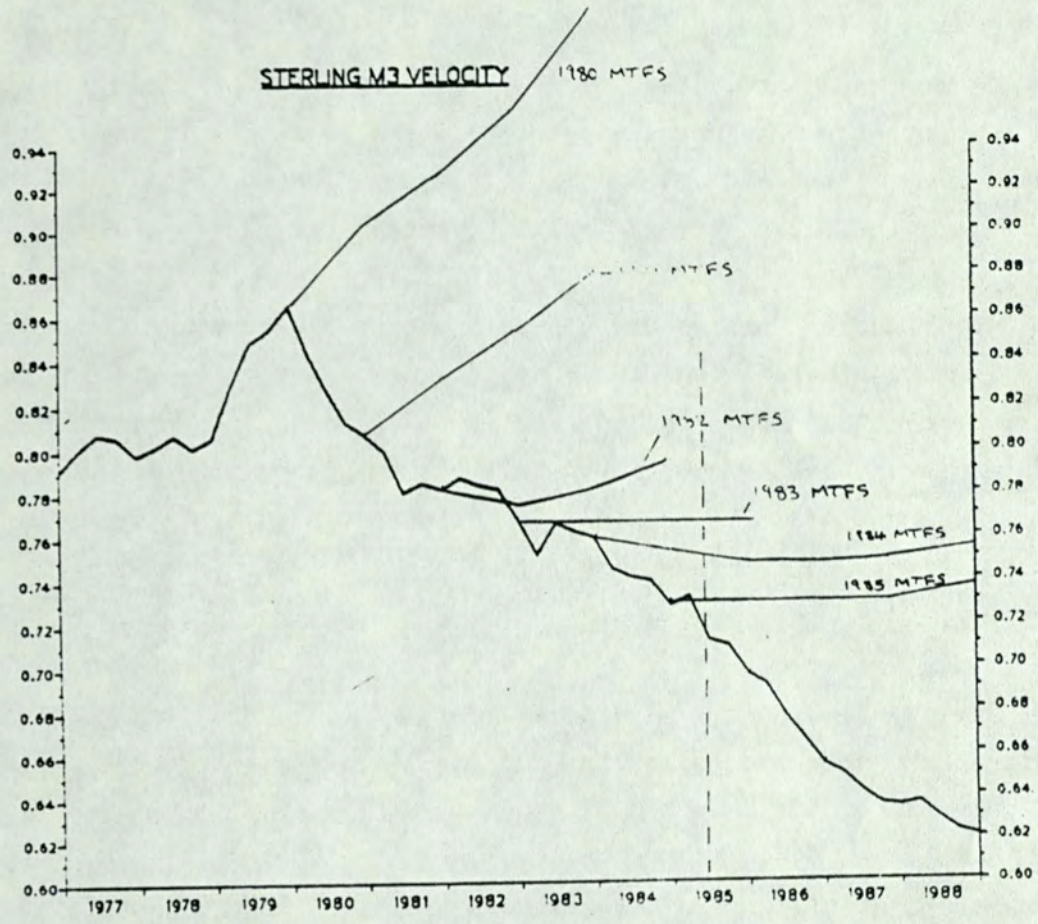
	MO		**£M3**		**PSL2A**
	MTFS range	**Outturn/Forecast**	**MTFS range**	**Outturn/Forecast**	**Outturn/ Forecast**
1984-85	(4-8)	5½	(6-10)	9½	13
1985-86	3-7	4½	5-9	13	12½
1986-87	2-6	3½	4-8	13	11½
1987-88	1-5	3½	3-7	12	11½



124. **M0 growth** has fallen by over one point over the past year, mainly in response to the rise in interest rates last winter, and is currently in the bottom half of its target range. The recent rise in interest rates will impart another downward impulse to M0, which will only be partly offset by buoyant personal incomes and expenditure. M0 growth could therefore stay in the 3-4 per cent range for most of the forecast period.

125. The forecast for **£M3 growth** - based on the assumption of no overfunding - assumes that the trends in velocity observed in recent years will continue: high real interest rates, financial liberalisation and the associated reduction in the margins between borrowing and lending for many customers all point to further rapid expansion in financial assets and liabilities. A range for £M3 in 1986-87, were it to be chosen purely on the basis of this central forecast, would be 11-15 per cent, 7 per cent above the range in the 1985 MTFS.

126. Early versions of the MTFS assumed a continuation of the rising velocity of the 1970s. More recent versions assumed that the growth of £M3 would be broadly in line with income - in fact, velocity has fallen almost continuously: see next chart.


STERLING M3 VELOCITY
1980 MTFS
1982 MTFS
1983 MTFS
1984 MTFS
1985 MTFS
0.94
0.92
0.90
0.88
0.86
0.84
0.82
0.80
0.78
0.76
0.74
0.72
0.70
0.68
0.66
0.64
0.62
0.60
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988

ANNEX: COMPARISON OF FORECASTS

Outside Forecasts

1. Table A compares the Treasury forecast with an average of outside forecasts. Both the Treasury and outside forecasters have revised up their GDP forecasts over the past year. The Treasury forecast is currently in the top half of the outside range for 1986, and is near the average for 1987.

2. The RPI inflation forecast is close to the outside average for both 1986 and 1987, whereas the earnings forecast is above the highest outside forecast (by the CBI) for 1986 before falling in line with the average for 1987. The implied higher real income growth in 1986, together with a higher fiscal adjustment to both 1986-87 and 1987-88 accounts for the higher Treasury forecast of private consumption.

3. The forecasts used are NIESR, LBS, Phillips & Drew, Simon & Coates, Henley, Cambridge, Oxford, Liverpool, CBI, OECD, CUBS and EC. Note that not all forecasts are used in working out the average - only those which are directly comparable.

4. Comparisons of oil prices and revenues are given in the separate report on oil, circulated by Mr Hacche.

Treasury Forecasts

5. Table B compares the internal January forecast with the last three Budget forecasts.

6. The outlook for GDP growth in 1986 is over half a per cent higher than in the last Budget forecast. This reflects higher oil production, and stronger growth of domestic demand, including fixed investment and government spending.

7. In contract to the FSBR forecast, which assumed a broadly constant exchange rate we now have a fall of around 6 per cent between 1985 and 1987, with lower real oil prices more than offsetting the effects of the projected fall in the dollar and higher domestic real interest rates.

SECRET

TABLE A - COMPARISON WITH OUTSIDE FORECASTS

	January Forecast	Outside Average	Outside range	
£M3 % change on year earlier				
1985-86	12.9	12.9	11.0(LBS)	15.5(Henley)
1986-87	12.8	11.6	9.7(LBS)	13.8(Henley)
1987-88	11.9	10.5	6.2(LBS)	13.3(Henley)
M0 % change on year earlier*				
1985-86	4.5	4.6	2.9(Henley)	5.75(NIESR)
1986-87	3.3	6.2	5.6(Henley)	7.1(LBS)
1987-88	3.6	2.7	1.3(LBS)	4.0(P&D)
PSBR £ bn				
1985-86	6.8	8.3	7.8(S&C)	9.3(Henley)
1986-87	7.6	8.6	7.5(LBS)	9.4(Henley)
1987-88	7.1	9.2	7.4(LBS)	11.1(Oxford)
Fiscal Adjustment (Annual)				
1986-87	2.2	1.6	0 (NIESR)	3.5(CBI)
1987-88	4.2	1.8	0 (NIESR)	3.8(S&C)
Exchange rate (1975 = 100)				
1986 Q4	75.0	76.5	73.1(Oxford)	80.3(NIESR)
1987 Q4	73.0	73.6	70.7(Oxford)	75.0(P&D, LBS)
Current account £ bn				
1985	3.6	3.2	1.3(L'pool)	4.25(OECD)
1986	4.3	2.6	1.1(CBI)	4.6(L'pool)
1987	1.6	-0.1	-4.2(Oxford)	4.5(L'pool)

	January Forecast	Outside Average	Outside range	
Consumption % change on year earlier				
1986	4.0	3.5	2.8(C'bridge)	4.2(S&C)
1987	3.9	2.7	1.8(NIESR, Henley)	3.7(LBS)
Import volume: goods and services % change				
1986	5.4	4.6	3.3(C'bridge)	6.6(CBI)
1987	4.1	4.6	2.7(NIESR)	8.1(Oxford)
Export volume: goods and services % change				
1986	3.6	2.6	0.5(Oxford)	4.3(CBI)
1987	1.7	2.3	1.4(C'bridge)	3.2(CBI)
GDP (output) volume % change				
1986	2.9	2.4	1.5(C'bridge)	3.7(CUBS)
1987	2.1	2.2	1.1(NIESR)	4.7(CUBS)
UK adult unemployment (millions)				
1986 Q4	3.1	3.10	3.03(S&C)	3.18(Henley)
1987 Q4	3.1	3.07	3.0(NIESR)	3.15(CBI)
RPI % change on year earlier				
1986 Q4	4.1	4.3	3.0(NIESR)	4.7(P&D)
1987 Q4	4.3	4.2	3.3(LBS)	5.0(P&D)
Average earnings % change on year earlier				
1986	8.7	7.7	6.6(L'pool)	8.3(CBI)
1987	6.8	6.8	4.6(L'pool)	7.5(S&C, P&D)

SECRET

TABLE B

COMPARISON OF TREASURY FORECASTS

	1983 MTFS/FSBR	1984 MTFS/FSBR	1985 MTFS/FSBR	January 1986 Forecast
Money Supply £M3				
(% change on year earlier)				
1984 Q1	9.0	9.5	8.1	9.8
1985 Q1	8.8	9.2	9.5	11.1
1986 Q1	7.5	8.2	8.0	13.4
1987 Q1	6.1	7.9	7.2	12.0
1988 Q1	-	6.0	6.2	11.0
PSBR				
£ billion (% of money GDP)				
1983-84	8.2(2.8)	10.0(3.3)	9.7(3.2)	9.7(3.2)
1984-85	8.9(2.5)	7.2(2.2)	10.5(3.2)	10.1(3.1)
1985-86	7.0(2.0)	7.0(2.0)	7.1(2.0)	6.8(1.9)
1986-87	6.4(1.8)	7.0(1.9)	7.5(2.0)	7.6(2.0)
1987-88	-	6.8(1.7)	7.0(1.8)	7.1(1.75)
Fiscal Adjustments (£ billion)*				
1983-84	-	-	-	-
1984-85	-0.4	-	-	-
1985-86	-3.8	-1.9	-	
1986-87	-8.8	-6.8	-3.7	-2.2
1987-88	-	-10.0	-6.8	-6.4
Nominal GDP (mp)				
(% change on year earlier)				
1983	7.5	8.6	8.4	8.5
1984	8.6	8.1	6.6	6.8
1985	7.9	6.9	8.5	8.8
1986	6.9	6.1	6.9	7.4
1987	-	5.7	6.1	6.5
RPI				
(% change on year earlier)				
1983 Q4	5.8	5.0	5.0	5.0
1984 Q4	5.4	4.3	4.8	4.8
1985 Q4	5.2	3.5	5.2	5.5
1986 Q4	5.1	4.5	3.8	4.1
1987 Q4	-	4.0	3.0	4.3

	1983 MTFS/FSBR	1984 MTFS/FSBR	1985 MTFS/FSBR	January 1986 Forecast
Current Balance (£ billion)				
1983	1.5	2.0	2.5	3.1
1984	1.5	2.2	0.1	1.1
1985	-0.6	0.7	2.9	3.6
1986	4.2	1.0	2.6	4.3
1987	-	-0.5	1.4	1.6
Manufacturing Output (% change on year earlier)				
1983	1.8	1.5	2.5	2.8
1984	2.4	3.6	3.4	3.8
1985	1.9	2.1	2.6	3.2
1986	0.9	1.4	2.0	2.4
1987	-	1.4	1.3	1.5
GDP Volume (% change on year earlier)				
1983	2.0	2.8	3.1	3.3
1984	2.7	3.1	2.5	2.3
1985	2.4	2.5	3.3	3.6
1986	1.9	2.0	2.2	2.8
1987	-	2.0	2.2	2.0
Interest Rates % (Short term)				
1983-84	9.6	9.7	9.7	9.7
1984-85	7.8	8.7	10.9	10.9
1985-86	7.4	7.8	11.9	12.2
1986-87	7.4	6.8	10.1	11.8
1987-88	-	6.1	9.3	10.8
World Trade in Manufactures, UK Weighted				
1983	1.0	1.3	1.4	0.8
1984	6.6	5.1	10.2	8.5
1985	5.7	4.5	5.5	4.2
1986	2.9	4.5	4.4	4.6
1987	-	3.8	4.5	3.5
UK Exports of Goods, Services (% change on year earlier)				
1983	0.9	0.6	1.4	2.6
1984	5.0	5.0	6.6	7.0
1985	4.9	3.9	6.4	6.6
1986	2.3	2.8	2.3	3.6
1987	-	2.8	2.7	1.7

	1983 MTFS/FSBR	1984 MTFS/FSBR	1985 MTFS/FSBR	January 1986 Forecast
Average Earnings				
(Private, not cyclically adj:- % change on year earlier)				
1983 Q3	7.3	8.3	8.7	9.3
1984 Q3	7.0	7.5	4.8	4.7
1985 Q3	6.5	7.3	9.3	10.0
1986 Q3	5.8	5.8	5.9	8.1
1987 Q3	-	4.8	4.7	6.8
Effective Exchange Rates				
(1975 = 100)				
1983	80.5	83.3	83.3	83.3
1984	81.8	83.2	78.6	78.6
1985	80.8	83.5	72.9	78.2
1986	79.6	82.8	74.0	75.8
1987	-	81.6	72.8	73.6
Unemployment				
(UK sa excl school leaver - million, new defn.)				
1983 Q4	2.9	2.9	2.9	2.9
1984 Q4	3.0	3.0	3.1	3.1
1985 Q4	3.1	3.0	3.1	3.2
1986 Q4	3.1	3.0	3.0	3.1
1987 Q4	-	3.0	3.0	3.1
I & C Companies Financial Surplus/Deficit, £ billion				
1983	0.7	6.4	6.9	5.1
1984	2.3	5.1	10.0	7.2
1985	1.8	2.0	8.7	8.5
1986	0.3	-0.3	4.1	5.5
1987	-	-0.9	5.5	4.1

* A negative sign indicates a reduction in taxes (see Fiscal Adjustments)

To be
Shredded.

PRESS

~~B/F~~ 31/1

no longer required

Rose — Draft of Sir A's minute: original checked by NW → PM's box

PRIME MINISTER

THE BUDGET OF MARCH 1985

The public sector financial deficit of the UK when measured as a percentage of GDP was roughly the same as that of the United States.

Even taking account of our higher savings rate than the United States, this is too high and is not sustainable. Such a high fiscal deficit throws a big burden on interest rates and crowds out private sector development.

A first budget priority should be to reduce the financial deficit of the public sector. In present conditions, this probably means a fiscal adjustment of less than $1bn. In terms of PSBR, it amounts to some £5½bn.

As we saw in 1981 such a 'tight' budget will not depress demand and reduce growth; on the contrary, it will generate market confidence, lower interest rates and promote expansion. You will regain control.

Whatever room there is for tax reductions should be concentrated on raising thresholds. They are still far too high and inhibit both employment and enterprise.

The MTFS

This is the appropriate time to drop M3, PSL2, or any other broad aggregate from the targets. They have been eliminated de facto long ago - we should formalise their demise. Our targets, as in Germany and Switzerland, should be the monetary base. As the Treasury papers have shown, this has always served us well and can be used with confidence to guard against persistent inflation. A steady declining growth rate for Mo to approximately zero will eliminate inflation.

The only argument against Mo is said to be City incredulity. However the City has been tutored in the past by the Bank to the view that Mo, as mainly notes and coin, could not be a suitable indicator, compared with some measure of credit, such as M3, PSL2, etc. This view has been discredited (and not merely in the UK). With the Banks cooperation, City credibility in Mo could be quickly established.

As far as the budgetary targets are concerned, may I suggest they be recast in the form of financial deficits of the public sector. These exclude, inter alia, the negative effects of asset sales and so they are much more appropriate as a means of fiscal effects than the PSBRs. In practise, this would not involve any substantial change in the movements of the PSBR or financial deficits since the asset sales are predicted to be about constant for the next three years.

The Exchange Rate

I can only reiterate what I have said so often: our domestic monetary policy should be adjusted to achieve stability and inflation-free growth in our domestic economy. To hold our domestic monetary policy hostage to all the rumours, reports, politics and external events that assail us is a recipe for violent instability in the whole economy. Of course we cannot ignore external events etc, but we should not magnify them and inflict them on Britain in the form of violent oscilations in interest rates.

In particular, the appropriate policy for a falling oil price is to let the exchange rate depreciate (but of course not to encourage a depreciation). I do not accept the "losing control" argument unless it can be shown clearly that monetary/fiscal policy is loose (as in December 1984 and January 1985). This is clearly not the case in January 1986; I think our present monetary policy is too restrictive.

In short, I think that the case which you made in this morning's meeting was analytically correct, and, although I venture far from my last here, politically adept.

ALAN WALTERS
24 January 1986

Sent by Bag

10 DOWNING STREET

From the Private Secretary

Prime Minister

The oil markets have firmed a little, and inter-bank rates have eased (3 months now at 13 1/4). The Chancellor is considering whether to hold off today, after all. He may come round to see you again within the next half hour.

The present exchange rates are $1.3965 and DM3.39.

I have explained to the

Treasury knew very relieved you would be if there were no increase today.

DRN
24/1

SRWANH

SECRET

4

PRIME MINISTER

INTEREST RATES AND YOUR MEETING WITH BRIAN GRIFFITHS AND ALAN WALTERS

You are meeting Brian Griffiths and Alan Walters for three-quarters of an hour at 0915 tomorrow morning. The Chancellor is holding a meeting to discuss the market position which will start at 0830 and he may come round to see you at about 0945. I understand that he does not feel strongly if Brian Griffiths and Alan Walters were to stay when he arrived.

The Chancellor, I understand, is inclined to think it would now be too risky not to bring about a 1½ percent increase in base rates. (I am not clear whether the clearing banks have asked for an increase of this size.) The Chancellor fears that to continue to put it off could risk a further serious and sudden move in the exchange rate. Others feel that it would be better to wait to see how the oil markets move and also to allow the political controversy to die down. The Chancellor may yet be persuaded by those who favour delay.

You will want to explore with Alan Walters and Brian Griffiths what their views are. I suspect that Alan at least will favour delay: he is likely to argue that if the markets take the exchange rate down too far they will come back again to a realistic level later.

For what it is worth, my own feeling would be in favour of delay, allowing the exchange rate to continue to take the strain. The risk is that if rates rise tomorrow and there is further political upheaval to come over the weekend or in the early part of next week, the markets will react and we may risk facing an increase in interest rates from 14 percent rather than 12½ percent.

It is also entirely reasonable to expect and to allow the exchange rate to depreciate when oil prices have fallen by a quarter or more in the space of a few weeks.

SECRET

You will no doubt want to test the Chancellor's arguments carefully if he does in fact conclude that an increase in base rates is justified. But if he remains convinced that an increase is necessary, his judgment will have been based on an assessment that the risks are simply too great to be borne. There clearly is a risk that failure to act, against the present political background, would be taken as a symptom of failure of will rather than a decision resulting from a careful assessment of the economic position.

Martin Sawer (Duty Clerk)

pp. DAVID NORGROVE
23 January 1986

NOT FOR PUBLICATION OR REFERENCE
TO CONTENT BEFORE TIME OF DELIVERY

Speech by the Rt Hon. J. Enoch Powell, MBE, MP, to the Annual Dinner of the Grimsby & Immingham Chamber of Commerce and Shipping at the Town Hall, Grimsby, at 8 p.m. Friday 21 February 1986.

I suppose it has something to do with recent ructions in the political and parliamentary world; but Britain has been indulging lately in an absolute orgy of superstitious terror. All sorts of harmless and in some cases gratifying events have been distorted by our fevered imagination into menacing hobgoblins and terrifying monsters. This may be good for members of my profession. It is shockingly bad for the rest of society to be fed on a diet of baseless alarm: it is bad for morale, it is bad for that indefinable sort of self-confidence which a nation needs in order to be happy and successful.

Nonsense about oil has had a lot to do with this. For ten years or more all sensible people have known that the international price of oil would one day take an almighty tumble. The globe on which we live is like a petroleum-sodden sponge: give it a poke almost anywhere, and oil and gas will spurt out. All the arm-twisting and chicanery of the world's oil producers could not forever go on sustaining prices at an unrealistic level. Apart from special interests which batten upon scarcity, the plunge in oil prices is GOOD NEWS in capital letters: one of the major factors of production has become cheaper. Instead of greeting this by running around by beating our brains out, we ought to "rejoice, rejoice", as somebody once said on some occasion.

For Britain the good news is specially good. It marks the reversal of that abrupt switch from current deficit to current surplus on our balance of payments which in recent years has been helping to force unemployment up and manufacturing production down. There is no virtue of course in doing more work than we need to obtain our requirements; but the artificially high price our oil commanded gave us an overdose of leisure which we were quite

unprepared to absorb. Thank goodness, we can now look forward, with any luck, to some decent trading deficits.

Yes, you heard me right the first time: I said "decent deficits". With a current surplus it is we who export our capital; with a current deficit it is the rest of the world which invests in us. How grumpy we get, though, when foreigners try to put money into Britain. The more the merrier, say I. So I laughed my way through the Sikorsky wrangle and the Leyland wrangle. Like most of my fellow countrymen, I am not too keen on foreigners; but I have no objection to their money. As the emperor Vespasian said of his profit from the Roman public 'loos, "it doesn't smell". Some ignorant fellows complain that we are selling the family furniture abroad. Not a bit of it; the furniture stays here, the capital comes here.

As for worrying about the Japanese and their export surplus, why on earth should we go knocking our foreheads on the doorstep of the Mikado? If it takes the fancy of the Japanese to export their savings, that's their affair. From our point of view it all helps to keep our disastrous surplus with the outside world within limits and so to stem the outflow of capital from Britain.

Too much of it has flowed to the United States. And here enters another bogey, with which the purveyors of mumbo-jumbo have terrorised the British public - the sterling exchange rate. Thank God for a fall in the exchange rate, though it is always portrayed as if it were the first intimation of Armageddon. The Americans under the much-admired Reagan administration have monstrously mismanaged their public finances. If it amuses them, they have a perfect right to do that as long as the lark continues. What I do object to is that, when they go around borrowing at exorbitant rates of interest and sucking in money from outside to cover their payments deficit and finance their domestic profligacy, they complain about the fall in the exchange rate of sterling and want us to oblige them by fiddling it.

To listen to these people and all those who parrot the cry for a fixed exchange rate, (which by definition means a false exchange rate,)

you would imagine that the variation in the value of sterling was a kind of disease and not an automatic protection for our economic sanity and political independence. Let us never go back to the days when we squeezed and squashed ourselves silly and ran up large debts to foreign governments for the privilege of holding our exchange rate to a figure that always had to be abandoned in the end.

Hurrah, then for a falling oil price and a falling pound. And let nobody spoil our delight by threatening us with inflation. The threat is empty bluster or deliberate deception. The days of ignorance are gone, when it was believed that any rise in any price contributed to cause inflation. If import prices go up because the exchange goes down, so be it; the general level of all prices can only rise if the Government balances its books by creating new money. That indeed is the one fly in the ointment, the one cloud on the horizon. Before anyone takes me for a modern Candide living in the best of all possible worlds, let me declare that year on year inflation is far too high in Britain today at 5.7%, a rate at which money loses half its value every twelve or thirteen years. The mere fact that inflation has been worse, much worse, in recent memory ought not to delude us into dismissing as insignificant such a dizzying deterioration in the standard of value and the medium of economic decision. The fact is that the Government is still quite deliberately debauching the currency. I say "deliberately", because on their own confession they have ensured that the rate of inflation has been prevented from falling further towards zero. If we do not watch out they will use the lower price of oil as an excuse for going softer still on inflation.

The argument runs as follows. Lower oil prices mean less revenue at existing tax rates. So they probably do, though not that much lower, if cheaper energy stimulates economic activity. However, suppose there will be a given shortfall of revenue. The Government, assuming inelastic expenditure, can do three things to

meet it: they can borrow that much more, which may necessitate higher rates of interest; or they can inflate that much more, or they can tax that much more. This last alternative, the honest alternative, the best alternative, is where the rub comes. Public expectation, especially in quarters to which the Government looks for electoral support, has been excited by the vision of two or perhaps three tax-reducing budgets before this present parliament comes to an end.

There is a good deal of superstition involved here - superstition about the electoral consequences of tax reductions, superstition about the economic consequences of tax reductions. But superstition is a fearful opponent for governments and chancellors of the Exchequer to face. All the more need for voices to be raised, and raised now to counter it. So here is one voice to cry out to Britain: "Things are going your way: don't spoil them. The price of oil is coming down: don't try to stop it. The surplus on current account is coming down: don't interfere with it. The sterling exchange rate is coming down: don't be tempted to fudge it. Inflation has come down, yes, but not nearly far and fast enough: don't feed it. Keep your spirits high and your nerve steady." So much to Britain; but to the Government and the Chancellor in particular, this: "If it comes to the choice, tax with a good conscience: tax, and fear not".

Prime Minister 4
DLS
29/1

ECONOMIC PERSPECTIVES Summary

MORGAN STANLEY

January 21, 1986

RETHINKING 1986: NEW DATA AND OLD PERCEPTIONS

Stephen S. Roach

Issue

Has the combination of a major GNP revision and a year-end spurt in economic activity altered our view that the economy will get off to a sluggish start in 1986?

Analysis

A comprehensive GNP revision has done little to alter the basic themes of our economic forecast. The cyclical contour of this expansion has survived the revisions intact, with a faster-than-normal phase of recovery followed by an unusually sharp slowdown that put the economy in growth recession territory from mid-1984 to mid-1985. Moreover, that sluggishness can still be attributed to a sharp widening of the U.S. foreign trade deficit that has produced an unprecedented drag on the economy's domestic income-generating capacity.

For the business sector, the GNP revisions reveal somewhat greater stress on purchasing power. The ratio of corporate profits to capital outlays has been lowered sharply over the past three years. Moreover, disappointing results of recent investment surveys, sluggish trends in capital goods orders, ample margins of slack capacity, and the possibility of a rollback of investment tax incentives all make for a fairly gloomy capital spending outlook.

Moreover, the consumer still appears to be overextended. From third quarter 1984 to third quarter 1985, real consumption is now estimated to have grown 3.9%, whereas real disposable income rose by only 0.9%. There has never been a more pronounced mismatch between income and spending over the past 35 years. Moreover, while historical levels of debt and saving ratios have been revised, both are still signaling intense pressure. By the end of the revision period (third quarter 1985), the personal saving rate remained 3.6 percentage points below its new norm, and the consumer debt burden still showed an unprecedented deterioration over 1984 and 1985.

Conclusion

Continued sluggish growth still seems to be the most likely scenario in the first half of this year. However, if there is a risk to our baseline forecast, it is more in the direction of unexpected weakness -- largely because the United States is still suffering from the lingering strains of a dollar-induced shortfall of aggregate income growth. Consequently, we feel that over the near term, downside risks outnumber those on the upside by a factor of two to one.

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INTEREST RATES

Statement to Reuters

The Bank of England's offer to lend to the market today at 12½ per cent follows the rise in market interest rates in the last few days. To have delayed would have risked giving the wrong signal. This response underlines the Government's determination to take no risks with inflation.

Positive

2. No risks.

3. Err on side of caution.

4. Prompt.

5. Straightforward.

Quotes

6. 1985 Budget: "There can be no doubt about the Government's commitment to maintain monetary conditions that will continue to bring down inflation. Short term interest rates will be held at the level needed to achieve this."

Autumn Statement Debate: "All that has happened since then is that the Government have demonstrated once again that we mean what we say. Not least by resolutely resisting the blandishments of those who would have us seek some opportunistic window through which to depart from that policy. It remains as firmly in place as ever."

Defensive

8. Nothing to do with Budget.

9. Worst thing for industry would be to put at risk achievement and prospect on inflation.

10. Interest rates bound to fluctuate but economy/money GDP on course.

11. Response, not autonomous initiative.

12. Delay could have risked uncertainty in markets/raised doubts about Government's commitment on inflation led to round-tripping.

E. R.

CONFIDENTIAL

PRIME MINISTER

MARKETS

Short-term interest rates continued to move up a little after the Bank gave its signal for an increase of 1 per cent in base rates. By the close, three-month inter-bank sterling was trading at $12\frac{3}{4} - \frac{5}{8}$ per cent.

The Treasury assure me that this is not in itself grounds for nervousness about a further increase. Rates often fluctuate after a move, and in any case, that level of interest rates is quite consistent with base rates at 12½ per cent.

At 1900 hours the exchange rate was at $1.44½ and nearly DM 3.56. I guess that would mean a figure on the Index of about 78½.

The Market Reports and the Treasury briefing line are below.

DAVID NORGROVE

8 January 1986

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① Mr. Norgrove
② Prime Minister

SECRET

Foreign Exchange Markets: Evening Report

date: 8 JANUARY 1986

Previous close		Today opening	Today close	% change in $ since NY close 20.9.85.
77·5	£ ERI	77·6	77·9	
82·1	£ ERI (excl $)	82·2	82·7	
1·6077	ECU/£	1·6118	1·6200	
1·4405	$/£	1·4385	1·4445	−4·9
3·5105	DM/£	3·5168	3·5369	
289·97	YEN/£	290·10	291·47	
125·1	$ERI	—	125·5	−10·1
2·4370	DM/$	2·4405	2·4485	−13·8
201·30	Yen/$	201·60	201·78	−15·4
	3 month interest rates			
12	UK interbank £	12 3/8	12 5/8	
8 1/16	Eurodollars	7 15/16	8	
+ 3 5/16	Uncovered margin	+4 7/16	+4 5/8	
4 1/16	Euromark	4 5/8	4 5/8	
$26.40	SPOT BRENT (JANUARY)	$25.75		

Market comment Sterling gained ½ cent and 2 pfennigs after the Bank signalled an increase of 1% in bank base rates. It approached $1·45 before easing back as the dollar strengthened. The dollar was firmer, underpinned by a drop of 0.1% in the unemployment rate and a higher than expected increase in non-farm jobs (+320,000). Since the close, the dollar has moved firmly through DM 2·45, which it has recently found difficult, and at 5·30pm rates are DM 2·46 with the £ at DM 3·5440. John Forth

Other countries market intervention ($m equivalent)

Germany	US	Denmark	Sweden +35 $ + 8 (DM) + 5 Yen
France	Japan	Holland +14 $	Spain +185 $
Italy −57 $, −92 (DM)	Ireland −13 $, −12 (DM)	Belgium	Portugal −17 $

$ million

UK reserves transactions

	A Today	B This month so far	C Expected for rest of month	D Total for month (B & C)	E Total since 1 Jun '85
Market Intervention	+2	−64	—	−64	−55
Off-market Intervention	−18	+474	−297	+177	−534
Total Intervention	−16	+410	−297	+113	−589
Net Borrowing	−19	−29	+83	+54	
Total change in Reserves	−35	+381 *	−214	+167	

*of which $ +145 m represents a change in the forward book

EF1 Division 233 5105

Hong Kong	Previous	Today	Change
Hong Kong dollar	7.8085	7.8075	little change
Hang Seng Index	1815.53	1826.84	up 11 points
Overnight interbank rate	7%	7%	unchanged

SECRET

DOMESTIC MARKETS: CLOSING REPORT FOR: Wednesday 8 January 1986

MONEY MARKETS

Interest rates	O'night	7 days	1 month	3 months	12 months
£ Interbank	10 (−1)	12 7/16 (+2 5/16)	12 23/32 (+1 1/32)	12 5/8 (+19/32)	12 1/2 (+7/16)
Euro $	( )	8 (—)	8 1/16 (—)	8 (—)	8 1/16 (—)
Differential	( )	+4 7/16 (+1 9/16)	+4 21/32 (+1 1/32)	+4 5/8 (+19/32)	+4 7/16 (+7/16)

Bills (discount rates) (days)	Band 1 (0-14)	Band 2 (15-31)	Band 3 (32-63)	Band 4 (64-91)
Eligible bank bills	12 1/2 − 1/4 (+1)	12 5/16 − (+13/16)	12 5/16 − 1/4 (+3/4)	12 3/16 − 1/8 (+5/8)

3 month Treasury bills 12 1/4 (+5/8) 3 month Local Authority bills 12 1/4 (+3/8)

Bank money market operations (£M)

Bills:	Band 1	Band 2	Band 3	Band 4
Dealing rates				
Official Purchases (+)	—	—	—	—

Total bills £ — m ~~bought/sold~~
Repurchase £ — m ~~unwinding on~~ at
Lending £ 330 m @ 12 1/2% to 10 Jan through Discount Window
Total operations £ 330 m against shortage/~~surplus~~ £400 m

STOCK MARKET

FT Ind-ord 1123.8 (−11.5) FTSE 100 1404.2 (−11.0) FT Govt Securities 81.56 (−0.23)

Gilt Edged Market

Authorities ~~bought~~/sold £ 139.9 m (net)

(Change on day)	Price £		Yield %		Trading
Shorts	−5/16	to −3/16	+0.15	to +0.06	Fairly Active
Mediums	−3/8	to 0	+0.10	to 0.	
Longs	−1/8	to 0	+0.02	to 0.	
Undated	−1/8	to 0	+0.04	to 0.	

Gilt Futures Mar Long Contract Open 108.23 Close 109.16 Volume 4140
Gilt Futures Mar Short Contract Open 94.50 Close 94.60 Volume 862

FOREIGN EXCHANGE

£ Effective	77.9 (+0.4)
$/£ rate	1.4445 (+0.004)
DM/£ rate	3.5369 (+0.0264)

US RATES

3 month CD's	7.85 (+0.09)
10 yr Tsy Bond	8.94 (−0.12)
20 yr Tsy Bond	9.38 (−0.18)

Money market rates closed sharply higher after the Bank lent to the market through the Discount Window at 12½% (1% over established dealing rates). Base rates are now 12½% with Midland moving first.
Gilts opened easier on press comment about higher interest rates. The lower prices brought in substantial switching demand and both the 10½T97 and the 9½Cv2004 were exhausted in early trading. The moves in interest rates left the market pondering the future and prices closed down 5/16 in shorts, ¼ in mediums and ⅛ in longs. Index-linked were on offer all day and closed down ⅜.
Futures closed up ¾ after opening down ¼ and options were unchanged on higher business. Equities opened firmer but declined throughout on base rate rises.

Rob Blaser

GILT-EDGED MARKET : DETAIL

Transactions basis, cash values (£ million); sales + purchases −

ISSUE DEPARTMENT: MARKET TRANSACTIONS

	Today	Banking January
1. Gross sales shorts	—	+49.8
2. " " mediums	+95.3	+149.4
3. " " longs and undated	+215.3	+248.4
4. Calls on part-paid Stock sold earlier	—	—
5. Buying in, other than next maturities	−163.6	−235.7
6. CRND: Market transactions	−0.8	−0.8
7. **Total 'gross' sales**	+146.7	+211.1
8. Buying in of next maturities	−6.7	−222.5
9. Redemptions	−0.1	−1.9
10. **Total transactions with market**	+139.9	−13.3

PRICES/YIELDS OF GILT-EDGED STOCKS

	5 years	10 years	20 years
Par yield curve at close last night	11.497	11.145	10.718
at previous close	11.364	11.048	10.645

Representative Stocks	Price	Yield
11% Exchequer 1991	100 1/8 (− 3/8)	11.51 (+0.10)
12% Treasury 1995	102 5/8 xd (− 1/8)	11.43 (+0.02)
11¾% Treasury 2003/07	106 1/8 xd (—)	10.81 (+0.01)
2% Index-linked 1988	115 5/8 (− 1/8)	5.25 (+0.06)
2½% Index-linked 2011	99 5/8 (− 3/8)	3.32 (+0.03)

TAP STOCKS AND RECENT ISSUES

	Price	Yield	Issue dept
Last official sales of tap A.			
B.			

KNOWN FUTURE GILT-EDGED TRANSACTIONS

	Part Payments (+)	Redemptions/expected buy-ins (−)
Banking Jan	+580	—
Banking Feb	—	—
Banking Mar	—	—

Sales required to meet 'Gross' sales Target for Banking Jan (1000)

£m 209

Subject ≪ Master

SECRET

File

3 DG2150

bc: Prof. Griffiths.

10 DOWNING STREET

From the Private Secretary

8 January 1986

Dear Rachel,

BASE RATES

The Prime Minister this morning discussed with the Chancellor, the Governor and Mr. George the position on interest rates.

The Chancellor and the Governor explained that market interest rates had moved up in the last two days for a combination of reasons. First, there were fears that the exchange rate might depreciate further, against the background of expectations of lower oil prices and concern about the high rate of growth of costs in the UK. Secondly, there was concern about the high rate of growth of bank lending, which included a large element of personal lending, both for housing and for general consumption. Market confidence had also not been helped by signs that the Government was in disarray over the Westlands affair. It had been expected that the clearing banks would themselves wish to increase base rates. But they were in fact reluctant to do so, preferring to wait to see how the markets moved: their own financial position did not require an increase at present. The difficulty was that if the Government appeared to hang back it would give an appearance of dither and indecision, which would increase the risk of a further increase in interest rates. An increase now could not be presented as responding to the clearers, but the Government could say that it was responding to the market.

The Prime Minister expressed concern that if the Government responded now to what seemed to be somewhat hysterical market pressures, the market would take interest rates higher still and the Government would be in a similar position again next week. This had been the experience on several occasions in the past. All present agreed that the risk of further market pressure certainly existed, but as Mr. George argued, a move now was needed as a matter of damage limitation.

The Prime Minister accepted that the authorities should signal an increase of 1 per cent in base rates. The Prime Minister emphasised, and the Chancellor and the Governor agreed, that any further market pressures for higher interest rates should be firmly resisted.

SECRET

I am sending a copy of this letter to John Bartlett (Governor of the Bank of England's Office).

Yours ever,

David,

David Norgrove

Mrs. Rachel Lomax,
H. M. Treasury.

Base Rates

10 DOWNING STREET

Prime Minister

I have told the Treasury that you would wish to be consulted again before any move in base rates tomorrow morning.

I would not put much weight on the point about Corporation Tax payments marked below – ~~it~~ tax payments would tend to affect the very short end, rather than the 3 months rate.

DLS
7/1

2

NOTE FOR THE RECORD

BASE RATES

The Chancellor today explained to the Prime Minister that there was a risk that base rates might need to rise tomorrow. The sterling three month interbank rate had risen to 12 per cent, a level at which a rise of a ½ per cent in base rates would be justified. This increase had occurred gradually over the space of a day or a day and a half, and the money numbers published today had had little effect, even though monetary growth had been lower than of late. The exchange rate had not moved dramatically and indeed had been stable against the dollar, but it had a soft tone and had moved down to 77½ on the effective rate. Expectations of lower oil prices had played some part in this, but there was rather generalised concern. (The Chancellor did not specify what this related to). Expectations of a fall in US interest rates had also been dissipated. As the exchange rate had softened, interest rates had risen in the expectation that this was what the authorities would want in order to reduce damage to the inflation prospects from a falling exchange rate.

The Chancellor said that if the authorities moved early tomorrow to validate the rise in market rates, this should have a salutary effect. But the need for a further increase could not be ruled out. Indeed, if market rates had risen further by the opening tomorrow, there might need to be an increase of more than a ½ per cent, which could trigger an increase in the mortgage rate when the building societies met on Friday. The effect on the mortgage rate was, however, now hard to predict with the weakening of the cartel.

The Prime Minister was concerned that an increase in base rates now would come as a great shock. It would cause concern, among others, to the CBI, and the Prime Minister also mentioned the effect on farmers whose incomes had fallen substantially over the past year. Interest rates were already very high. The Prime Minister also argued that to increase

base rates after a rise in market rates which had lasted only a day or a day and a half would be seen as hasty.

In reply the Chancellor pointed to the difficulty of resisting the rise in market rates: this would be taken to show lack of resolve.

The Prime Minister concluded by saying that it would be necessary to wait to see where the markets opened tomorrow.

DRN

David Norgrove

7 January 1985

SECRET

PRIME MINISTER

BASE RATES

I should warn you that there has been a return of the risk of an increase in base rates. Three month sterling inter-bank rates have crept up over the last day or so to $11\frac{15}{16}$-$\frac{13}{16}$% and are on the verge of causing a move. The Bank are more nervous than the Treasury but both agree on the possibility.

The background is continuing nervousness in the markets about oil prices, and there has been some further selling of sterling today, mostly against the DM which at the time of dictating this (1700) is trading at 3.52. The exchange rate index is a little below 78.

I asked whether the money numbers tomorrow might reassure. The Treasury think the benefits of better monetary growth may be offset by the high bank lending figure.

I imagine reports in the press of the latest comments by Phillips & Drew and Simon & Coates have also not helped. Both are gloomy about the prospects for control of public spending and fiscal restraint.

See also my separate note for tomorrow's meeting with the Chancellor.

DAVID NORGROVE

6 January 1986

VC3AJT

SECRET

AAWalters, 1985

file

The New Palgrave

Peter Bauer

The earliest and most distinguished critic of development economics, Bauer launched his research with a classic study of the rubber industry (bib 1948), where he showed that the very rapid growth was a consequence of voluntary responses usually of illiterate peasants to expanded opportunities due, largely, to contacts with the West. In West African Trade, he showed that, contrary to the views of development economists, the extensive system of traders was efficient in providing expanding production for the market and material welfare. State intervention in the form of marketing boards was shown to be a mechanism for exploiting monopsony power to the detrement of producers, particularly the small farmers, and to the benefit of the rulers. Stabilization of farm incomes did not require state marketing; it could be achieved by the farmers themselves.

His empirical studies, based on tight reasoning and close observation, lead Bauer to challenge two pillars of development economics - the need for comprehensive central planning and the efficacy of aid (i.e. intergovernmental transfers), and the theoretical bases of such policy prescriptions (including the 'vicious circle' of poverty, the 'investment fetish', the ubiquitous 'externalities' and economies of scale, the inevitability of the decline in the relative price of commodities.) Bauer showed that economic development depended basically on the motivations and mores of the people, rather than arithmetic accretions of 'resources'. He stressed the corrosive and corrupting politicization of economic life with its stultifying effects on development.

The meticulous scholarship and historical depth of Bauer's work was unusual if not unique in development studies. The veracity of Bauer's ideas and the poverty of development economics have become increasingly clear in the 1970s and 1980s. In 1983 his elevation to the peerage as Baron Bauer of Market Ward in the City of Cambridge recognised his outstanding contributions to scholarship.

The Rubber Industry, Cambridge, Mass, Harvard University Press 1948.
West African Trade, Cambridge, England, Cambridge University Press, 1954.
Reality and Rhetoric: Studies in the Economics of Development, Cambridge, Mass, Harvard University Press,1984.

Congestion:

Palgrave Dictionary AAWalters

Property Rights and Congestion,

Throughout history congestion has been a common phenomenon. Although in many economic parables it is convenient to start with a Robinson Crusoe economy, Man Friday soon makes an appearance. And so the possibility of Crusoe and Friday getting in one another's way is soon apparent. The competition of people for resources - for fish or fowl - is the economic problem. While resources are so plentiful that, whatever the scale of the hunting and however big the kill, the marginal costs of bagging a deer is in no way affected, then there is no potential for congestion. The only problem is the allocation of time to hunting and to pursuits other than the chase. This is a society of gatherers where no man's use diminishes another's. In modern terminology (Samuelson), game is a pure public good provided by a benevolent Being. Whether such elysian fields ever existed is to be doubted, for it is always true that one quarry will be more convenient than another. There will always be competition for the game.

With a Hobbesian view of man's nature, such competition is likely to begin with - or degenerate into - brute force, death or banishment with the the winner taking all. While such violent solutions to the problem of scarcity have by no means been abolished, more social and civilized arrangements are nowadays

the rule rather than the exception. The investiture of property rights in terms of allocating and defending priorities in the use of specific resources is by far the most common form of avoiding regimes of terror or violent conflict. (Demsetz 1982)

Allocation of property rights by status was the main feature of pre-capitalist Western societies - and it still a predominant method in communist bloc states and in many countries in the third world. But irrespective of the initial allocation of property rights, the development of capitalism essentially sanctioned and even encouraged the negotiability of those rights. Any person could contract freely with any other person to improve their mutual satisfactions, provided that they could trade in well-defined and enforced rights.

With the ambient conditions of scarcity, congestion, like "shortages", appears either when the property rights are not well defined or when mutual trading and contracting is excluded. Thus consider an elevator with a capacity of 10 persons when 15 people appear to demand a lift, so that at least 5 people must incur the costs of a wait for the next available space. In most modern societies there is no inherent investiture of the right to a place in the first elevator. However social behaviour sometimes recognises a rule of convenience or status - such as elderly, handicapped, chief executive officer and women to take priority. But such rules would have to be enormously complex to avoid all conflict. In practice most societies recognise a simple rule of the queue - or first-come-first-served, (FCFS). It is remarkable that queuing rules are to be found ubiquitously,

and very different societies appear to find the rule fair although rather wasteful; seemingly, equity is worth the cost.

Even with the FCFS rule, however there is considerable scope for contracting mutually advantageous trades. The eleventh man in the queue might offer to buy the place of one of the first ten - and someone with an assured place may be willing to trade his place and wait for the next elevator in exchange for the offer of the eleventh man. Deals may be so struck that those who value the speedy lift highly may buy the places of those who do not. Since all contracts are freely negotiated, people must be at least as well off and so there is a Pareto improvement. There is however still the inefficiency of the queue; clearly it would have been better if no more than ten people had arrived for the lift and those ten had been the people who valued most the service at that time. The queue involves waste in waiting. Yet it is easy to devise, in principle, alternative schemes for the allocation of property rights which do not involve the waste of time and resources in queuing. For example, a lottery might allocate the ten places in the elevator - (and indeed such a system was used at the London School of Economics to allocate parking places, but, of course, only to the faculty.)

If the ownership of the right to designate the qualifications for travel in the elevator is vested in the owner of the elevator, and one assumes that the owner will maximise his profits, then he will find it efficient, transactions costs and stochastic variations aside, to sell the right to travel the elevator directly to the travelling public. There will be no

queue and no evidence of congestion. Well-specified property rights, zero transactions costs, profit maximization and freedom to contract are sufficient, but clearly not necessary, to banish congestion. The private provision of elevators, often by the users themselved, ensures that there is in fact no persistent strucural congestion.

Persistent or structural congestion, as distinct from accidental or transitory stochastic congestion, is normally to be found in the lack of specification of a property right, usually involving the public sector. For example, it is widely believed that there is considerable congestion in many fishing grounds--too many fisherman chasing too few fish. The number of fish is limited and so the marginal cost of fishing for a particular boat should reflect the fact that additional fish netted will increase the costs of other vessels catching fish; there are fewer fish and less spawn etc. The point is that the fish are not owned by a profit maximizing entity who extracts a royalty for each fish caught. They are nominally in the ownership of the state, if in national waters, but the state charges no royalty per fish caught. Scarce fish are not priced but treated as free. Thus the fishing grounds are congested and over-fished.

Highway Congestion

The most important form of congestion is on the highways, and particularly on the city streets. The highways are normally owned and operated by the state. If the state authorities were profit seeking entitites, then they would charge prices for the

use of the city streets that reflects the intensity of demand relative to the scarce capacity available. They would levy tolls in order to maximize their net revenue from the street system. But traditionally the state has not charged prices or tolls for the use of the city streets that reflects their scarcity. The urban roads are 'free' for all users (provided they have paid their license duty and acquired the right to use any of the roads in the national network as intensively as they wish). Thus people try to make too much use of the road network in areas where road capacity is scarce relative to demand. The urban streets become overcrowded, vehicle speeds slow as they get in one another's way, and the costs of a trip rise. Congestion is rather different from queuing; one cannot buy a place up front of the traffic jam as one can with negotiable positions in the disciplined queue. But in other respects - for example the waste of resources involved - queuing and congestion have the same characteristics.

The formal economic modelling of congestion can proceed either by analysing the phenomenon in terms of demand or in the form of the supply and cost conditions. Following the historical precedent of Dupuit (1849) and Pigou (1912) the approach is usually from the cost and supply side. The first assumption is that traffic consists of homogeneous vehicles with identical technical characteristics and cost functions. Each vehicle is operated by people with the same utility functions and the same levels of income, and so the same valuation of time. In order to avoid problems at the end or begining of the road, we might

conveniently assume that the road is a circle, with traffic going round and round. Let c(x) be the cost incurred for travelling one kilometre, where x is the number of kilometres traveled by all the vehicles on the circular route of k kilometres in circumference. The density of vehicles is then x/k. Thus the total cost of the x vehicle-trips of 1 kilometre each is then $C(x) = x.c(x)$.

As the number of trips on the road increases the density of vehicles on the road rises, and so the speed of the traffic flow falls, and c(x) rises. These are the familiar conditons of increasing congestion on the road. An individual deciding whether to make another trip will reckon the cost involved as c(x) per kilometre, and will make that trip if his valuation of the worth of the trip is at least as great as c(x) per kilometre. But the addition of another vehicle on the road will slow down all existing vehicles and so increase the costs of all other road users. Consequently the marginal costs of the additional trip consist not merely the private costs of the particular motorist but the additional costs he inflicts on others by adding to the congestion of the highway. The marginal costs of the trip are $dC/dx = c + x.dc/dx$, where c measures the private marginal cost of the individual and x.dc/dx measures the increase in cost to each user (dc/dx) multiplied by the number of user-trips (x).

Clearly, if as we have assumed there is no price levied for the use of the highway, private marginal costs are less than the true marginal costs. Then private decisions will result in there

being too much traffic on the road. This state may be conveniently defined as the condition of congestion. (In common usage congestion may be used to denote circumstances where there is some interaction and slowing of vehicles below their traffic-free speed. With this wider definition, some congestion is virtually always efficient, and there may be too little congestion on some highways. In this article the common usage definition will be eschewed and throughout the technical definition denoting too much traffic and too dense a traffic flow will be employed.)

The underlying reason for congestion is that the authorities do not charge an appropriate rent for the use of the highway. Were the highway to be owned by a profit-seeking private owner, a toll would be levied for the use of the road at least as high as the cost which the marginal motorist imposes on others (x.dc/dx). (And if the road owner were to enjoy some monopoly power, rather than be a member of a large number of highway owners competing to supply road services, then he would exact a monopoly rent in excess of (x.dc/dx). But we continue with the fiction of a large number of privately-owned competitive road suppliers so that the analogue with private business is clear.) In his classic work Pigou (1912) used the priceless road illustration as a paradigm for competitive industry, and thereby concluded that competitive industry would always over-expand and degenerate into conditions of congestion. As Knight (1924) pointed out, under conditions of private ownership of resources, including roads, there would be no such overuse (congestion),

since the road-owners would charge a competitive price for their services. Pigou was correct in the particular illustration of the 'free' road, but it was a distortion introduced by the public sector which would have not appeared under conditions of private ownership.

The normative conclusion is that it would be best, or at least better, if the authorities adopted a pattern of road pricing that simulated the behaviour of a competitive privately owned road system. For a specified level of traffic, say $x=x_i$, the authorities should charge a toll for the use of the road of $x.(dc/dx)$ evaluated at $x=x_i$. This can be interpreted as the product of the private cost of a trip (c) multiplied by the elasticity of that cost with respect to the number of trips $[(x/c).(dc/dx)]$, evaluated at $x=x_i$.

This calculation gives the optimum supply price of road space when the traffic is at the level x_i. If, however, the level x_i represents the traffic equilibrium when there is a zero charge for the road service, as shown in figure 1, then one must take into account the fact that raising the price of the total trip from $c(x_i)$ to $c(x_i) + x.(dc/dx)$ will give rise to a reduction of traffic along the demand curve. As traffic falls, both cost and the optimum toll also decline. The new equilibrium toll will be $x_o.(dc/dx)$ for the optimum level of traffic x_o and private cost $c(x_o)$. The optimum toll will always be below that calculated for the existing level of toll-free equilibrium traffic flow.

A rising value for the c(x) function is intuitively

plausible and fits in well with corresponding notions of the theory of the firm and industry. But in figure 1 the c(x) function becomes vertical at a level of trips shown as max, but instead of the cost curve staying vertical for all values exceeding c(max), it is shown as backward bending (in a broken line), becoming eventually asymptotic to the vertical cost axis. The rationalization for the backward-bending segment is best considered in terms of the flow/density/speed relationship by which trips are produced. Clearly the flow of vehicles past any given point of our circular road represents the number of trips completed. But the flow per hour is equal to the product of the density of vehicles (number per kilometre) and the speed of those vehicles (kilometres per hour). As vehicles join the road, density increases and speed is reduced. At low densities the reduction in speed is small, so that additional vehicles and increases of density will increase flow. However as more vehicles jam into the existing road-space the effects of the additional density on speed will be so important that the slower speeds reduce the flow of trips. Ultimately one can imagine the bumper to bumper conditions of the complete jam. Then flow is zero and costs approach very high values indeed.

In this description of traffic flow, there is an obvious analogue with the theory of fluid dynamics, (Walters, 1961). In the simplest form of the steady state flow theory:

$$s = b[\log D(s=0) - \log D(s)]$$

where s is the speed and D is the density at which that specified speed is attained, and x=sD. This gives a very simple form to

the elasticity of speed with respect to traffic flow, namely dlogs/dlogx = b/(b-s). The parameter b measures the critical speed at which flow is maximised. In statistical studies of traffic flow one finds values of b ranging from about 12 k.p.h.for city streets to 26 to 30 k.p.h. for urban freeways and motorways. There is thus some evidence that the fluid-dynamic model is useful for interpreting conditions of very dense traffic.

There is obviously considerable difficulty in dealing with such backward bending curves. For any given level of trips there are two conceivable levels of cost - one high level associated with a high density, and one low level corresponding to the light density. In any rational arrangement of affairs one would expect that the backward-bending high-density conditions would be avoided by some system of exclusion, by pricing or other means. But it would be foolhardy to assume that such rational arrangements would be the norm; clearly the observed frequent traffic jams are not consistent with economic rationality. The possibility of a high-density high-cost equilibrium being stable, such as point A in figure 1, cannot be dismissed. There is however also another locally-stable equilibrium at point C, on the rising part of c(x). There may be many such locally-stable equilibria and some unstable ones, such as that represented by point B in figure 1. The chaotic nature of traffic flow in many cities suggests that it would not be entirely wise to ignore such phenomena - although one might argue that such conditions are likely to be transitory and of limited interest. Very little

analytical or empirical attention has been paid to such problems of multiple equilibria and stability.

Various other models derived from the theory of thermodynamics and the statistical theory of queues have been used to model the congested aspects of road traffic. Although useful for simulating the interaction of congestion and flows in networks, the thermodynamic analogue has not been of much use in understanding the economics of congestion. The theory of queues and the stochastic processes derived to model lightly congested traffic have not been notably successful in producing theoretical simulations of observed processes, so again little has been done to interpret them in economic terms.

The empirical study of congestion has, however, found that the studies by traffic engineers of the relationship between speed, flow and density have been an invaluable basis for the economic assessment of the costs of congestion and the levels of the appropriate road tolls. Regression analysis of speed on flow has been the staple of analysis, sometimes using a rather unsatisfactory linear approximation for the rising section of the cost curve (and the falling section of the speed curve), and occasionally using the logarithmic form of the fluid dynamics analogue. The job of the economist was to translate a speed-flow relationship into a cost-flow form. The simplest approximation for very congested traffic is that cost is inversely proportional to speed. For less congested traffic, however, the approximation usually adopted is: $c = m + n/s$, where m and n are constants which depend on the currency of measurement, and c is cost per

kilometre, (Smeed 1968.)

Since the speed-flow relationships conform to theoretical expectation (with the exception of those with light flow and low density), the cost-flow version of the relationship is also consistent with the form displayed in figure 1. Taking observed levels of flow, density, speed and cost on urban highways, one may calculate the gap between marginal social cost and private cost (i.e. a measure of $x.(dc/dx)$. For cost inversely proportional to speed and with the fluid dynamic model, the optimum toll $t(s)$ at speed s is then $(cb)/(s-b)$. For some urban highways however, the situation is clearly on the backward-bending part of the cost curve. Formally the optimum toll at that point is infinite. But such a conclusion takes no account of the reaction of demand; one may merely take it as a reminder that it is patently wasteful to have so highly congested a road. Even if the demand curve lies to the right of the whole of the rising section of the cost curve, the optimum arrangement will always be to bring traffic down so that the equilibrium flow is on the rising section of the cost curve. This makes it important to know the shape of the demand curve and the values of the elasticities of demand over relevant ranges of flow.

Unfortunately we know much less about the elasticity of demand for trips than we do about the cost functions. Substitution elasticities between one road and another can be adduced from minimum cost (usually minimum time) routings by programming models, but substitutions between modes and the long run development of urban areas an movement are more

intractable. Nevertheless some work by John Tanner, reported in Smeed (1968), showed that the level of optimum tolls was not very sensitive to different assumptions about elasticities of demand; but this result has not been fully explored and explained.

The empirical studies suggest that the optimum toll for town and city traffic during peak periods is probably at least 50 per cent and, in many cases, as much as 100 per cent of the private cost of the journey. Off-peak the appropriate tolls are perhaps nearer to 10 to 40 per cent of the private cost. (In many cities, particularly those in the third world such as Bangkok, Lagos and Sao Paolo, the peak lasts for more than eight hours). The main implication for policy is that the wastes of congestion are very high and that there is a good prima facie case for reducing the demand for trips probably by some sort of pricing mechanism.

The best policy to deal with urban road congestion is likely to be some form of road pricing. However road pricing is the exception rather than the rule. Most governments have simply stood idly by as the wastes of congestion mount. When the traffic jams become quite unacceptable, the normal procedure is to impose regulations to ration the use of the streets. In Lagos for example, odd numbered license plates were allowed to be used on odd days and even numbers on even days. The most ubiquitous policy is to discourage the private motorist, with a particularly low occupancy to road space ratio, and to promote mass transit by rail or bus. Various priority systems with special bus lanes and

impediments for cars has been the usual policy. A proper application of road pricing has been practised in only one case - Singapore. There the private motorist pays a daily or a monthly fee to enter the restricted area of downtown Singapore during the morning rush hours. The scheme was instituted in 1975 and has been judged by both the government and independent observers as a considerable success on economic and political criteria (World Bank 1985). Rather similar schemes have been considered for London, Washington DC and many other cities, but political considerations have prevented their implementation. The development of information technology has made feasible many sophisticated systems of computer controlled pricing. One such system has been introduced on a trial experimental basis in Hongkong, (World Bank 1985). The technical objections to road pricing have been largely overcome, but the distributional, vested interests and political hurdles have yet to be surmounted.

Congestion in Airports and Ports

After highways, perhaps the most important examples of congestion are to be found in airports and ports. Both differ from the urban road congestion insofar as it is the normal practice to charge fees for landing aircraft and for harbouring ships. The problem of congestion arises when such fees do not reflect the scarcity of the facilities. (For some examples in ports, see Bennathan and Walters 1979, and in airports, Park 1971). Landing fees or port dues may be subject to legal limitations or political pressure. Yet in practice it has been

much easier to adjust airport and port fees to reflect scarcity, including seasonal or diurnal peaks, than to introduce congestion tolls on the highways.

Conclusion

The economic analysis of congestion has made some useful progress and the ideas and the policy measures that flow from those notions have a firm place in the economics of public policy. However the policy of congestion tolls has been resisted by most governments, presumably because it is believed that there is not sufficient electoral support for such measures. In that sense, the political economy of congestion pricing has been largely a failure. And it is difficult to see what changes would ensure its success.

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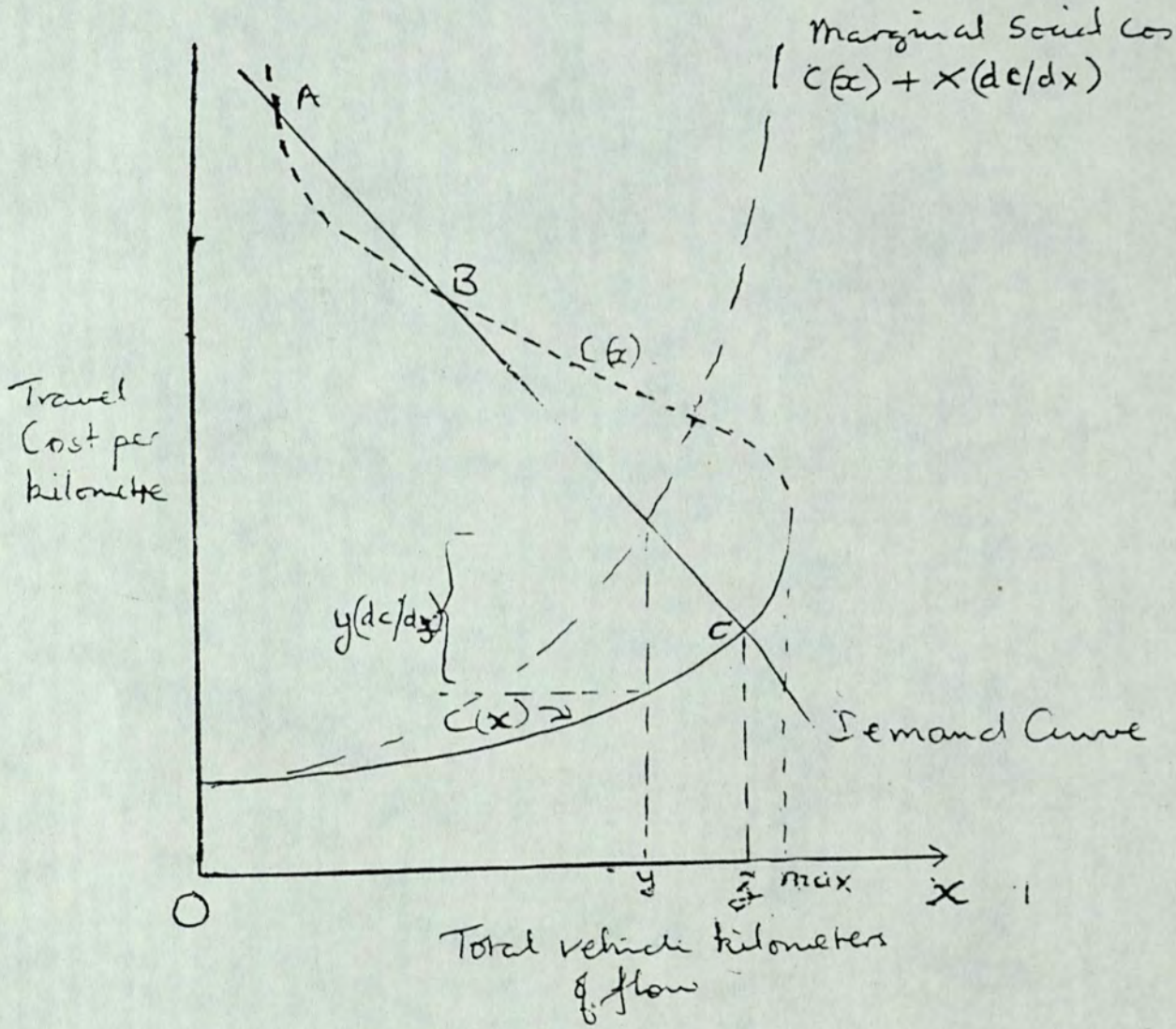

Fig 1 Demand and Supply on a Congested Highway

July 26, 1985 VERSION

Palgrave Dictionary of Pol Ec.

Milton Friedman.
AAW/aaw

The Public Image of Friedman

The conventional view of Friedman is that he has been the one of the most ardent and most effective advocates of free enterprise and monetarist policies over the four decades 1945 to 1985. The success of his advocacy, if far short of his wishes, has, by any objective standard, been enormous. In the mid 1980s the contrast with the previous thirty years is quite stark. Throughout these three decades, the public sector in terms of government expenditure as a fraction of GDP has grown inexorably in virtually all countries in the West. For the OECD countries the percentage of GDP which was annexed by the public sector rose from about 30 per cent in 1960 to about 42 per cent in 1980. Throughout the 1960s even into the early 1970s, this rise in the expenditure of the public sector was thought to be benign; it provided what was usually thought to be much needed aggregate demand and kept output and growth and employment at gratifyingly high levels. In the mid-1980s by contrast, virtually all governments in the West (and one or two in the East) have embraced policies of restraining and even reducing the relative size of the public sector. It is now argued that the expansion of the public sector begets not growth and high employment but stagnation and low productivity. The growth of government has resulted in a politicization of the ordinary business of life which the voters of the Western democracies have found unsatifactory, even unsavory.

Thus has Western opinion, even among the clerisy, moved decisively in its preference for those economic freedoms so eloquently advocated by Friedman. It may be argued however that the West has moved even further in embracing the

basic tenets of monetarism. In the 1950s and early 1960s, the fine tuning of fiscal policy was the epitome of macroeconomic management; control of the money supply was very much a secondary, even contemptible, matter and was given the main task of merely maintaining 'orderly markets' for government debt. Inflation was thought to be due to 'too low' a level of unemployment as well as to miscellaneous other factors such as trades unions, import prices, etc; few people blamed a burgeoning money supply. In the 1980s however virtually all governments accepted that a runaway money stock was the basic cause of the inflation of the 1970s. Monetary targets are now one of the basic ingredients of all medium term strategies to contain inflation. There is, as Friedman's tireless teaching tells us, a great gap between policy and performance, between rhetoric and reality. Nevertheless there has been a sea-change in attitudes and some considerable change in policy.

It is not possible to provide any neat attribution of influence in these great changes in attitude and policy. I suspect Friedman himself would give by far the largest weight to the experience of the 1970s, particularly the disappointments with government spending and with the great inflation from 1965 to 1981. The explanation of these events and the development of an alternative strategy with institutions that would ensure individual economic liberty and freedom from inflation was, in the public perception, Friedman's great contribution to the reforms. In his appearances on television, in his contributions to the newspapers (mainly Newsweek), he appeared as a great persuader. His arguments were critical in promoting the ideas of an all volunteer army and in the voucher schemes for education and health. In effectiveness, breadth and scope, his only rival among the economists of the twentieth century is Keynes.

Early Years

The son of a poor immigrant dry-goods merchant, who died when Friedman was 15, he worked his way through college by taking jobs as a waiter and store assistant. Friedman was clearly outside the famed East-coast establishment of the United States, although he did spend a year on graduate studies at the ivy league school of Columbia. He graduated (BA) at Rutgers University in 1932 and completed his AM at Chicago the following year. After the fellowship at Columbia in 1933-34, he returned to Chicago as a research assistant to Henry Schultz until 1935 when he joined the staff of the National Resources Committee. From 1937 he started that long association with the National Bureau of Economic Research which persisted until 1981. In 1940 there followed a brief period as visiting professor of economics at Wisconsin. Then after a two year stint 1941-3 in the Treasury in the division of tax research, he became the associate director of the statistical research group in the division of war research at Columbia University until the end of World War II, when he spent a year as associate professor at the University of Minnesota, before returning to Chicago as professor of economics in 1946, the year in which he received a Ph.D. from Columbia. His teachers were at Rutgers, Homer Jones and Arthur Burns, at Chicago, Frank Knight and Jacob Viner, and at Columbia, Harold Hotelling and Wesley Mitchell.

Superficially this record seems not impressive. Yet it encompasses what some scholars, particularly statisticians, would regard as Friedman's most impressive contributions. Inspired by Hotelling's work on the rank correlation coefficient, the first seminal contribution was his development

of the use of rank order statistics to avoid making the assumption of normality in the analysis of variance,(Selected Biography 1937). After fifty years this article is still regarded as one of the two or three critical papers in the development of non-parametric methods in the analysis of variance. It was followed by a discussion of the efficiency of tests of significance of ranked data, Sel. Bib.1940. It is not surprising that these papers have been of considerable practical use, since they were largely a development of Friedman applying his prodigious mind to the practical problems he encountered in analysing incomes and consumer expenditure at the National Bureau and Washington. Even at this early stage Friedman's work bears the imprint that readily identifies all his subsequent work. It is seemingly 'simple', eschewing complexities and complications, concentrating on essentials: all combined into a lucid exposition.

The detailed analysis of data on incomes and expenditures was the main occupation of Friedman during these years. With the exception of Kuznets, Mitchell and Burns, it is difficult to find any eminent economist who had acquired such a grounding in the basic empirical material of economics. It is characteristic of all his work that the organization of such data would suggest theoretical developments and new ways of arranging the material, and above all new insights into the economic process. His first published article (Sel Bib 1934) was on a method of using the separability of the utility function to measure price elasticities from budgetary data. This exploration of new insights into old data was particularly evident in his book (with Kuznets as joint author) on incomes from private professional practice (Sel Bib 1945); there one sees the first signs of the permanent income hypothesis and, indeed, the perceptive reader may guess what is likely to follow. In his

doctoral thesis Friedman argued that the process of state licensure enabled the medical profession more effectively to limit entry into their profession and so enabled them to exploit their patients, keeping fees high and competitors out. The fact that the argument was tightly constructed and buttressed with convincing evidence generated the most vehement opposition and animosity from that proud profession, which appears unabated four decades later.

The war-time service in the statistical research group, although an interlude in Friedman's basic work on incomes and expenditures, generated one of the most remarkable advances in statistical theory since the seminal contributions of Sir Ronald Fisher. The group was a galaxy, consisting of Abraham Wald, Allen Wallis, Wolfowitz, Hotelling, and many other distinguished statisticians. The sampling inspection of war-time production of munitions etc was a tedious process of selecting a sample of a given size and testing to see the fraction of good ones in the batch. Friedman together with Allen Wallis and a Captain Schuyler, observed that testing a given size of sample was clearly wasteful. The process of testing gave information which enabled one to determine the degree of confidence achieved. Thus instead of continuing to test up to a fixed size of sample, the testing could be halted whenever a predertermined level of confidence in the decision had been reached. Friedman formulated the basic idea of what later came to be called 'sequential sampling' and caught the interest and imagination of Wald, who eventually produced the influential book Sequential Analysis. The ideas were adopted very rapidly and sequential analysis became the standard method of quality control inspection. Like so many of Friedman's contribtions, in retrospect it seems remarkably simple and obvious to apply basic economic

ideas to quality control; that however is a measure of his genius.

At the end of World War II, it is clear that Friedman could have continued his work as a statistician. He would have achieved a stature probably as great as that of his most influential teacher, Harold Hotelling. Alternatively he had all the basic qualifications to take the lead in developing the burgeoning field of econometrics, with its great emphasis on the adaptation of statistical theory to modelling economic phenomena. He chose neither. His excursions into statistics were utilitarian rather than speculative and he could see little to be gained by the endless sharpening of statistical knives which was the stuff of econometrics during those years following World War II. In this decade, his contributions to statistics were even more intimately linked with his strong belief, implanted largely by Mitchell, that economics could acquire plausibility only by being subjected to empirical verification. In spite of the predilections of many economists, Friedman believed that economics should be viewed as an empirical science.

1946-1955

Although the problems of planning scientific experiments and sampling occupied some of his time, this decade at Chicago, much influenced by the wisdom of Frank Knight, witnessed the rapid development of economics as a positive science with its own methodology. The prevailing view of economic theory, as developed by Lionel (later Lord) Robbins, was that the veracity of theory could be tested primarily by the correspondence between the assumptions and the facts. In his "Methodology of Positive Economics" (Sel Bib 1953), Friedman argued per contra that even if one could specify empirical correlates

for the assumptions (and this cannot be done in cases where the assumptions are 'ideal types' such as homo economicus), that is irrelevant for judging the usefulness of the theory. Only by the correspondence of the predictions and facts should they be provisionally accepted or rejected. Results, not assumptions, should be the main focus of our scientific activity in understanding the real world. This approach applied the new philosophy of science, developed by (later Sir) Karl Popper, to economics, and by implication to associated social sciences. To countless students, Friedman provided an agenda for, what later Imre Lakatos called, a progressive research program. The simplicity of a theory in its ability to explain a lot in exchange for a little input and the degree of 'surprise' in the predictions were the hallmarks of the new approach to theory. But it was in the efficacy and power of the empirical tests that substantial progress was to be made.

In subsequent years the "Methodology.." has been the subject of enormous controversy. There is some general agreement that in applying the theory one cannot dismiss the factual basis of the assumptions in quite such a cavalier-like manner. Furthermore no-one would be rash enough to declare a theory discredited if there were a single or a few counter examples to contradict it. Such absolution has given way to more subtle interpretations depending, as Lakatos argued, on the new and surprising insights to be obtained. But there is no doubt that the substance of Friedman's "Methodology.." has not merely stood the test of time but has also had a profound and lasting effect on the profession.

The application of this methodological approach reached its apotheosis in what most academic economists would regard as Friedman's greatest work A

Theory of the Consumption Function (Sel Bib 1957). The fundamental proposition that emerged from the General Theory of Keynes was that households expanded their consumption spending by an amount less than the increase in their current income, and that this relationship was sufficiently stable to form the basis for the multiplier through which an increase in autonomous expenditure at the macro level generated a considerably larger increase in real aggregate demand. Since the regularity and predictability of the consumption function was central for the Keynesian control of the economy, it was with trepidation that many observers found that there were considerable inconsistencies between the patterns of household behaviour, particularly over the cross section data from household surveys and the time series of the historical record. Certainly it appeared that the data were quite inconsistent with the Keynesian consumption function. Friedman showed that the Keynesian concept of household behaviour was fundamentally flawed, and that the statistical results suffered from the regression fallacy. People adjusted their consumption with respect to variations in their long term expected (or 'permanent') income, and paid little heed to transitory variations. This basic idea was not new - indeed it can be found in 18th century writings of Bernoulli - but Friedman's development showed his genius for simplicity and for the insights of thinking concretely.

But the main quality of the Theory of the Consumption Function was the incomparable amassing, organization and interpretation of the evidence. The relatively low propensities to consume evident in the cross section data were shown to be entirely consistent with the much higher propensities that emerged from analyses of aggregate time series, when both sets of figures were interpreted in the form of the permanent income hypothesis. Because of the

transitory component in the cross section samples of households, the variance of measured income exceeded the variance of permanent income, and so the slope of the regression of consumer spending on income was much lower than in the aggregate times series regressions, where the transitory component was trivially small. The permanent income hypothesis adequately passed the acid test of using little to explain much.

The integrity of scholarship was demonstrated by the diligent search to find evidence to attempt to discredit the permanent income hypothesis. It was not, and is not, normal practice to scour the literature and statistical evidence for material that might discredit a theory. But Friedman used the hypothesis in the most imaginative way to forecast, for example, the values of regression coefficients for different groups with varying fractions of transitory to permanent income. And he left instructions for other researchers to guide them in tests to be made with further analyses of different data. One of the great contributions of this book was to give a new standard for empirical economics generally. Clearly this was how it should be done. The second important effect was introducing the concept of permanent income into virtually every field of applied economics, such as monetary economics, housing, transportation, international trade, and so on. It was a new way thinking about chance variations and peoples decisions in the real world.

A particularly fruitful theoretical approach to the utility analysis of risk and the measurement of utility appeared in two papers (with L.J. Savage Sel Bib 1948, 1952). Using axioms which most observers would widely regard as acceptable and reasonable, these papers showed that choice under conditions of

uncertainty could be represented as a simple process of maximizing expected utility. Thus the utilities of each of the chance outcomes were each weighted by the probability of that outcome, and the sum gave an index of expected utility which, given the axioms, would be maximised by choosing from the alternative uncertain prospects. Again the basic idea was not new (it was developed by Bernoulli in solving the St Petersburg Paradox), but Friedman and Savage discovered new insights and implications with wide ranging applications. They pointed out that if the function describing the utility of wealth displayed both convex and concave elements at different levels of wealth.the expected utility hypothesis could rationalize the widespread practice of simultaneously gambling and insuring More generally, the simplicity of the hypothesis had a profound effect on the theory and practice of portfolio selection. For the pure economic theorist it offered the attractive proposition that, up to an arbitrary linear transformation of origin and scale, utility should be regarded as a cardinal magnitude.

These papers did not still the cardinalist-ordinalist debate, but they did generate much reflection and re-evaluation of evidence of choice under conditions of risk. Subsequent discussion (particularly by Maurice Allais) suggested that one of the axioms (the socalled 'strong independence axiom' which asserted that the preference order would not be affected by mixing these outcomes with equiprobable alternative outcomes) was clearly implausible and violated frequently in practical decisions. Research suggested also that in some fields, for example in air passenger insurance, the expected utility hypothesis was discredited. Nevertheless the hypothesis still forms a cornerstone of all work - and particularly practical work - in choice among risky alternatives. With some minor exceptions, these papers mark the last

contributions of Friedman to the pure theory of statistics and decision making. Many statisticians regard the diversion of such a prodigous and fertile mind from its natural field as a great shame and loss.

The gain to empirical economics - and during these years, particularly to the theory of price - was, one suspects, worth the loss. The reformulation of Marshallian demand theory, as a practical instrument of analysis (Sel Bib 1949) was an exercise in meticulous scholarship in the history of thought but which also argued for an approach, which he attributed to Marshall, with a firm grip on the essentials of demand analysis as a positive discipline. But the analysis of economic policy, and particularly a critique of the logical structure of the arguments and the empirical evidence adduced to support those propositions, became increasingly important. Thus the critique of the arguments showing the inferiority of excise taxes compared with alternative income taxes (Sel Bib 1952) exposed basic methodological weaknesses in what were the standard treatments of the day.

The demonstration of the uses, as well as some abuses, of the theory of price was one of the highlights of Friedman's lectures, from 1946 to 1976 (with a gap from 1963 to 1973), at the graduate school of the University of Chicago. The exploitation of demand and supply as an "engine of discovery" reached out well beyond those conventionally defined limits of the subject. In these lectures Friedman gave full rein to his persistence and determination fearlessly to pursue the argument, with subtlety and imagination, wherever it led. To the students it opened up new vistas - such as the theory of human capital - and exciting ways of unravelling puzzles and resolving problems. In his hands, economics had both power and point, reality and relevance. (Sel Bib 1962). As distinct from much economic work, where complicated ideas are

developed in a simple way, Friedman showed how to interpret simple ideas in a most sophisticated way.

This was characteristic of his work on money which, with the inauguration of his monetary workshop in 1951 began to be a major interest for Friedman himself and the distinguished students and faculty that he inspired. The motivations for studying money, although in part derived from his association with Lloyd Mints, were probably mainly related to the fact that monetary policy, as a main tool of macroeconomic management, was consistent with a wide degree of free unfettered enterprise which appealed to the liberal (which will be used here in the 19thcentury sense) Friedman. The prevailing Keynesian orthodoxy, with its emphasis on expanding the public sector, appeared to threaten the liberal society. The Keynesian contempt for money was a tempting target difficult to resist. But undoubtedly Friedman's imagination had been challenged by the Chicago school's (particularly Knight and Simon) preference for rules rather than authorities in macro as well as micro economic policy. The uncertainties of the economic environment would be much reduced if the Federal Reserve Board followed a simple rule of a fixed and known expansion of the money stock, rather than indulging in unexpected large shifts in vain attempts to stabilize the economy. Whatever his motives however (and one should note that motives are quite irrelevant in judging substantive propositions), for the next thirty years, Friedman's work was focussed on money. At last monetary economics was to be interpreted as part of the central corpus of price theory; it was to be integrated into economics.

The Monetary Revolution and the Rise of Monetarism, 1956-1975.

In the late 1950s, to anyone subjected to the Anglo-Saxon schools of economics during the previous two decades, any attempt to revive monetary economics appeared to be foolhardy, like flogging a decomposing horse. The Radcliffe Committee (cross-ref needed), advised by the most eminent economists, had reported in 1959 that the quantity of money was of little or no interest since the velocity of circulation had no limits. The quantity theory of money was subject to particular scorn as a mere identity and without content. As Friedman was to point out, however, all theory consists of tautologies; all that theory does is to rearrange the implications of the axioms to produce interesting even surprising consequences. But they remain empty and devoid of substantive as distinct from speculative content, until they have been tested against a wide body of facts.

Of course the quantity theory of money had been tested against experience and data for many years and over several critical periods of change. The most distinguished exponents of such tests had included Irving Fisher and Keynes himself, as well as the irrepressible Clark Warburton. Yet the methodology was murky, the statistics slim, and interrelationships between data and theory obscure. In Studies in the Quantity Theory of Money (Sel Bib 1956), Friedman and his co-authors re-defined the quantity theory in terms of statements specifying a degree of stability in the demand for money. It was proposed that the demand for money by the individual household would be a stable function of its money income (later thought to be permanent income or wealth) and the cost of holding money represented by the rate of interest and the expected rate of inflation.

Friedman's presentation of the theory of the demand for money in the first essay in Studies is one of his most widely quoted papers, primarily

because it is thought to show that in presenting the money demand function as a portfolio decision with respect to alternative assets, rather than a demand related to the flow of transactions and income, Friedman was a closet Keynesian. Substantively this was a side issue; the main point was the stability of demand particularly with respect to nominal income or wealth. (Unfortunately this first essay was not one of Friedman's better expositions). The other essays in Studies, particularly that of Cagan on hyperinflations and Selden on velocity, however, established the value of examining nominal income and inflations in the context of the demand for money. The quantity theory in its new reborn Chicago form had passed its first tests.

The unknowns, however, remained legion. The vexed question of the nature of the regime controlling the supply of money, and how to interpret the problem of identfying the demand function in the data were to persist, in the eyes of many critics, as the major weakness in such studies. Was the stock of money reacting passively to changes in nominal incomes (or wealth) or were prices and output responding to endogenous changes in the supply of money ? The Chicago workshop averred that the answer to such questions could be obtained only by painstaking research into the history of the monetary process. Undoubtedly there were occasions when the money stock passively responded to changes in nominal income, but equally obvious were instances where the money supply changed for reasons quite independent of past or contemporaneous movements in money incomes. The role of the balance of payments and the exchange rate regime was clearly recognised and it is not difficult to discover the genesis of the monetary theory of the balance of payments in "Real and Psuedo Gold Standards" (1961) and other essays in

Dollars and Deficits, Sel Bib 1968.

Although the detailed development of the history of the money supply process and the relationships with gold and exchange rates was to appear in the monumental A Monetary History of the United States, 1867-1960, Sel Bib 1963, Friedman had already made it perfectly clear that a stable growth of the money supply was unlikely to be feasible under a regime of fixed exchange rates. His advocacy of free exchange rates (in 1959) followed logically on his analysis of the "dollar shortage" in 1953. Friedman was one of the very few economists (Gottfried Harberler and Egon Sohmen were among them) who clearly showed that the ambient dollar shortage was merely a consequence of fixed exchange rates and divergent monetary policies. His analysis was amply justified when by the 1960s, due to the change in monetary policies, the dollar shortage had turned into a dollar glut.

Yet in spite of the increasing attention paid to the balance of payments and the money supply process generally, the prime focus of Friedman's work remained the examination of monetary variations on nominal income and prices and output. The main questions were: (a) what was the relative importance of monetary compared with fiscal variations (the Keynes vs Monetarist debate), (b) what was the time pattern of adjustment, and (c) could expansionary financial or fiscal policies affect real output in the short or long run? The answers which evolved from Friedman's work showed that: (a) although an increased fiscal deficit had an impact effect on nominal income, this soon disappeared,whereas, after a lag, the increased rate of money growth permanently augmented the rate inflation, (b) the adjustment of nominal income to an increased rate of monetary growth involves lags that are "long and

variable", and (c) in the long run, additional monetary growth affects only the rate of inflation and has virtually no effect either on the level of output or its growth rate. In essence Friedman found that variations in the rate of growth of the money supply had short run effects, sometimes as in 1931 of a devastating magnitude, on real output as well as on prices; but in the long run (more than three years) the only substantial effect was on prices.

Over the 1960s and 1970s, the long-run results of Friedman's research were widely accepted. The logic as well as the data were appealing: nominal variations (in money) have nominal effects (on prices) and no real effects (on output). But such agreement did not readily extend to the short run claims of first the impotence of fiscal policy in countering cyclical oscillations and shocks and secondly the large but unpredictable effects on monetary variation on real output and employment. The claims of Keynesian economists for the stability and size of the fiscal multipliers continued, but it is noteworthy that estimates of the size of the multipliers, except for those produced by the Cambridge (England) school, were substantially reduced in the 1980s. (One is not able to determine whether the economists or the economies have become less Keynesian and more monetarist.)

One of abiding criticisms of Friedman's work (much of it in joint authorship with Anna Schwartz) on money is that it has no theoretical structure - or more charitably that such theoretical structure as exists is implicit rather than explicit. Monetary transmissions processes are alleged to be 'black boxes'with no precise specification of the way in which money works its magic. Friedman attempted to produce a theoretical underpinning of his approach to research in Milton Friedman's Monetary Framework, Sel Bib

1974, by producing a seven equation basic model of the (closed) economy. The critical difference between the Keynesian and classical model was the choice of the last equation; the Keynesian chose to specify the price level as fixed by exogeous forces and the level of output was a variable determined by the level of aggregate demand, whereas the classical economists held that the level of real output was fixed by technology, skill, etc and that the price level was determined by the model. With this simple model, Friedman was able to highlight the differences of method and approach as primarily views about the size and stability of the coefficients of the system. In principle, at least, such issues could be resolved by appeals to the evidence. But in one respect the Framework made little progress -this was in providing a sound basis for the dynamics of the adjustment, through output, price and interest rate effects, to the new long run equilibrium. The transmission mechanism and dynamics remain enshrouded in the gloom of black box.

Yet in spite of what many theoretical economists considered to be drastic limitations for sound theoretical developments, in the most important and influential paper in macroeconomics in the post-war years, Friedman showed that the basis of macroeconomic policy, as a trade off between unemployment and inflation, was fundamentally flawed, Sel Bib 1968. In the long run there was no trade-off between unemployment and inflation, whereas in the short run the trade off took place only while people adjusted to the new inflationary environment. The transitory trade off occured only because people were temporarily surprised by the new inflationary environment. The over-riding objective of contractual arrangements was to fix real wages and prices. Money served as a veil, sometimes seductive but always obscuring underlying reality. The so-called Phillips Curve (ed cross ref) was a short term

temptation rather than a long term choice.

Friedman caught opinion at ebb and turned it into a flood. Throughout the 1960s it appeared that the trade-off between unemployment and inflation was becoming more and more illusiory. Unemployment went up but inflation did not go down; it also increased. Into the 1970s and particularly during the great inflationary recession of 1974/5 , when both inflation and unemployment reached new highs in most OECD countries, it appeared that only Friedman's view made any sense. Like Keynes's General Theory, it was one of the very few contributions that changed both the approach of professional economists and the policies adopted by finance ministers. Sometime during the 1970s, most governments recognised that the road to fuller employment did not lie over the high sierra of soaring inflation. Doctrinally, economists took into their toolbox the Friedman concept of a 'natural rate' of unemployment where inflation would neither accelerate nor decelerate. (The word 'natural' being considered either normative or even desirable was generally eschewed in favour of the term 'non-accelerating inflation rate of unemployment' or NAIRU). This level of unemployment was determined by the nature of labor markets, such as the conventions of wage contracts, the degree of mobility, the level of unemployment benefits, the marginal utility of income, and many other 'structural' factors which are independent of the rate of inflation. As in the case of the permanent income hypothesis, to which it is distantly related, the concept of the 'natural rate' had applications in fields far from labor markets. And at the same time the concept provided one of the many missing links between macroeconomics of aggregate output and inflation and the microeconomics of industrial adjustment and resource allocation. Again in retrospect it all seems obvious; but that merely measures the magnitude of the

contribution.

By any standards -even those of Keynes and the General Theory - Friedman's contribution to monetary analysis and policy must be ranked very high. Every economist and finance minister and banker felt his influence. But, as an accomplishment of the intellect, one suspects that most of Friedman's peers would still regard his work on the consumption function as the maximum maximorum of his contributions to economics. Friedman's monetary analysis did not have that sense of comprehensiveness and structural balance that are the hallmarks of his work on consumer spending. One closed A Theory of the Consumption Function, not with the feeling that nothing more need be said, but that whatever was discovered in the future must fit neatly into this superb and satisfying framework. The architecture could accommodate, and indeed so-far has shaped and absorbed all new contributions. The Monetary History and the Framework, however, although probably more influential in doctrine and policy, did not provide the commodious and harmonic form of the Consumption Function. A number of awkward corners left one wondering what to do. And since the theoretical plans were left obscure, sometimes there were questions whether the superstructure would really hold up. But this does not belittle the Monetary History so much as praise the Consumption Function.

1975-1985

The award of the Nobel Prize for Economics, long overdue in 1977, at last recorded that Friedman's great contributions had even penetrated the Swedish academies. Inevitably Friedman's rise to stardom had given many more opportunities to pursuade electorates through the medium of the popular press

(primarily in the columns of Newsweek from 1966 to 1984) and television (in the popular PBS and BBC series "Free to Choose" in 1980). His contributions to pursuasive journalism delighted many, infuriated some, and made all his serious readers, if not wiser, then certainly better informed. In all these popular articles the high professional standards of integrity were maintained. But at the same time Friedman continued with his scholarly work on monetary analysis (again mainly with Anna Schwartz as co-worker). The main output, after more than 20 years of effort, was Monetary Trends in the United States and the United Kingdom; Their Relation to Income, Prices and Interest Rates, 1867-1975, (Sel Bib 1982).

The main methodological decision lying behind this study was that since there was too much inexplicable variation in short run variations in income and money, it was best to ignore these and concentrate on comparing the cyclical phase averages. These would screen out the short term effect and would enable an analysis to be made of the underlying long term money-income-interst relationships. Even for this team of Friedman and Schwartz, the treatment of the data and the integrity of their analysis reached new highs of meticulous scholarship.

Yet, considering the enormous value of the input of time and energy, the results are, as the authors confess, hardly worth the cost. For the most part the study confirms, and demonstrates with comparative data for the USA and the UK, the basic propositions on velocity, real income, prices and interest rates that had emerged in the History.

In his scholarly work in the decade 1976-85, it may be claimed that Friedman has fallen prey to the same temptations that affected Alfred Marshall

(cross ref). For many years of his mature professional career, Marshall spent much of his time revising and refining his great Principles. In retrospect it seemed to be a great loss to scholarship that Marshall did not leave the Principles well alone and turn to his projected study of the economics of the state. The opportunity was missed. It would be, however, a travesty to draw a close parallel between Friedman and Marshall in their mature years. Perhaps with the example of Marshall in mind, Friedman has generally launched his studies on the profession and then left them largely to fend for themselves. (The only exception is the text-book Price Theory; a Provisional Text in the 1976 edition). Yet there is a sense in which Friedman has been trapped by his immense success in monetary economics which has prevented him from deploying his mind in scholarly work in other fields of economics.

The possibilities are revealed in Friedman's more popular writings on issues such as public spending, price and rent control, taxation, and many issues in microeconomics. Characteristic flashes of insight and phrase, together with the innovations of approach - especially the simplifications - give the professional reader a tantalizing taste of what might have been yet another great contribution to economic science. Many economists have always believed that, in spite of his great strides in money, Friedman's relative advantage was always in the study of price theory and its manifest applications. There is the measure of the man.

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DRAFT/AAW/mee/1/31/85

Currency Boards

Currency boards, once ubiquitous in the colonial regimes of Africa, Asia and the Caribbean, now survive only in such small countries as Singapore, Brunei and Hongkong. The main characteristic of the currency board system is that the board stands ready to exchange domestic currency for the foreign reserve currency at a specified and fixed rate. To perform this function the board is required to hold realizable financial assets in the reserve currency at least equal to the value of the domestic currency outstanding. Hence in the currency board system there can be no fiduciary issue. The backing to the currency must be at least 100 percent. Although in principle it is the currency board that is required to convert on demand all offers of domestic or reserve currency, in practice, where there is a banking system, however elementary, it is the banks which have carried out most of the exchange business. The buying and selling rates for both currencies have a sufficient spread so that the costs of exchange are covered. This convertibility of currencies in the currency board system does not extend to bank deposits or any other financial assets. If a person has a bank deposit and wishes to use the currency board to convert it to foreign currency then the deposit must be first converted into domestic currency and then presented to the currency board.

These disciplines of convertibility and the avoidance of deficit financing were characteristic of much of 19th century Britain and France. The

principle of the currency board was enshrined in the provisions of the (British) Bank Charter Act of 1844. The Issue Department of the Bank of England was to act like a currency board. It is not surprising that this principle was considered proper for the newly acquired colonies. At first settlers and officials used the notes and coin of the imperial power as a normal extension of imperial trade. The metropolitan currency and coin, since it was widely accepted and considered "as good as gold," served as a stable means of exchange and as a store of value in those largely inflation free days of colonial occupation.

There were disadvantages of circulating the metropolitan currency, for example, sterling notes and gold sovereigns, in the colonies. First, there was a high risk of destruction or loss. Second, real resources were locked into the circulating media and produced no rate of return. Any loss of currency notes would be to the benefit of the issuer (e.g., the Bank of England) and the colony would correspondingly lose the real value of the notes. The institution of a currency board enable the colony to avoid such loss. The Bank of England note could be stored in the currency board's vaults and local currency issued to the same value. Thus the accidental loss of a domestic note would not diminish the net assets of the colony. In addition, the currency board would find it efficient to replace worn notes from its stock without having its assets tied up in sending battered Bank of England notes back to London for reissue.

In practice the currency board did not need to hold all its reserves in Bank of England notes. It could buy interest bearing financial assets of suitable liquidity. Provided these assets could be converted at sufficiently

short notice without significant loss into bank notes (or provided the currency board could borrow notes on such security), the principles of convertibility, 100 percent reserves and no fiduciary issue were satisfied. This more sophisticated currency board system could be used to earn at least some of the profits of seignorage for the benefit of the colony.

Most colonies developed a currency board system although a few countries continued to circulate some foreign notes and coins as parallel currencies. The non-colonial countries of Liberia and Panama however have used the United States dollar as a circulating medium. In the case of Liberia it was argued that there were doubts whether the people would have confidence in a currency board supervised by the government of Liberia. In particular, there were fears - alas not groundless - that the monetary system would be used improperly to finance government spending.

As colonies became independent states in the 1950's and 1960's they generally eschewed the currency board system and formed Central Banks to manage their currencies, ostensibly for "development" purposes. Some countries, such as Singapore, continued to operate a sophisticated currency board system. And Hongkong, after experimenting with an unpegged currency from 1972, returned to a currency board system based on the United States dollar in October 1983.

The financial experience of countries which departed from currency board systems has not been auspicious. Increasing inflation, generated largely by deficit financing through Central Bank credit and note issue, has been characteristic of most of the two or three decades since independence.

The objective of promoting growth and development has not been generally achieved; indeed in Africa the experience and the forecast is one of degeneration. And it is difficult to avoid the conclusion that the financial instability brought in train by the the abrogation of the currency board system played a considerable role in this process. Nevertheless, it is unlikely that, whatever the arguments in favor of the currency board system, there will ever be a resuscitation of what is wrongly regarded as a manipulative monetary mechanism of colonialism or neo-imperialism.

The claims for a currency board system are many, some clearly dubious. One main claim is that the currency board system provides an annual increment of the money supply which is simply the mirror image of the surplus on the current balance of payments. If there were no banks, or if the banks acted only as depositories or "cloakrooms" for currency, and if there were no imports or exports of capital in the form of foreign currency, then this assertion would be correct. The only way in which the residents could acquire foreign currency, and so swap for domestic currency, would be through net earnings from trade. When there is a surplus on the current account the money supply grows by that amount, and when a deficit appears the money stock contracts by the value of the deficit. This one-to-one relationship was thought to provide an automatic system which ensured that monetary behaviour always moved to eliminate a deficit or a surplus.

With notes and coin as the sole form of money and with no capital imports of foreign currency this one-to-one model was clearly valid. However, with the additional elements of bank deposits and credit the issue becomes much less clear cut. A proportional relation still holds even with a fully

developed system of bank deposits acting as money and bank credit, provided first that there are no foreign capital movements, second that the banks maintain domestic currency in their reserves as a constant fraction of their deposit liabilities, and third that the public hold a constant ratio of domestic currency to bank deposits. All these fixed ratios would ensure that the M_1 definition of the money supply (currency plus checking accounts) would expand proportionally, but not one-to-one with the current balance.

If there are capital flows other than those required to settle the net bills of the trade account, then the proportionality disappears. A flow of capital, such as a colonial branch bank borrowing from its parent, will entail the acquisition of a foreign financial asset (as well as the corresponding liability). The branch bank, if required to hold reserves in domestic currency, will exchange its foreign financial asset (or strictly currency) at the currency board and acquire domestic currency reserves. So, keeping the reserve fraction constant, it will extend loans and expand deposits thus increasing the deposit component of the money supply. The limit to such borrowing and domestic credit creation is set by the demand for credit in the colony, which in turn depends on the marginal profitability of credit in the colony relative to the interest rate. (This rate will normally be at a slight premium over the metropolitan interest rate). In practice the limit to such borrowings will be set by judgements of bankers and businessmen of the capacity and willingness of domestic borrowers to pay the servicing charges.

There is one set of circumstances which would insulate the monetary system from external capital flows. This would be the case where the

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importation of capital is effected only to supply the foreign exchange component of a domestic investment which would otherwise not occur. The insulation is complete if the investment generates profits in foreign exchange which just offsets the servicing charges. These conditions of foreign capital flows were probably a fair approximation to reality for the period covered by the currency board era. But with the dominance of western commercial bank lending to Third World governments, they are hardly characteristic of modern capital flows. Capital flows normally do affect monetary conditions.

The proportionality proposition is also upset by changes in the reserve-deposit ratios and by any changes in the fraction of the money stock which the public desires to hold in the form of currency. Prudential control of banks, often the responsibility of the Central Bank in the parent bank's country, usually takes the form of specifying minimum reserves which may be less than the prudential reserves held normally by banks. The branch banks may thus decide to extend credit and deposits, when conditions of confidence and credibility change, by running down their reserve to deposit ratio to somewhere near the specified minimum. The ability of branch banks generally to borrow from the head office in London gives considerable latitude to their liquidity requirements and virtually guarantees the solvency of the branch in the colony.

In the long run much more important than the reserve deposit ratio are changes in the currency-deposit ratio of the public. The modern process of financial innovation economizes on cash. The use of the check rather than cash is the predominant financial trend in all countries. For any given quantity of currency and other bank reserves the choice of the public for a

larger ratio of deposits to currency has provided the main impetus for an expansion of the money supply (M_1) in currency board systems. The stability and confidence generated by the currency board system undoubtedly much encouraged the use of deposits.

This phenomenon nullifies one of the main criticisms of the currency board system, namely that it provides a stultifying monetary constraint on development and inhibits growth in the colony. It is perhaps ironic that the countries that have retained their currency board arrangements, Singapore and Hongkong, have been the highest growth economies in the oil-importing Third World. Their money supply has expanded partly through current balance surpluses and capital imports, but mainly through the increased use of deposits associated with the financial stability of the currency board system. Both Singapore and Hongkong inflated during the late 1960's and 1970's at roughly the same relatively low rates as the currencies on which they were based. Thus they avoided the excessive inflation which affected many Third World countries which had adopted more "advanced" systems of central bank finance.

Another important criticism was thought to be not only the preclusion of counter-cyclical monetary and budgetary policy, but also the promotion of an actually pro-cyclical policy. Many currency board colonies produced export crops which were sold in markets with widely fluctuating prices. The collapse of commodity prices in a world recession generally gave rise to a large deficit on the current balance and so induced the currency board to contract the money supply. The isomorphic case of a boom in export prices was thought to be less onerous. Under a liberal trade regime the increase in foreign

exchange receipts from exports could be offset in part by an expansion of imports which would damp down the inflationary pressure generated by the rise in export prices. Although no monetary manipulation can turn a one-commodity export economy into a nicely diversified recession-proof system, there was no reason, apart from extraneous regulations, why the authorities as well as firms and persons could not hold or transfer foreign assets as a precaution against such oscillations. In the case of the Hongkong currency board, the freedom to hold assets in any form and any currency is the sine qua non of the financial system. And, for many decades, the government of Hongkong has held a large portfolio of foreign financial assets which can be used to expand or contract the currency board issue.

It has been thought that the currency board system is likely to exacerbate liquidity shortages and even the solvency of the domestic banking system, and so make it difficult to contain runs on banks and all the fear and instability that inevitably follows. Again, this criticism has proven largely invalid. Since most banking business was carried out by the branches of metropolitan banks, there was little fear of a run on a particular branch causing solvency problems, and liquidity shortages could be covered quickly by transfer. Moreover the knowledge that the resources of the parent banks lay behind the branch gave rise to a singular confidence and so nipped any incipient run in the bud. For the local banks, which had no such recourse, the ebb and flow of confidence were much more serious (as in the United States in 1931-3 and Hongkong in 1983). Insofar as the currency board system promotes international branch banking, so it promotes stability.

Although the currency board system did not have all the virtues or

faults which were attributed to it, it did have some singular advantages. To some extent it depoliticized the monetary system and insulated the public purse from plundering politicians. There was no resort to the printing press to reward political allies or ruin one's opponents. It gave a real credibility to the fixed exchange rate so that people willingly held both currency and deposits knowing that they would maintain their value. Similarly it precluded the possibility that the exchange rate would be used to attempt to solve political and social problems. These constraints, once thought to be vices, are now widely regarded as virtues. The evident failure of trying to promote growth or equality by inflationary finance may create a new respect for currency board. The return of Hongkong in 1983 to a full currency board system based on the US dollar was in response to political uncertainties as well as the realization that such financial stability was sorely needed. It would be rash, however, to imagine that currency boards are the wave of the future. One suspects that they may be used rather more frequently in small economies that are heavily dependent on large trading partners. Similarly they are likely to remain the basic system for the great trading centers such as Singapore and Hongkong where they have worked so well. The most demanding requirement of a currency board system is that, even under the most trying conditions, the financial community have faith in the board honoring its exchange obligations at the specified partty. Few Third World governments command such credibility. Thus, the currency board is unlikely to be the main vehicle for monetary and fiscal rectitude in the Third World.

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DRAFT/Transport/AWA/mee/WAA

April 30, 1985

Transport

Definition and Magnitudes.

The obvious definition of tranportation is the movement of goods or people over space. But conventionally we do not include short trips in the household or office or warehouse or factory as part of transport; such activities of movement are reckoned to be part of the household chore or industrial process. Only movements outside the home or factory are normally reckoned to require the services of the transport sector, as normally defined. In many definitions of transport, particularly in Western industrialized countries, non-motorized forms of carriage are excluded. Walking trips or manually-hauled freight, bicycle journeys, and even animal-powered journeys are usually excluded -except for special studies such as access to mass transit facilities where walking may play a ubiquitous role, or in cities, such as Amsterdam and Cambridge (England) where bicycles are a common form of transit. In third world countries, however, such manual or animal-powered operations still play a significant, perhaps a major role in the sector. Even in the mid-1980s it is very likely that, considering only passenger trips of over one kilometre in length the vast majority in the third world are walked (World Bank 1985).

In measuring the size of the transport sector, these issues of definition must be constantly borne in mind. If we confine the transport sector to mechanical carriage, then it is likely that in most Western industrialised countries, transport accounts for about 10 to 12

per cent of the gross domestic product (GDP). As well as excluding walking and cycling, this percentage does not take into account the value of time that people and goods spend in transit. If some allowance is made for this time (at values discussed below) then the percentage would rise to over 15 per cent,and perhaps as much as 20 per cent of GDP. In primitive societies in the third world, such as the Sahel countries of Africa, the percentage is likely to be much higher, whereas in the constrained city states of Singapore and Hong Kong it is rather lower.

Throughout the world the dominant form of transport is by road. In the Western industrialised countries, some 75 to 85 per cent of transport sector resources are attibuted to truck, bus or car. The remaining 15 to 25 per cent are distributed over rail, water and air, depending on geographical, historical and political conditions. In the third world this dominance of road transport, with one or two important exceptions such as India, tends to be even more pronounced. Transport by truck, bus and car is growing at rates higher than the growth of GNP in much of the third world.

Institutions and Organizations

The institutional structure of transport tends to be broadly similar in all countries. The road transport industry is typically organised in small, even very small, owner-driver units operating in a competitive, if often regulated, environment. Railways, per contra, are generally large monopolies almost always owned and, in principle at least, regulated by the state. State-owned airline monopolies are still

the nornmal form organization; the outstanding exception is the United States. But there is some evidence of a trend towards competition and private ownership in air transport. Ocean transport, especially the bulk cargo business, is mainly in the hands of competitive private owners, although many countries have state-owned shipping lines which although they often have reserved cargoes, generally try to compete for free cargo .

The institutional and organizational structure of transport has affected the study of transport economics - and perhaps even the results of such studies have influenced government policies and so the instituional forms. Transport economics has hardly been one of the central concerns of the discipline of economics. Yet over the years it has provided a fruitful field for the development of ideas which turn out to have a wide field of application.

Monopoly Power and Regulations

In the 19th century, apart from the interest in transport cost as some some sort of natural barrier to trade, the interests of economists centered mainly on the problems of controlling what were widely thought to be natural monopolies. Regulation of tariffs and fares predated the railways, but the rapid expansion of steam locomotion raised the issue of control and regulation to the centre of political dispute.

From the middle of the 19th century laws were passed prohibiting "undue" (UK) or "unfair" (USA) preference in the fixing of rail freight rates and fares. Behind this legislation lay the

widespread fear that the railways would use their monopolistic bargaining powers to discriminate against the small shipper and a fortiori against the individual passenger. From the last quarter of the 19th century the hazy ideas on which this legislation was based were redefined by Marshall, Taussig, Edgeworth Pigou and Ramsay. The theory of a discriminating monopoly provided a rationalization for "charging what the traffic will bear," as well as providing the basis for modern theories of optimum taxation and utility pricing.

Besides requiring what were thought to be the fair prices, the law had something to say about the provision of services. The general idea was to prevent the railways using withdrawal, or the threat of withdrawal, as a way of avoiding their common carrier obligation to provide adequate service. The implication was that the railways should maintain services even if that implied that loss-making services had to be cross subsidized from profitable ones. Throughout the 20th century the closure of a rail line or even the withdrawal of a service has entailed major political or legal action.

The railways were never the absolute monopolists of popular fable. Their power was much restricted by other rail companies, water transport and highway competition. Initially, unregulated trucks and buses grew rapidly after World War I, and were said to be "creaming" off the railways profitable traffic of commodities with a high value relative to bulk. Thus the railways argued that they were left with the low-value, bulky traffic such as coal and minerals, which could not bear a high freight rate. The railways and established large truckers complained that the trucking industry and particularly new entrants were

indulging in "wasteful competition" with cut-throat tariffs. These complaints, in addition to excessive, repeated bankruptcies in the 1930s led in Britain to the substantial control of entry and fares and in the USA and Germany, to trucking and bus tariffs.

In the 1930's, 1940s and much of 1950s, transport economists were largely concerned with the examination of the consequences, and a judgement of the efficacy, of the restrictive rail legislation of the previous century and new regulatory mechanism imposed on trucks and buses. Gilbert Walker (UK), James Nelson (USA) and Walter Eucken (Germany) showed that the conventional wisdom was quite discredited by the evidence (Walker 1948). The common understanding that the railways made profits from their high value traffic and lost money on their bulk traffic was quite wrong - the opposite of the truth. (In Gilbert Walker's aphorism the railways' traffic cream was at the bottom, not the top of the bottle). Secondly it was shown that the pre-regulation bankruptcy rates of truckers were unusually low, not high, and that regulation was primarily an obstacle to efficiency and innovation. Thirdly the scholars demonstrated that regulation entailed absurd wastes of resources in empty back hauls, idle capacity and, in the United States, circuitous routings. They showed the unmistakable signs of what came later to be called the captive regulatory agency. (It was perhaps the sign of the times that they did not extend their analysis to the wastes that restrictive trades union behaviour so encouraged.) The rapid accumulation of evidence of the waste, inefficiency and inequity of regulation, including that of the new regulated transport industry, was the main factor behind the derregulation movement which gathered

momentum in the 1950s and 1960s, culminating in the extensive deregulations of the 1970s and 1980s (Keeler, 1983).

Although (in 1985) it is rather too soon to give a definitive view of the effects of deregulation, the interim results appear to be entirely consistent with the implications suggested by transport economists such as Walker and Nelson. No evidence of wasteful competition, whatever that omnibus term may mean, can be readily detected in the derregulated trucking industry (in the UK or Australia, for example). And freedom has meant a large increase in efficiency with lower fares (as in the United States airline industry). Significantly, there has been little evidence of any movement to re-regulate those industries which have been freed (Friedlander, 1981).

(Editors should there not be some cross reference to the entry on Regulation of Industry ?)

The precise process of deregulation has varied considerably depending on political and social conditions and whether or not the industry has substantial elements of public ownership. Most of the railroads of the world (the most notable exception being those in the United States) had been taken into public ownership by the 1950s. Regulations requiring the privately-owned rail companies to maintain unprofitable services, the limitations on their pricing policies together with notorious feather-bedding and restrictive practices had all served to render them financially inviable and dependent on subsidies from the state. The flight of private capital from such an

unpromising industry was countered by nationalization. With persistent regulation, however, changing the ownership did not have any substantial beneficial effect on what had come to be called the railway problem, except to make the railways more subject to political pressure and union militancy. The financial deficits waxed rather than waned - to become a major worry to finance ministers all over the world. The fear that such deficits would grow even faster if road transport were free to compete with rail has been one of the main constraints on deregulation of trucking and buses in continental Europe and Japan, thus providing an example of the cancerous type of infection that is typical of regulation. It is unlikely that there will be any substantial privatization and deregulation of railways in the foreseable future. On the other hand because of the example of the United States there does seem both scope and hope for substantial deregulation and privatization of the airline industry in Europe together with some further freeing of trucks and buses.

Supply, Demand and Quantification

From the 1950s onwards the content of transport economics changed considerably. Although work continued on the issues of law and regulation; the new transport economists were more interested in the analysis and above all the measurement of economic phenomena in transport. Analysis primarily took the form of seeking to refine and develop basic spatial models of economic activity and the specification of the salient characteristics of transport supply and demand.

From the supply side one of the main aims has been to determine the structure of the production function and its dual the cost function. In particular the implementation of regulations often, implicitly at least, required evidence on costs. But the theoretical as distinct from the political rationalization for subsidies to rail, ports, airports, etc. required demonstration of substantial economics of scale. The earliest studies of rail costs focused on the whether total costs varied less than proportionately to the variation of traffic. Lumpiness in the production of transport services and discountinous jumps in the cost function had been recognized in the 19th century. The track is fixed and the track costs thus vary little with respect to traffic, that is until a new additional track is needed. By plotting railway costs against ton-miles the first studies suggested that there were considerable economies of scale in the average railway operation.

Perhaps the most important development in cost function analysis from the late 1950s onwards was the integration of the engineering and economic approaches (Wohl and Hendrickson, 1984). Both models and data were taken over from engineering and interpreted in economic terms, often thereby improving the engineers' interpretation and forecasts. The engineering-economics applications were particularly fruitful in pipelines, airlines and shipping but above all in the analysis of road traffic. The economic interpretation of the traffic engineers' gravity model, for example, provided new insights both economic and engineering. Old data could be usefully reworked and re-interpreted. Perhaps the most important particular benefit was in the analyis of the social costs of congestion (see Congestion page.....) and

the development of better systems of user costs for highways and urban streets. The various statistical models of the theory of queues and basic principles from the theory of fluid dynamics have proved useful bases for modelling traffic flow with results that have been interpreted in terms of social costs of congestion.

The specification of the transportation process in terms of its engineering elements, the attribution of unit costs to inputs, and the development of a synthetic cost function has been particularly useful for modelling the multi-product nature of transport services. The carriage of a consignment or passenger from point A to point B in a particular time interval is a service distinct from, and with finite substitutability for, another service from C to D in another time interval. Yet clearly some aggregation is required over space and time. Transportation firms themselves tend to think and to price their services in terms of aggregates. Yet in the econometric analysis aggregation still tends to be rather ad hoc.

The basic theoretical requirement of aggregation -- additive separability - does not readily apply to most transportation processes. And the variability of marginal costs due to the variations in load factor, or empty capacity, makes it particularly hazardous to aggregate outputs. (The marginal costs of freight when capacity is full may be more than three times the marginal costs where there is empty space to be filled on a back-haul).

The levels of costs that have emerged from the econometric-engineering studies have been most useful for comparative purposes. For example, one important application is whether a rail subway or a bus

system should be developed to deal with the increased demand for urban passenger transport. As shown in World Bank (1985), such comparative studies have shown that subway rail systems cost two or three times that of alternative bus systems.

The most important application of the cost model is the issue of the existence and extent of economies of scale. As the 19th-century studies suggested, railways experience substantial economies of scale; more recent studies have shown their cost elasticities ranging from 0.35 to 0.80. By using their fixed assets, particularly the track, more intensively, unit costs can be much reduced. In road transport, per contra, scale economies are quickly exhausted and the trucking and bus firms soon reach their minimum-cost outputs. (Such results are consistent with the ubiquity of the small firm for both bus and trucking operations in an unregulated environment.) Similarly for airlines the evidence suggests that, for the prevailing size of airlines in the United States, there are no signs of scale economies.

Refinements of the production function and in particular the cost function, have included the elaboration of the specification of qualitative characteristics of the output of services, (so-called hedonic measurements) and the influence of the stochastic nature of demand on costs. It was always clear that quality of service played a dominant role in the valuation of transport services. Speed of delivery (freight) and time of trip (passenger) as well as comfort and safety were the necessary ceteris paribus of competitive studies of cost functions. But shipper and passenger valuations of such quality-of-

service variables must be incorporated in cost models if the results are to have useful validity.

The value which is to be attributed to time is also a parameter of some, often critical, importance. Although time is often important in freight transport, it is clearly of crucial importance in passenger transit. Many comparisons of cost also involve differences in the time of trip, so that some evaluation of time savings is necessary in order to draw implications. The market value of time can be observed as people trade off time against money in decisions such as the use of a toll road rather than a free highway, or in taking an air trip rather than a surface trip. From studies of these situations, some signs of regularity have been observed. It has been adduced that (a) if the person is travelling on his firm's time, the savings of time can be valued at the wage costs per hour of the person involved, (b) if he is travelling during his leisure time and in a vehicle, then he values time saved at roughly one third to one quarter of his earnings during his working time, and (c) if he is waiting at the bus stop or rail platform, then he values such waiting time about as much as his wage rate per hour. These are the trade-offs observed in the market for time of trip, and in a competitive system these trade-offs will be reflected in the decisions of competitive firms in their production functions.

Safety is yet another characteristic of transport services, again particularly passenger services, which is implicit but important. Indeed traffic accidents are the second major source of mortality in developing countries (after water-borne intestinal disease). The valuation of injury or loss of life is fraught with

daunting philosophical difficulties. But fortunately we do not need to ask, let alone answer, the questions concerned with the 'value of a life'. In practice the person travelling makes an implicit decision about the change in the probability of losing his life (or being injured etc) and the cost involved. No-one 'buys' a life, either his own or that of any other person, on the market (except for certain villains); but people do implicitly value changes in the probability of being killed or injured. This trade-off between safety and money and time is practised when a man jay-walks or when he skips a servicing of the brakes and steering of his motor car. Little research however has been pusued to discover these implicit valuations. Most of the valuations of life and limb which are employed in practical applications, such as highway construction and road-use regulations, have been calculated from the money costs of damage, loss of useful output while incapacitated, the costs of medical services, and some notional sum for pain and discomfort.

Finally there is the problem of allowing for other 'externalities' or 'the social and environmental effects' of transport activities. Air pollution, noxious noise, and the disfigurement of the landscape with perhaps the loss of part of the "national heritage" are the most important items considered in such calculations. The best measure of the cost is the loss of rent of facilities, such as houses, shops. land, etc, which are affected. This loss of rent needs to be inserted in a dynamic model of the adjustment process; then one can find the capitalised net present value of the disamenity created by the new transport facility. The most sophisticated applications of this

environmental model have been for aircraft noise shadows associated with new runways at airports. (Walters 1978). The valuation of loss of amenity is generally carried out by some version of the Clawson method. (Editors provide reference here).

The Demand for Transport.

The reaction of people and firms to a reduction or increase of fares, transport costs or freight rates has always been a central issue of economic development. A general knowledge of what were later to be called demand elasticities had been incorporated in tariffs and fares since classical times. The principle of charging "what the traffic will bear" and fixing freight rates proportional to the value per kilogram of the commodity was a primitive but effective way of discriminating according to the inverse of the elasticity of demand.

The systematic study of transport demand by professional economists and statisticians began after World War II. The first studies were generally statistical analyses of aggregate data, where the emphasis was primarily on modal choice. The distribution of aggregate freight traffic modes was analyzed by regression analysis. It was however difficult to interpret the results in the usual form of elasticities of demand or substitution, since the functional forms and theoretical specification had no obvious basis in economic theory of either the firm or of the consumer. Moreover the levels of aggregation tended to be too large to be of use in deriving useful estimates of parameters. The thrust of much research in the 1970s and 1980s changed to disaggregated data and models. The functional forms were derived from the traditional

theory of the consumer, for passenger travel, and from the cost minimizing motive of the theory of the firm for freight transportation.

For passenger transport, perhaps the most important econometric development was that of the logit and probit models (Winston 1985). This models the discrete choice of transportation mode in terms of maximizing utility, attributing to each individual a random element of utility which describes his peculiarities and unobservable tastes for travel. Thus for any given measured characteristics of the population and for given conditions of transportation, one will observe a certain fraction using a particular mode. This probability of using that mode is then described as a functional form of the characteristics of the modes and, of course, other social and economic characteristics of the traveller.

Essentially these models give decision rules for discrete choices. In another sense they provide a statistical description of our ignorance by specifying a probability density distribution to delineate what we do not know about the choice of mode. One objective is to try to reduce this degree of ignorance by defining groupings, such as commuters and shoppers, which have distinctly different patterns of behaviour. A second objective is the joint modelling of both the decision on which mode to use and the choice of another continuous variable, such as frequency of trip, or in the case of freight transport the size of the consignment or shipment. The continuous choice decision is then contingent upon the discrete decision on mode. This opens up a rich seam of possible models.

Notwithstanding the statistical complexities of these models,

there are some basic economic constraints on transport demand. First it is a derived demand and so must conform to the Marshallian laws (Editor - reference to entry on derived demand). If there is no conceivable substitution of different modes or markets, then the market elasticity of demand for transport is measured by the multiple of the final market elasticity of demand for the commodity and the fraction of the final price accounted for by transport costs. On such assumptions elasticities of demand are low, even very low. The transport of such items as lumber, minerals and even coal - especially by ocean - approximates such conditions. Studies have confirmed that the freight-tariff elasticities are indeed very low - less than 0.1 (in absolute terms). Yet very few transport operations conform closely to these assumptions. Even in the case of minerals, coal or timber, there is often an alternative source which topples the demand curve from its near vertical slope. Since alternative sources probably become available in discrete jumps, it may well be that the elasticity is very low within a small range, but as the alternative becomes profitable the elasticity will rise substantially. Thus one finds that historically, as transport costs have declined in real terms, the near monopoly of local sources has been eroded as more distant sources become profitable to tap. For freight operations where other modes are competitive, the market elasticity of demand for any given mode tends to be very high(absolutely) because of the ease of substitution, for example of truck for rail, or air for truck.

Even in freight transport, it seems that transit time is of considerable importance in defining the quality of the service.

Speeding the transit and perhaps even more important, improving the reliability, are attributes which command high premiums for many goods. The shipper saves on inventory costs and maintains a tighter control of the production and distribution process. The numerical values of freight elasticities of demand with respect to time of transit tend to be of the order of 0.4 to 0.7 for all commodities except the bulk-hauled minerals. The more speedy transit by truck has explained much of the switch of traffic from slow rail to fast truck in the past half century.

The time-of-trip and, a fortiori, the waiting time are even more important in explaining the modal choice of passengers, particularly in city transportation. The time-of-trip elasticity tends to be larger (absolutely) than the fare elasticity. But for most studies of passenger travel the market elasticities tend to be less than one (in absolute terms) for a particular mode. The main exceptions are for leisure travel by rail bus and air. Then the elasticities tend to be around two. This is consistent with the profitability of the policy of some railways in promoting cheap 'excursion fares' as a way of segmenting the market. Of course individual airlines or buses, in a competitive environment, will always find that the elasticities with respect to both price and time will be considerably larger than the corresponding market elasticities. So an individual operator will have the greater incentive to keep his fares low and beat the competition. The lowish elasticity of demand for the mode, compared with the high elasticities for competitive firms within a particular mode (excepting perhaps the railroads), illustrates the value of ensuring a competitive

discipline on both pricing and quality of service characteristics.

The high value that people place on time and convenience has many other implications for the structure of transportation services. For example it may be much better to have more frequent, if more costly services, than are produced by choosing vehicles and equipment that minimize the costs to the operator. The competitive operators might well find that the savings in pecuniary cost by adopting the large vehicle with substantial economies of scale are more than offset by the reduction in demand for their services caused by the lower frequency of service -and so longer waiting times. And the higher the levels of income of the passengers the greater the value that they will place on higher frequencies and greater convenience.

Investment

The main use of the studies of production and cost functions, on the one hand, and demand function on the other is to develop a critique of pricing policy and to provide a basis for investment appraisal. The basic criterion is to find the net present value (NPV) of future revenues and outgoings by discounting with a rate of interest that measures the marginal productivity of capital in alternative uses. The rule is that the investment is worthwhile if the NPV exceeds zero. There are many alternative criteria which have been suggested to supplement or supplant the NPV principle, such as the benefit-cost ratio, the first year rate of return and the implicit rate of return.

Although the latter is useful as an evocative and easily understood 'rate of profit', none should be allowed to surplant the NPV method, since all may involve substantial error in application.

The benefits and costs to be entered into the calculation normally assume that the price of the service is, under competitive market conditions, an appropriate indication of the value that the consumer places on the marginal unit that he buys, and that the supply price is competitively determined and reflects marginal costs. These general conditions seem to be widely satisfied in the road sector, and rather more qualified in rail, airlines and ocean or inland waterway transport.

Many of the complications of investment appraisal arise, as in the cost studies, from the multi-product nature of the services. An improvement of a particular road may displace traffic or generate new vehicle flows on many another facility, and it is often very important to take into account such secondary effects, such as the benefits which consumers may lose (or gain) through the additional congestion (or decongestion) of existing highways. The procedure recommended by theory is to measure the areas under the demand curves for individual roads, while holding the costs conditions on all other roads fixed. This tedious process can be circumvented if one is willing to assume that, first all demand curves are compensated, and secondly that we may approximate the demand curve for the services of the road by a linear

form over the relevant range of traffic. Then the gain to road users is

$$- 0.5 \sum_{i} (q_1 i - q_0 i) (p_1 i - p_0 i)$$

where

$q_0 i$ is the number of ith-type trips without the project
$q_1 i$ is the number of ith-type trips with the project

and $p_0 i$ and $p_1 i$ are the associated prices of trips.

This is a much simpler procedure and works well in practical situations. Yet it is important to recall that it depends crucially on the efficacy of the modelling system for road traffic and on the various valuations of cost, particurly the costs of time.

It is relatively easy to estimate the benefits of the increase in efficiency of the use of assets, such as vehicles or runways or terminal capacity. One can estimate the expenditure so avoided by making verifiable assumptions about the rates of utilization. In practice most investment appraisals involving passengers turn critically on the modelling of time savings and the valuation of such savings. Occasionally problems of valuation are of dominant importance in investments in freight transport (such as the widening of the Suez canal) when there is expected to be a large and persistent overhang of excess capacity for some years; but such cases are the exception rather than the rule.

By the late 1960s most OECD governments had developed systematic procedures for the appraisal of government investments in transport. Such an approach enabled governments more readily to

identify white elephants and to sequence their programs in a more efficient way. However it is not at all clear that the improved appraisals had any substantial effect on programs, at least until the austerities of the mid 1970s. (For example the interstate highway system in the United States saw considerable over-investment in roads that carried little traffic.) The political pressures for particular investments were often of much more importance in the decision making process than any rational calculations of costs and benefits, (Walters 1978). The list of undesirable and loss making projects is depressingly long and formidable for most countries. Apart from such prominent cases as Concorde, one must include perhaps most railway investment, subways, many airports and some ports on such a list.

The Political Economy of Transport - Inequity and Inefficiency

Since most transport activities have normally involved considerable state intervention - often involving not merely state participation but actual ownership of transport concerns - the problem of understanding transportation industries and the analysis of the consequences of exogenous change and of policies needs to be studied in terms of the political processes and the power of the interest coalitions. Many democratic legislatures have arrogated to themselves the power to control closely the services, rates and fares, and investment and manning programs of state-owned or regulated industries. This power is most obviously demonstrated in the inability to contract unprofitable rail or bus or airline services. Coalitions of legislature members will form to block withdrawal of service or closure

of the line, even though the constituents who benefit may gain or retain a very small proportion of the large cost involved in providing that service. Although it would be more efficient to 'buy-off' the users of the service, a sense of misplaced propriety combined with legal constraint has inhibited the development of such side payments.

Because of the concentration of ownership - usually in the state itself - railways and ports tend to be fertile ground for the formation of powerful trades unions. By exercising control over the arteries of commerce, the unions can exact much danegeld. Perhaps more important is that their power is deployed in legislatures and executive branches of government. Such power can be quite awsome - as for example that which the railway trades union exercised in Argentina in the 1950s and 1960s.

Although the problem of exercising control and financial discipline over state supported or state owned industries has been seen to be of crucial importance - at least since the end of World War II - little progress appears to have been made. The(Herbert) Morrison formula, used in the U.K., was to allow the nationalised railways to operate without political interference in day-to-day decision making. The legislature and executive were to have control only over broad policy issues. And the public corporation was to be required to cover its costs,"taking one year with another". The failure of the Morrison approach was complete. Not only was there continuous political interference and substantial and persistent large losses, political control over the strategy was, until the 1980s, largely dominated by the trades unions. Conditions in other OECD countries, although varying in

detail, are quite similar. Even in third world countries, such as India, the power of the rail unions (together with the bureaucrats of Indian Railways) has been sufficient to keep competitive road operators under very large handicaps, and to maintain rail operations when they should long have been superceded by road.

The solutions to the overweening power of nationalised transport organisations and their trades unions and the politicization of transport decisions have not come easily. Perhaps the best approach is the privatization of such large bureaucratic organisations. The United States with its dispersion of ownership of railroads seems to have avoided many of the problems that affect other OECD countries with their nationalised concerns. (In the United States, the exception has been Amtrak, the subsidized passenger service.) But, once nationalised, it is not easy to disentangle the integrated system and dispose of its parts. This approach has proved much more succesful in the case of the ports (perhaps in the latter half of the 1980s, airports), airlines and even buses (World Bank, 1985). Various other approaches have been proposed, such as a constitutional limitation on legislature's directives combined with suitable incentive payments for staff and management; but such solutions have yet to be tried. The inefficiencies of state-owned and regulated systems remain the major problem.

Productivity, Technology and the Development of Transport.

Over the historical record the measures of the productivity of many transport industries have shown a creditable performance, relative to most other industries. The only marked exceptions are the railways

and urban buses. For highway transport, airlines and certain shipping services, the gains in productivity have exceeded those in most manufacturing industries. In large part such gains have been due to the improvement of equipment used by the transport industries. The increase in the efficiency of aircraft, ships and road vehicles have been both sustained and, in some cases, dramatic. In the decades of 1950 to 1980 one of the main gains in efficiency was due to the increased capacity of equipment - the jumbo tankers and aircraft. The variety and quality of service, however, haves also expanded considerably.

One of the most important innovations, however, was a product of the transport industries as such, namely containerization and its forerunner, palletization. This simplified handling problems for freight, particularly for non-bulk, non-mineral consignments, greatly reduced the inputs of unskilled labor, and speeded up transit as well as reducing pilferage and damage. Containerization, having transformed ports, shipping and much trucking, has still (in 1985) much more potential penetration ahead with profound effects on distribution systems.

The silicon chip must affect the future of transport. The use of the developing information technology is still very much in its infancy in the transport sector. The potential is great. For example a computerised road pricing system for urban areas is now fesible and prototypes are being tested (World Bank 1985). And plausible control and guidance systems have gone beyond the drawing board stage. But the range of profitable application cannot be foreseen.

Much of the gain in future productivity and reductions of cost may come

from institutional change. It has been shown that privatization of public sector transport operations often has a dramatic effect in reducing costs and improving the quality of the service (World Bank 1985). Private provision of urban bus services usually costs about 50 to 60% of the costs of public provision. The private airlines in the United States provide services which are only about 40% of the (adjusted)costs of the state-owned airlines in Europe. In addition the record of the private sector in promoting and paying for innovations is far better than that of the public sector firms. There is good reason to be optimistic about the future privatization programs of governments of the West. However whether such programs will persist in the face of the opposition of vested interests is a question which must remain unanswered.

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that it provides for Britain. He is trying to suggest that because some things may be wrong somewhere that applies to the whole City. That is not correct.

Mr. Robert Atkins: While we are on the subject of aerospace, has my right hon. Friend noticed today that the figures for the British aerospace industry are £1 billion up on this time last year, representing a 23 per cent. increase, and of that some 60 per cent. are exports to the world? Does not she think that that is the jewel in the crown of British manufacturing industry?

The Prime Minister: I congratulate the aerospace industry on its excellent export record and would like to point out that other parts of manufacturing industry have done very well. Indeed, exports by manufacturing industry were a record last year.

Q4. **Mr. Sean Hughes** asked the Prime Minister if she will list her official engagements for Tuesday 17 December.

The Prime Minister: I refer the hon. Gentleman to the reply that I gave some moments ago.

Mr. Hughes: Does the fact that the under-25 age group appears to be another group targeted for cuts in welfare benefits mean that the Prime Minister now accepts the point of view of the vice-chairman of the Tory party that too many young people will not get off their backsides and find work?

The Prime Minister: As I said earlier, no one has done more for youth training than this Government. The one millionth youth trainee has now entered the scheme. *[Interruption.]* I am sorry that the Labour party treats these matters with such levity.

Q5. **Mr. Freeman** asked the Prime Minister if she will list her official engagements for Tuesday 17 Decembe

The Prime Minister: I refer my hon. Friend to the reply that I gave some moments ago.

Mr. Freeman: Is my right hon. Friend aware of the excellent reception on the Conservative Benches to yesterday's White Paper, especially for the proposal for a broader spread of personal pensions? Will she continue to preach the principles of thrift and the broader spread of financial assets?

The Prime Minister: I am glad that my hon. Friend welcomes the White Paper. It is meant, among other things, to give wider choice to those who wish to save through a personal pension scheme and build up a capital fund on their own account. It is also directed to help more effectively those in greatest need, such as young families, through the new family credit scheme, and to give improved incentives to work.

It means that the commitment that we enter into can be afforded. That is a matter to which the Opposition have given no attention since the last election. Indeed, since then they have already promised an additional £10 billion without specifying from where that will come.

Mr. Adley: On a point of order, Mr. Speaker. You will have noticed that, during Question Time, once again the tactics of the Labour party were to shout down my right hon. Friend the Prime Minister at every opportunity—*[Interruption.]*—as they are trying to do to me now. Will you please use your influence to protect this House from the barbaric tactics of the Opposition?

Mr. Speaker: Order. The noise during Question Time today was rather greater than usual, so I agree with the hon. Gentleman on that point.

Banking Supervision

3.31 pm

The Chancellor of the Exchequer (Mr. Nigel Lawson): With permission, Mr. Speaker, I should like to make a statement.

I am publishing today a White Paper setting out the Government's proposals for strengthening banking supervision, with a view to bringing a new banking Bill before the House early in the next Session.

The proposals contained in the White Paper reflect the vital importance that this Government attach to effective supervision. They build on the findings of the review of banking supervision that I set up exactly a year ago today under the chairmanship of the Governor of the Bank of England, in the wake of the Johnson Matthey Bankers debacle. Six months later, when the group's report was published, I told the House that the Government were minded to accept its two key recommendations. I can now confirm that both will be implemented.

First, the new legislation will extend to banks the higher supervisory standards that Labour's 1979 Banking Act applied only to licensed deposit takers, and not to recognised banks. That means that the so-called two-tier system will go. I have, however concluded that it would be right to confine the use of the name "bank" to institutions with at least £5 million in paid up equity capital.

Second, the Government will do whatever is needed to permit effective two-way communication between supervisors and bank auditors. If this can be done on the basis of agreed professional guidelines, underpinned by statute, well and good; if not, we shall not hesitate to take appropriate further powers.

However, assisted by the extensive consultations that have taken place since I made my statement to the House in June, I have become convinced that it would be right in a number of respects to go beyond the Leigh-Pemberton committee's recommendations.

The key to better supervision is the organisation and ability of the supervisors themselves. Last October, the Governor announced changes in the Bank's organisation to give supervision a higher priority. To carry that further, he will now set up, as soon as possible, a new board of banking supervision within the Bank of England. The board will be given statutory backing in the forthcoming legislation. It will be chaired by the Governor, and a majority of its members will be experienced practitioners from outside the Bank of England. That will bring independent outside expertise to bear at the highest level and give more forceful direction to the task of bank supervision. The board's views will be separately identified in the Bank's annual report, which I lay before the House.

Second, supervisors cannot do their jobs unless they have adequate, accurate and timely information. That was one clear lesson of the JMB affair. Under the existing legislation, it is not a criminal offence to mislead the supervisors, even if this is done knowingly or recklessly. I propose to make it one—with appropriate penalties.

As I told the House in June, one of the most conspicuous reasons for JMB's failure was that it was over-committed to a small number of closely related borrowers. Building on the Leigh-Pemberton committee's recommendation, I propose to make it a statutory requirement for banks to notify all such exposures in excess of 10 per cent. of their capital base; and all exposures in excess of 25 per cent. will require prior notification.

Important as they are, rules of this king are not enough. Supervisors need to have a better knowledge of individual institutions at first hand. I therefore welcome the steps that have recently been taken to increase the frequency of supervisory visits to banks, on a routine basis as well as where there are grounds for prudential concern.

The nature of banking is changing fast and the supervisory system has to keep up with it. We cannot preseribe for every eventuality in advance. In particular, there is a risk that new forms of deposit-taking may fall through the supervisory net. I therefore propose to take powers to vary by secondary legislation the definition of deposits and deposit-taking around which the legislation will continue to be structured.

I am also very conscious that banking supervision can no longer be considered in isolation. The Government are urgently considering the supervisory problems posed by the growth of financial conglomerates. One of the most obvious requirements is that those who supervise banks should be able to exchange information with other supervisory authorities. Legislation this session will make that possible. Changes in the confidentiality requirements, including those in the Banking Act, will be secured through the financial services and building societies Bills this session.

The details of these and other proposals are in the White Paper. They represent a considered, full and prompt response to the real lessons of the Johnson Matthey Bankers affair. The system of supervision we will be putting in place will be strict, without being a straitjacket. The proposals avoid the pitfalls of unnecessary bureaucracy and administrative upheaval. They also avoid the danger of setting out rules so rigid that they encourage compliance with their letter but not with their spirit.

As I told the House in June, an effective system of banking supervision is essential, not merely for the protection of depositors but for the financial health of the economy as a whole. Effective supervision is also a vital weapon in the fight against fraud, which the Government are determined to do all in their power to combat. Supervision cannot eradicate risk—nor should it—and it must not stifle competition. Nor, above all, can it derogate in the slightest degree from the overriding responsibility of managers to run their businesses soundly and properly.

Together with the Building Societies Bill, to be read for the Second time on Thursday, and the forthcoming financial services legislation, I believe that the proposals outlined in this White Paper will help to create a comprehensive and effective statutory framework for a rapidly changing financial services sector.

I commend the White Paper to the House.

Mr. Roy Hattersley (Birmingham, Sparkbrook): Does the Chancellor realise that outside the City and the Tory party the proposals that he has outlined will be regarded as grossly inadequate, a reflection more of the City's views and values than of the growing concern about supervision of the City in general and the banking system in particular? Will he understand that confidence will not be restored while the duties of supervision essentially remain within the Bank of England? Negligence in the Bank of England contributed to the Johnson Matthey scandal. When asked

to report on the lessons learnt from that affair, an inquiry dominated by the Bank of England made recommendations that even the Chancellor rejects; yet the power of supervision is to be given to the Bank of England.

While the Chancellor, in his own words, retains the powers "within the Bank of England", some of the proposaals that we welcome and some of the proposls that our pressure brought about — such as the statutory backing and the extension of the criminal law to cover the misleading of supervisors — will be seen as generally inadequate.

I ask the Chancellor the basic question relating to his statement: Why must the board of banking supervision remain in the City's own club? Why can it not be created outside, with all the additional confidence that its independence would provide?

Will the right hon. Gentleman answer some specific questions? For example, when the supervisory body is told of an exposure of more than 25 per cent., what powers will that body possess? If it discovers that the bank in question is over-exposed, what can it do about it other than note it and worry about it?

What changes does the right hon. Gentleman propose in the confidentiality requirements? When shall we hear of them and when will they be passed into law? Indeed, does he appreciate the need for speed in this operation and the need to introduce the new legislation—the statutory backing — quickly to overcome any feeling that the Government do not want to tackle this matter urgently?

Do the Chancellor and the Leader of the House appreciate that the whole question of the supervision of the City is now such a matter of national concern that a debate in the House is urgently needed? Are they aware that, if the Government will not give time for such a debate, the Opposition will provide it at the first opportunity?

Mr. Lawson: My response to the right hon. Gentleman's last point is that I have set out in the White Paper important matters which I recognise the House might well wish to debate. However, that is a matter for the Leader of the House.

The right hon. Gentleman's categorisation of the measures which I have outlined, and which are outlined more fully, as inadequate, is wholly and completely untrue, but we shall, no doubt, have an opportunity to discuss that in the context of the forthcoming Bill.

The right hon. Gentleman asked some specific questions and made allegations about the Bank of England, allegations which I wholly reject. The JMB affair was a lapse, but a lapse from a very high supervisory standard which the Bank of England has carried out—*[Interruption.]*—over a number of years and which is recognised as such throughout the world.

The legislative framework which I am now tightening was put in place by the Labour Government. That framework, the 1979 Act, was inadequate. It took them five years—from the secondary banking crisis of 1974 until 1979—to legislate. I am proposing to legislate twice as fast after the JMB affair.

The right hon. Gentleman asked what the supervisory body could do. It has the ultimate power to revoke the licence of any bank to take deposits, and that is a very profound sanction indeed.

The answer to the right hon. Gentleman's question about the confidentiality requirements—I assume that he was referring to the relationship between auditors and supervisors—is that he will see them set out in annex 4 at the back of the White Paper.

Sir William Clark (Croydon, South): Is my right hon. Friend aware that many people, in the City and throughout the country, will welcome the strengthening of the 1979 Act, particularly in bringing the banks under control and especially in view of the imminence of the Financial Services Bill?

Is he further aware that the flexibility between auditors and supervisors should ensure that any misdemeanour, or suggestion of misdemeanour, involving any deposit taker, be it a bank or any other deposit taker, will be immediately recognised? A two-way movement of information, from supervisors to auditors and from auditors to supervisors, will ensure that, if an investigation is necessary, it will be speedy and accurate. That should be wholeheartedly welcomed by the House and the City because it is essential to ensure that the integrity of the City is maintained.

Mr. Lawson: My hon. Friend is right. Communication between supervisors and auditors is an entirely new departure. Up to now, supervisors have not communicated with auditors and auditors have not communicated with supervisors. That will be changed, and I am grateful for the help of the various accountants' bodies in co-operating fully with the changes that we have in mind. Normally that communication will take place in the presence of the bank in question, but there is provision in exceptional circumstances for the communication to take place directly between the supervisors and auditors.

Mr. Ian Wrigglesworth (Stockton, South): Is the Chancellor aware that some of us argued long before the Banking Act 1979 was put on the statute book that the Bank of England should not be responsible for banking supervision? Will he therefore reconsider the role that the Bank of England will play? Although the establishment of the new board is a welcome step, will he confirm that all its members will be appointed by the Governor of the Bank of England? Does he agree that it would be much better if the Bank of England carried on its role as a central bank like other central banks and that the supervisory function should be carried out by an independent board? Will he consider that possibility? Will he also note that the other provisions in the statement are a welcome strengthening of the present regime?

Mr. Lawson: I note the points made by the hon. Gentleman. As a member of the Labour party, he was a supporter of the Bankers Act 1979. Appointments to the board of banking supervision will be made by the Governor, but they must be made with my approval. I believe that that answers his point. Whether the supervisory authority should be the central bank is a fair point. If the hon. Gentleman reads the annex to the White Paper about overseas experience, he will see that in some countries the supervisory authority is the central bank but that in others it is not. As we have always had the Bank of England as the supervisory authority, I believe that it is better to build on and strengthen that authority rather than to have a tremendous upheaval which I do not believe would be warranted or fruitful.

Mr. Terence Higgins (Worthing): Does my right hon. Friend agree that his statement will be greatly welcomed, because those of us who are anxious that the City's

[Mr. Terence Higgins]

reputation should not be damaged by abuses of the system feel that the steps that he proposes will be helpful? Would it not be extraordinarily dangerous at this stage to set up an entirely separate organisation with no experience of those matters rather than to build on the Bank of England's foundation? Will he give us an assurance that we shall not have to wait for the legislation to be introduced before positive steps are taken to improve the present position?

Mr. Lawson: My right hon. Friend is correct, and I welcome his remarks. Steps have already been taken. Mr. Sidney Proctor has been appointed special adviser on supervision to the Governor. He is an extremely experienced and distinguished commercial banker who has retired and can devote a great deal of time to the matter. The Governor has also strengthened numerically and in other ways the Bank of England's banking supervision department. In addition, the establishment of the board of banking supervision will not have to wait for the legislation. The Governor proposes to get on with that straight away.

Mr. Brian Sedgemore (Hackney, South and Shoreditch): Bearing in mind that this statement arises in large measure out of the wanton negligence of Robin Leigh-Pemberton, the Governor of the Bank of England, how can anyone place any trust in a system of supervision organised by that appalling deadbeat? Is it not time that the Chancellor of the Exchequer had the bottle to tell the Prime Minister that Pemberton is not merely a disaster; he is a disgrace?

Mr. Lawson: There has been a great deal of talk about fraud of one kind or another. Fraud must be rooted out wherever it is found. Fortunately, it takes place only in exceptional circumstances in the City of London. It is wrong to imply otherwise.

The biggest fraud so far exposed is the hon. Member for Hackney, South and Shoreditch (Mr. Sedgemore). He poses as the man who got things moving. *[Interruption.]* Listen to this. He did not even start—*Hansard* will show that this is so—his seemingly unending series of allegations until after my statement of 17 July informing the House that the fraud squad had already been called in. By engaging in a scurrilous McCarthyite smear campaign under the cloak of parliamentary privilege to further his sordid political objectives, the hon. Gentleman is succeeding only in damaging the good name of the City to the delight of our competitors overseas, and in impeding the police in their attempt to bring wrongdoers to court, as the police have already pointed out to him. To describe the hon. Gentleman as a pest would be unfair to pests.

Sir Peter Tapsell (East Lindsey): While any illegalities must be vigorously hunted down and their perpetrators suitably punished——

Mr. Sedgemore: You snivelling little git.

Mr. Speaker: Order. I prefer not to hear all of that.

Sir Peter Tapsell: Those of us who most abhor the scandals in the City at present sometimes find the interventions of the hon. Member for Hackney, South and Shoreditch (Mr. Sedgemore) to be counter-productive. While any illegalities must be hunted down and their perpetrators suitably punished, should we not, even in the present political atmosphere, be careful to bear in mind that the Bank of England is an extremely important national asset, particularly in the international sphere, where on many occasions it has saved past Labour Governments? Indeed, if there is ever another, Labour Government, they will probably look to it to save them again. Should we not bear that in mind when scoring short-term party political points? My personal belief is that the Bank of England is, in the British context, the appropriate body to continue to conduct banking supervision.

Mr. Lawson: I entirely agree with my hon. Friend. As he will have heard, I reached the same conclusion.

Mr. Ron Leighton (Newham, North-East): Will the Chancellor of the Exchequer explain where market forces end and fraud begins?

Mr. Lawson: If the hon. Gentleman does not know that, he is not fit to be a Member of the House.

Sir Peter Hordern (Horsham): Will my right hon. Friend consider whether it should be the duty of the auditors of the day to report independently to the bank's supervisors without the knowledge of the bank, if necessary?

Mr. Lawson: That is a difficult question, and my hon. Friend is right to raise it. I believe that that would place considerable difficulties in the way of auditors. My conclusion is that it is better to adopt the normal procedure, and that the auditor and supervisor should have their dialogue in the presence of the bank in question, while reserving powers, if need be, in special circumstances for there to be a direct dialogue between auditors and supervisors without the presence of the bank.

Mr. D. N. Campbell-Savours (Workington): Will the Chancellor consider adopting in the Bill the principle that I have been advocating for defence contractors who make excess profits, whereby if an employee identifies fraud he should be compensated from the public purse?

Mr. Lawson: The hon. Gentleman is an assiduous Committee member, as I know from experience on many occasions in Standing Committees on Finance Bills of old, and I am sure that he will find himself in Committee on this Bill, when he can make that point. However, I do not think that that would be a sensible proposal.

Mr. Peter Rees (Dover): Does my right hon. Friend agree that the Governor of the Bank of England is a distinguished and honourable public servant who deserves better of the House than to be traduced by the vulgar criticisms of the hon. Member for Hackney, South and Shoreditch (Mr. Sedgemore)?

Mr. Lawson: I agree strongly with my right hon. and learned Friend. It is appalling how the hon. Gentleman seeks to traduce the Governor of the Bank of England, the Bank of England and the entire City of London to further his political objectives. It can mean only that people in Tokyo, Frankfurt, Zurich and other places will laugh all the way to their banks.

Mr. John Ryman (Blyth Valley): Will the Chancellor consider calmly and quietly for a moment what real sanctions there are, apart from the ultimate sanction of revocation of the licence, if the supervision board finds negligence or fraud? A complaint to the police takes a long time to investigate, and the resources of the fraud squad

are far too limited to cope with the mass of complaints that emerge from time to time and that require thorough and lengthy investigation.

Mr. Lawson: As I announced, the legislation will create a new offence of misleading the supervisors for which there will be severe penalties, substantial fines or imprisonment. I announced as far back as July 1984 the Government's decision to set up a fraud investigation group, which was before the Johnson Matthey Bankers affair, and which has considerably strengthened the Government's and the authorities' resources for pursuing fraud wherever it may be.

Mr. Alex Fletcher (Edinburgh, Central): I welcome my right hon. Friend's statement, but I should like to press him a little further on the question of resources. I am sure that he will agree that more staff will be needed and will have to be sufficiently qualified as accountants, lawyers, bankers and others, not just in banking supervision but in insurance and other things as well. Can he assure the House that, in attracting people of the right quality, there will be no Civil Service-type restrictions on the grades at which they can be employed so that they can come into the business and do a proper job?

Mr. Lawson: It is important that those who are engaged in the seeking out and prosecution of fraud, whether in the Department of Trade and Industry or in the Department of the Director of Public Prosecutions, must be of sufficient calibre, and that is something that the Government will unstintingly seek to achieve.

Mr. Allan Rogers (Rhondda): Will the Chancellor accept that his proposal will be seen by the public at large as following the old principle of "set a thief to catch a thief"? Will he suggest ways in which he might undertake some positive screening of the people who will be on the supervisory board?

Mr. Lawson: The hon. Member should know that I have suggested a considerable strengthening of the system of banking supervision, which has a good record. That is widely acknowledged throughout the world. The JMB affair was a lapse from its high standard. The measures that I have announced will strengthen it still futher and make it better than any other banking supervision system.

Mr. Tim Smith (Beaconsfield): Are not these proposals tough and comprehensive — much more so than anything proposed by the Labour Government of which the right hon. Member for Birmingham, Sparkbrook (Mr. Hattersley) was a member? Is not the real danger that, if we go too far, 2 million jobs and £6 billion worth of exports will be threatened as financial services companies move offshore?

Mr. Lawson: My hon. Friend is right—there is a real danger of that. I do not ask anybody to pronounce now, but I hope that when hon. Members have read the White Paper and seen what is proposed they will desist from uninformed criticism, which can only be bad for the country.

Mr. Stuart Randall (Kingston upon Hull, West): I am sure that the Chancellor will agree that the various fraud cases about which we have heard recently have reduced in the eyes of the British public confidence in the City and all the other institutions. Does he agree that, in order to regain that confidence, it would be desirable to publish some of the findings of the new board of banking supervision? Will that happen, and, if so, to what extent?

Mr. Lawson: The board of banking supervision will make an independent report of its own, to be contained within the annual report of the Bank of England. What it chooses to report will inevitably be governed by the laws concerning banking confidentiality.

Mr. Anthony Beaumont-Dark (Birmingham, Selly Oak): Does my right hon. Friend agree that the Bill that he has announced today could be tough, along with the Financial Services Bill, and that the need for that is because of the huge financial conglomerates that will come about and may spawn things of which many in the City will not have experience. Bearing in mind also that the Bank of England is an adviser to the Chancellor of the Exchequer, would it not be a sensible move if the Chancellor imported into his Department some people of great expertise in the City—although not those who are likely to go back to the City, who may have something else to gain? Would it not be a good idea if three or four people who have spent their lives in the City and understand it and the Treasury were there so that they could give five to seven years of good advice to prevent many of these things from happening? In the end is it not right that the buck stops here? Whenever there is a scandal, the Government cannot say that it has nothing to do with them. If it is in the end, therefore, to do with Government, is it not better for the Chancellor to have his own team of experts on hand to handle his advice?

Mr. Lawson: I am grateful to my hon. Friend. I am quite sure that he means well, as he always does, but I have to say two things to him. First, I have every confidence in my officials in the Treasury. Secondly, the duty of supervising British banks is not laid upon the Treasury but is laid, and will be quite clearly laid by the legislation to which I have referred, on the Bank of England. Therefore, there will be a duty laid on the Bank of England to have supervisory staff of the appropriate quality and calibre and also to have independent outsiders to ensure that there is a strengthening of the enforcement of supervision at the top.

Several Hon. Members *rose*——

Mr. Speaker: Order. I have to protect the subsequent business of the House. The Chancellor announced that there will be a debate. However, I draw to the attention of the House the fact that there will be an opportunity tomorrow to debate this matter on the Consolidated Fund Bill under item no. 3.

Mr. Rob Hayward (Kingswood): On a point of order, Mr. Speaker. May I ask that during the Christmas recess you should ask that all speeches should be looked at, given the language used by the hon. Member for Hackney, South and Shoreditch (Mr. Sedgemore), aimed at the Chancellor of the Exchequer? It described him as a snivelling little git. It was clearly audible in the Chamber and such language is clearly disgraceful and unparliamentary.

Mr. Speaker: Order. In a highly charged atmosphere I did not hear all that was said and I do not think that it was directed at the Chancellor of the Exchequer. Although it may not, in strict terms, be unparliamentary language, it is not the kind of language that we want to hear in civilised debate.

Mr. Dennis Skinner (Bolsover): On a point of order, Mr. Speaker. You probably heard the Chancellor of the Exchequer say in response to the question of my hon. Friend the Member for Hackney, South and Shoreditch (Mr. Sedgemore) that questions on these matters had not been put down until July. May I remind you that I put down questions on 23 October 1984? For that reason, I thought that there might be a chance to explain that in a question to the Chancellor.

Mr. Speaker: That is bad luck on the hon. Gentleman. However, he is one of the hon. Members who has applied for a debate on the Consolidated Fund, and he stands a very good chance of being called.

Mr. Richard Holt (Langbaurgh): Further to the point of order raised by my hon. Friend the Member for Kingswood (Mr. Hayward), Mr. Speaker. Whether or not the atmosphere was charged the remark was clearly audible throughout the Chamber. Will you use your good offices, Mr. Speaker, to call upon the hon. Gentleman to withdraw it?

Mr. Speaker: Order. First, I do not know which hon. Gentleman made that comment. Unfortunately, or perhaps fortunately, under this canopy I do not hear everything.

Mr. Sedgemore: On a point of order, Mr. Speaker. In view of your reference to civilised debate in the House, I wonder whether you could strike a balance between an East End epithet and an allegation. I have told the truth. Since when has the truth been a McCarthyite smear?

Mr. Speaker: Order. I must say to the hon. Gentleman and to all other hon. Members that we should take great care about imputations concerning the characters of others who are not in the House.

Supplementary Benefit (Board and Lodging Payments)

4.3 pm

The Minister for Social Security (Mr. Tony Newton): With permission, Mr. Speaker, I should like to make a statement about the position concerning supplementary benefit board and lodging payments following the Court of Appeal decision last Friday.

As the House will be aware, the court upheld Mr. Justice Mann's decision in the Divisional Court on 31 July that there was no power to make two paragraphs of the regulations passed by the House in April. The court rejected a cross appeal that the Social Security Advisory committee had not been properly consulted before the regulations were made.

The House will wish to know that the Government do not intend to appeal further. We shall take steps to identify from our records those cases in which arrears may be due because we did not meet the full charge, and to pay these arrears as soon as possible. To this end, we have sought and received from the court today further guidance on how such arrears should be assessed.

I should make it clear that the Court of Appeal judgment does not affect the current benefit position of those in board and lodging. Those payments are covered by the fresh regulations agreed by the House last month which came into effect on 25 November.

Mrs. Margaret Beckett (Derby, South): Is the Minister for Social Security aware that his statement, both in its nature and in its perfunctory length, is an insult to the House and, much more than that, that it is an insult to the thousands of elderly, handicapped and vulnerable people who have been illegally cheated and short-changed by the Government since the regulations came into effect? How dare the Minister come to the Dispatch Box to make that statement and utter not one word of apology or explanation for all the suffering that has been caused. It is not even as if the Government can complain that they have not been warned. Initially when the regulations were introduced the Social Security Advisory Committee heard from over 500 organisations that wrote to condemn the proposed regulations. It was the largest number ever to condemn such proposals, apart from those who wrote to condemn the Fowler reviews.

We should like the Minister to say, first, whether it is the case, as he claims in his statement, that the Government sought clarification from the court or whether, as we have been informed, the Government tried once again to put pressure on the court to weaken the judgment that had been delivered so as to deprive claimants. Will the Minister admit that if the Government had accepted the plain implications of the judgment—that cash limits also are illegal—not only would many claimants have been saved hardship but his Department's task in identifying those who should have repayments would have been made singularly easier?

Secondly, will the Minister tell us how his Department proposes to trace those who are owed money? Does he understand that it would be completely unacceptable and grossly unjust to place the burden of the claim upon individuals rather than upon his Department in seeking to identify them?

17 DEC 1985

FROM: MRS R LOMAX
DATE: 17 December 1985

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr Cassell
Mr A Wilson
Mr Peretz
Mr Scholar
Mr Hall
Mr Dyer
Mr Board
Mr D Jones
Mr H Davies

MR CULPIN

BANKING SUPERVISION: CHANCELLOR'S STATEMENT

I attach the final version of the Chancellor's Statement for this afternoon.

RL.

RACHEL LOMAX

BANKING SUPERVISION

With permission, Mr Speaker, I should like to make a statement.

2. I am publishing today a White Paper setting out the Government's proposals for strengthening banking supervision, with a view to bringing a new Banking Bill before the House early in the next session.

3. The proposals contained in the White Paper reflect the vital importance this Government attaches to effective supervision. They build on the findings of the review of banking supervision which I set up exactly a year ago today under the Chairmanship of the Governor of the Bank of England, in the wake of the Johnson Matthey Bankers debacle. Six months later, when the Group's report was published, I told the House that the Government was minded to accept its two key recommendations. I can now confirm that both will be implemented.

4. First, the new legislation will extend to banks the higher supervisory standards which Labour's 1979 Banking Act applied only to licensed deposit takers, and not to recognised banks. This means that the so called two-tier system will go. I have however concluded that it would be right to confine the use of the name "bank" to institutions with at least £5 million paid up equity capital.

5. Second, the Government will do whatever is needed to permit effective two-way communication between supervisors and bank auditors. If this can be done on the basis of agreed professional guidelines, underpinned by statute, well and good; if not, we shall not hesitate to take appropriate further powers.

6. However, assisted by the extensive consultations that have taken place since I made my statement to the House in June, I have become convinced that it would be right in a number of respects to go beyond the Leigh-Pemberton Committee's recommendations.

7. The key to better supervision is the organisation and ability of the supervisors themselves. Last October the Governor announced changes in the Bank's organisation to give supervision a higher priority. To carry this further, he will now set up as soon as possible a new Board of Banking Supervision within the Bank of England. The new Board will be given statutory backing in the forthcoming legislation. It will be chaired by the Governor; a majority of its members will be experienced practitioners from outside the Bank of England. This will bring independent outside expertise to bear at the highest level and give more forceful direction to the task of bank supervision. The Board's views will be separately identified in the Bank's annual report, which I lay before the House.

8. Second, supervisors cannot do their jobs unless they have adequate, accurate and timely information. This was one clear lesson of the JMB affair. Under the existing legislation, it is not a criminal offence to mislead the supervisors, even if this is done knowingly or recklessly. I propose to make it one - with appropriate penalties.

9. As I told the House in June, one of the most conspicuous reasons for JMB's failure was that it was over-committed to a small number of closely-related borrowers. Building on the Leigh-Pemberton Group's recommendation, I propose to make it a statutory requirement for banks to notify all such exposures in excess of 10 per cent of their capital base; and all exposures in excess of 25 per cent will require prior notification.

10. But important as they are, rules of this kind are not enough. Supervisors need to have a better knowledge of individual institutions at first hand. I therefore welcome the steps that have recently been taken to increase the frequency of supervisory visits to banks, on a routine basis as well as where there are grounds for prudential concern.

11. The nature of banking is changing fast and the supervisory system has to keep up with it. We cannot prescribe for every eventuality in advance. In particular there is a risk that new

forms of deposit-taking may fall through the supervisory net. I therefore propose to take powers to vary by secondary legislation the definition of deposits and deposit-taking around which the legislation will continue to be structured.

12. I am also very conscious that Banking Supervision can no longer be considered in isolation. The Government is urgently considering the supervisory problems posed by the growth of financial conglomerates. One of the most obvious requirements is that those who supervise banks should be able to exchange information with other supervisory authorities. Legislation this session will make this possible. Changes in the confidentiality requirements, including those in the Banking Act, will be secured through the Financial Services and Building Societies Bills this session.

13. The details of these and other proposals are in the White Paper. They represent a considered, full and prompt response to the real lessons of the Johnson Matthey Bankers affair. The system of supervision we will be putting in place will be strict, without being a straight jacket. The proposals avoid the pitfalls of unnecessary bureaucracy and administrative upheaval. They also avoid the danger of setting out rules so rigid that they encourage compliance with their letter but not their spirit.

14. As I told the House in June, an effective system of banking supervision is essential, not merely for the protection of depositors but for the financial health of the economy as a whole. Effective supervision is also a vital weapon in the fight against fraud, which the Government is determined to do all in its power to combat. But supervision cannot eradicate risk - nor should it. And it must not stifle competition. Nor, above all, can it derogate in the slightest degree from the overriding responsibility of managers to run their businesses soundly and properly.

15. Together with the Building Societies Bill, to be read for the second time on Thursday, and the forthcoming Financial Services legislation, I believe the proposals outlined in this White Paper will help create a comprehensive and effective statutory framework for a rapidly changing financial services sector.

16. I commend the White Paper to the House.

CHANCELLOR OF THE EXCHEQUER

David

Two main points about Sedgemore so that he doesn't start making specific allegations about fraud until after the police has been called in (17 July - Ch announced this to the House - Sedgemore knows this).

You might like to see a rejected extract from the Ch's speech today which gives

on have on JurB,

handed.

Rh.

12/12

FROM: MRS R LOMAX
DATE: 12 December

PS/CHIEF SECRETARY

cc: PS/Economic Secretary
Sir P Middleton
Mr Cassell
Mr Peretz
Mr Culpin
Mr Hall
Mr Board
Mr H Davies

AUTUMN STATEMENT DEBATE: JMB

The Chancellor has substantially shortened the passage on JMB provided by Mr Culpin. In the light of this morning's papers, he does not now plan to use it, but he thinks the Chief Secretary might find it useful for his wind-up.

RL

RACHEL LOMAX

Next week I shall be presenting a White Paper on banking supervision.

That White Paper arises out of the Johnson Matthey debacle of last year. Johnson Matthey Bankers was rescued by the Bank of England in October 1984. The following December I set up a high powered Committee to consider urgently the implications and to make recommendations. I announced this, at once, to the House, and I was able to come back to the House within 6 months with the results.

I have looked back at the statement I made in December, and at the questions I was asked in the House. The main concern was whether the Bank was right to rescue JMB, and whether taxpayers' money was at stake. I said then, and I repeat now, that I have committed no taxpayers money to Johnson Matthey and given no guarantees. [Pick up comments from Thursday's paper].

One thing I was <u>not</u> asked about in the House was fraud or allegations of fraud. The record of Hansard is clear. Some hon members may find this a little surprising, as some now claim, with all the ease of hindsight, that fraud has been obvious since 1983 or 1982 or even 1981.

As soon as it became clear that there were serious and unexplained gaps and omissions in the records of JMB, the Bank of England called in the Fraud Squad and I so informed the House. That was in July of this year. It is largely since then that the campaign of

accusations and innuendo, led by the Hon. Member for South Hackney, has mounted.

I acted swiftly and openly throughout - both in setting up a review committee in December and in informing the House in July that the Police were conducting investigations. I have done that because it is vital that the health of our financial institutions be upheld.

Where there is fraud, it must be brought to book. Where there is abuse, it must be rooted out. There can be absolutely no doubt about that.

At each stage, I have given the House more information than has been revealed in previous banking fiascoes. But I do not myself employ policemen or even bank supervisors. If anyone - either in this House or elsewhere - has evidence of fraud or abuse, they should give it at once to the police. No-one should play politics with this, and I will not do so.

ANNEX A

JMB : EXCHANGES WITH MR SEDGEMORE* FROM OCTOBER 1984 TO JULY 1985

20 June 1985 (col. 460)	Supplementary question to Chancellor's statement	)
27 June (col. 1066)	Oral question	) extracts attached
17 July (col. 323)	Supplementary question to Chancellor's statement	) all removed at review) in accordance with) procedures re. published
26 July (cols. 1440-4)	Adjournment debate	) papers.

x There was no correspondence with Mr Sedgemore prior to 15 August 1985 when Mr Sedgemore sent the Chancellor a dossier of papers several inches thick. These were sent to, inter alia, the police.

HF1 Division
HM Treasury
6 December 1985

Should not this be inter alios. Ask Rachel?

* Others were more active in early correspondence and in Parliamentary activity eg Mr Tony Blair, Mr Dennis Skinner.

Spare for Parliamentary section of bfg. submitted Wed's night

DB

FROM D R H BOARD
11 December 1985

CHANCELLOR

cc Chief Secretary
Economic Secretary
Sir P Middleton
Mr Cassell
Mr Peretz
Mr Hall
Mr Culpin
Mr H Davies
Parliamentary Clerk

JMB BRIEFING

I attach revised briefing. I understand No 10 would like a copy tonight.

2. The briefing is in the standard Treasury format and the draft line to take is in section B (positive); it reflects discussion with Mr Peretz in the light of the transcript of Mr Walker's press conference. We will however revise this section tomorrow morning if tomorrow's Press coverage makes this desirable.

Douglas Board

D R H BOARD

BRIEFING ON JMB

(A) FACTUAL

A1. Key dates:

early August 1984 - Bank/JMB supervisory meeting. Arthur Young (auditors) requested to re-examine loan book.

25 September - JMB inform Bank that revised estimate of provisions threaten JMB's solvency.

1 October - Announcement that JM plc have put in £50m and that Bank of England has taken over JMB for nominal sum.

17 December - Chancellor's statement announcing banking supervision review.

20 June 1985 - Chancellor's statement presenting banking supervision report and Bank of England's annual report. JMB announce suit against Arthur Young. "No prima facie evidence of fraud has so far been uncovered."

17 July - Chancellor's statement; JMB have requested police to come in. Preliminary report to be made to DPP on whether any criminal offences appear to have been committed.

24 October - Letter from David Walker to Sedgemore denying, inter alia, fraud by the Bank of England. Copy placed in Library of House. Chancellor's written answer publishes Solicitor General's letter to Sedgemore of 21 October refuting "cover up".

6 November - Bank announces prospective buyers to be approached on confidential basis.

28 November - Police announce evidence of fraud upon JMB in 1981 uncovered; Fraud Investigation Group set up.

11 December - JMB publish accounts for period to end-June (see A2 for factual summary).

Costs of rescue (as in JMB's accounts published on December 1985

Overall loss in accounts of £217.8m borne by:

Private sector	(£m)	
Johnson Matthey plc	152	(comprising -
		102 last reported value of JMB in JM plc's accounts
		50 additional injection part of rescue).
Other banks' estimated share of indemnity	26.65	
	178.65	
Bank of England		
Babk's estimated share of indemnity	26.65	
As shareholder	12.5	
	39.15	
TOTAL	217.8	

Comparison with Chancellor's 20 June statement:

Estimate of potential cost to Bank of England ~~cost~~ now £39.15m, of which £26.65m under indemnity. Estimate in June was £34m, all under the indemnity.

The estimated loss of £12.5m attributed to the Bank of England as shareholder is on the basis of JMB's net worth on 30 June. There may well be scope as JMB's assets are realised for further reducing the call under the indemnity; and have yet to see what price JMB will fetch when sold, or what damages may be receivable from suit against former auditors (Arthur Young).

(a) Including £50m injection, Chancellor's June statement referred to £180m loss borne by JMB/JM plc. Why different from £152m above?

(b) Chancellor's June statement referred to estimated £248m loss - Why different from £217.8m above?

Different accounting bases. June figures included an estimated loss of £28m of JMB's internal resources on top of the £102m book value for JMB in JM plc's previous consolidated accounts, the presentation adopted in JMB's audited accounts has to reflect that. Detailed questions to JMB.

[IF PRESSED: Emphasise the position on cost to Bank of England stated above. Underlying changes between June figures and published accounts are at the margin: eg Bank's report in June estimated £248m provisions required at 30 April 1985, published accounts show £255m provisions at 30 June 1985.]

(B) POSITIVE/LINE TO TAKE

(a) JMB's accounts

This is the first properly audited* picture of the extent of mismanagement left behind by JMB's previous management on the banking side of the business. It confirms an utterly deplorable state of affairs in the loan book and in the provisions made for bad debts which the new management inherited.

(b) £39m cost to Bank of England?

Interim snapshot. Don't yet know if there will be any loss to the Bank of England:

- may be further progress in reducing provisions (and so the final call under the indemnities);

- possible gains when JMB is sold;

- possible damages from JMB's suit against its former auditors (Arthur Young)

Position not yet satisfactory (as JMB acknowledge) as, in current operating terms, the result is no more than break even - but this represents a considerable improvement.

(c) Fraud

Welcome the opportunity which JMB have taken to spell out again their full co-operation with the police. Government fully determined to see fraud rooted out wherever it occurs.

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* AVOID EXPLICIT CRITICISM OF PREVIOUS AUDITORS OUTSIDE PROTECTION OF PARLIAMENTARY PRIVILEGE

(C) DEFENSIVE

C1-10: Fraud

C11-19: JMB - public money/public accountability

C1. Police called in too late?

My RHF the Chancellor explained the position to the House on 17 July. When the Bank of England took over JMB they found a mess. That had to be sorted out. That work got to the point of establishing serious and unexplained gaps in the records and the police were called in.

C2. When will the results of the police investigation be known?

The timetable for the police investigation is not a matter for me, but the House will be informed of the outcome.

C3. Police have discovered fraud upon JMB in 1981. Pohoomull case went to DPP in 1983. Why did Bank take so long to wake up?

Fact is, as the Chancellor told the House on 17 July, even at that date strictly speaking prima facie evidence of fraud at JMB had not been established. Does not help to wrap up allegations against JMB in a confusing and misleading package with sensational allegations against customers. Question implies it has taken the police from July to the end of November 1985 to discover something which had been obvious since 1983 or 1984 - patent nonsense.

C4. Are JMB employees responsible for the accounts under investigation still in place?

Since JMB's rescue there has been a complete reorganisation of its banking functions in the course of which 8 individuals have either resigned or been dismissed.

C5. Why were the services of Mr Ian Fraser (alleged by Mr Sedgemore to be a crook) retained after the rescue? "Deal" with Sipra? Calling in receivers against Gomba/Shamji?

This is a question for the JMB board.

[Substitute page]

IF PRESSED on possible Companies Act violations by former directors:] Any matters revealed by the accounts which call for investigations by DTI will certainly be looked into.

C6. Bank of England guilty of fraud?

The Bank of England have categorically denied this allegation in a detailed letter of 24 October, which has been placed in the Library of the House.

C7. Do you believe the Bank?

I believe we should look forward to the results of the police investigation in this respect. The statement issued by JMB with their accounts on 11 December suggests they and the Bank of England are looking forward to that too.

C8. Why then did Chancellor ask Sedgemore to withdraw his allegations?

There were two allegations which my RHF the Chancellor rightly asked the hon Member for Hackney South and Shoreditch (Mr Sedgemore) to withdraw: First, the grave allegation that the police investigation was a "cover up", which my learned Friend the Solicitor General had plainly refuted. Second that the Bank of England had been party to attempted fraud. The Bank categorically refuted this in Mr Walker's letter of 24 October which was placed in the Library of the House. My RHF the Chancellor emphasised that "If there are any matters for the police to pursue I am confident they will do so", and he has consistently urged the hon Member to place any evidence directly and promptly in the hands of the police.

[SUPPLEMENTARY IF MR SEDGEMORE ASKS ABOUT POLICE LETTER TO HIM: I understand the police have privately written to the hon Member for Hackney South and Shoreditch (Mr Sedgemore) asking him not to put publicity before the success of the police investigations. They have written entirely on their own initiative but the fact they have had to do so speaks for itself.]

C9. Symptomatic of wider decline in City standards; need for broad inquiry?

Don't accept this. The police have the full backing of the Government in rooting out corruption and fraud wherever it may be uncovered. Steps have already been taken to improve the effectiveness of the prosecution of fraud. The Fraud Investigation Group was established in January to strengthen co-operation between the police, DPP and DTI and has been doing a great deal of work. The Financial Services Bill will give investigators more powers. Effective investigation must, however, be followed by effective trial; and the law and procedure on complex fraud trials is under review by Lord Justice Roskill's Committee. I understand its report is expected early next year.

C10. Financial Services Bill? Lloyds?

Matter for my RHF the Secretary of State for Trade and Industry.

C11. JMB: public money used?

No taxpayer's money. Bank's own resources involved in rescue. These came from profits derived from the Bank's own activities, not voted by Parliament.

C12. JMB clearly not profitable, how much more money are Bank going to lose?

Matter for the Bank of England, but point out that JMB's statement on its accounts clearly shows the £12.5m erosion of its net worth is more than accounted for by non-recurring factors. The Bank's intention remains to sell JMB as soon as practicable for the best possible price. [Dr Owen's claims that JMB's bullion business in trouble have been vindicated? Accounts show £7.1m profit on bullion operations] [Refer more detailed questions to JMB.]

C13. Who gets the benefit of proceeds from selling JMB/JMB's action against Arthur Young?

The Bank of England and the private sector banks who provided the rescue, according to the terms of the agreements between them.

C14. Is it true that the Bank of England would have to give warranties/indemnities to sell JMB?

The Bank would have to weigh up the financial advantages and disadvantages to it of doing so.

C15. Bank dividend to Treasury?

Not affected. Losses to date have been absorbed by the Banking Department of the Bank of England. [IF PRESSED: Dividend to the Treasury has been published in the Bank's 1985 annual report: £25.3m for year to February 1985 compared with £21.75m the year before.]

C16. JMB will simply be sold on the back of its tax losses - taxpayer gets ripped off after all?

No special tax treatment. Inland Revenue have yet to agree JMB's position and JMB have made that clear. Not possible to know the detailed tax effects of hypothetical courses of action, but quite likely that more tax revenue would have been lost if JMB had collapsed.

C17. Need for an inquiry?

Point out that my learned Friend the Solicitor General's letter of 21 October to the hon Member for Hackney South and Shoreditch (Mr Sedgemore) refuted the hon Member's assertion that the criminal process is unsuited to find out what happened.

[IF PRESSED: Precedent of secondary banking crisis in 1970s. The Bank - on its own authority - provided financial support. The right hon Member for Leeds East (Mr Healey) told the House his approval was not sought or required. The then Labour Government did not

institute a public inquiry. The House was told virtually nothing. (**NOT FOR USE** - although the Select Committee on Nationalised Industries subsequently took evidence from the Bank).]

[ADDITIONAL SUPPLEMENTARY POINT:

The hon Member for Hackney South and Shoreditch (Mr Sedgemore) has told the Press that he wants an inquiry and that he thinks it would be necessary to give some of the witnesses immunity from prosecution. He might be right. But I would actually like to see any criminals brought to book.]

C18. JMB at risk from tin troubles on London Metal Exchange?

Its trading activities are a matter for JMB: see JMB's annual report.

C19. Johnson Matthey plc (JM plc) has had an easy ride (just declared an interim dividend?

JM plc, which owned JMB lost its existing investment in JMB and put a further £50m in before selling JMB to the Bank of England for £1. That was the maximum contribution which the Bank of England, and other private banks who helped to rescue JMB, judged JM plc could make. To do this JM plc had to receive a capital injection from its parent.

(12 copies)

D A Walker
Executive Director

BANK OF ENGLAND
LONDON
EC2R 8AH

10 December 1985

D L C Peretz Esq
H M Treasury
Parliament Stree
S W 1

Dear David,

JMB REPORT AND ACCOUNTS

I am enclosing three copies of the JMB Report and Accounts and of the two press notices that accompany them. As you know, we are releasing these under an embargo for 2300 hours tomorrow, 11 December, so that Thursday morning's press will give the first reporting of all this.

I am sending a similar set of documents simultaneously to Rachel Lomax.

Yours ever.

cc Sir P Middleton
M. Boarder

David

Johnson Matthey Bankers Limited

Press Notice

EMBARGO

JOHNSON MATTHEY BANKERS REPORT AND ACCOUNTS

1 Johnson Matthey Bankers Limited published today their report and accounts for the 15-month period to 30 June 1985. JMB was acquired by the Bank of England on 1 October 1984 and the reporting period was subsequently extended to enable the new board to get to grips with the accounting and other difficulties that they had found and to complete a capital reconstruction that was achieved on 18 June 1985.

2 The profit and loss account shows that JMB lost £70 million in the 15-month period and needed to provide a further £140 million to make good the shortfall of provisions against bad and doubtful debts at the previous year-end. This produced a loss attributable to shareholders of £210 million. Already included in this figure was an item of £11.3 million recoverable under the indemnity as interest. There was also a favourable movement to reserves of £3.5 million outside the profit and loss account. Taking these figures together, they produce an overall loss of £217.8 million before any of the contributions from outside sources that have supported JMB since 1 October 1984.

3 This loss of £217.8 million has been borne by:

	£m	£m
Johnson Matthey plc		152.0
Other banks under the indemnity:		
Principal	21.0	
Interest	5.65	26.65
Bank of England		
Under the indemnity	26.65	
as shareholder	12.5	39.15
		£217.8m

4 The total amount of provisions against the loan book in the balance sheet at 30 June 1985 was £254 million. Of this amount, £234 million was set up during the 15-month period, almost wholly by the new board. Although this immense provisioning exercise took place after 30 September 1984, it was entirely in respect of loans and advances made prior to that date. Claims under the indemnity are, as shown above, borne equally by the Bank of England and the group of banks who are the other contributors. These claims, called and anticipated, are currently expected to total £53 million; a reduction of £15 million from the £68 million foreseen at the end of April in the Annual Report of the Bank of England.

5 Within the overall pre-tax loss of £69.4 million, profit and loss has been attributed to main activities as follows, each activity having been credited with the benefit or charged with the interest cost of the capital resources allocated to it.

	£m (bracketed figures signify a loss)
Bullion operations	7.1
Commodities dealing	0.3
Futures broking	(2.7)
Insurance broking	1.0
	5.7
Banking	(73.7)
Closure and reorganisation costs	(1.4)
	(69.4)

6 The 15-month period fell into two parts divided by 30 September 1984. The losses of the banking department were attributable to events that preceded 30 September 1984. Their effect was to strip JMB of its entire capital and reserves at that time (ie £102 million as last reported in the consolidated accounts of the former shareholder), together with JM plc's cash contribution of £50 million. Thereafter, additional banking losses were to be covered by the indemnity. Effective protection as the indemnity was, it did no more than leave JMB in a "nil capital" condition. To remedy this, the Bank of England placed £100 million on deposit with JMB on 22 November 1984 and converted this into share and loan capital on 18 June 1985.

7 The consolidated balance sheet at 30 June 1985 shows JMB's net worth at £87.5 million, an erosion of £12.5 million of the new funds provided by the Bank of England. That decline is attributable to three main factors, all of them of an exceptional nature. They are:

	£m
The additional interest cost from operating without normal capital between 1 October 1984 and 18 June 1985	7.0
The cost of foreign exchange cover for doubtful debts denominated in US dollars, not indemnified	4.7
Closure and reorganisation costs	1.4
	£13.1m

This indicates that at the ordinary operating level JMB broadly achieved a break-even result in the period from 1 October 1984 to 30 June 1985. This is not satisfactory but it marks a turning point.

8 The erosion of net worth, taken together with the contribution of the Bank of England under the indemnity, points to an estimated potential burden on the Bank of England as seen now of £39 million. Leaving aside the outcome of the claim against the previous auditors and of other litigation in which JMB is involved, the eventual final cost of the rescue to the Bank of England will be reduced if and to the extent that future realisations permit further writing-back of provisions; it will, of course, depend also on the terms of disposal of the group.

9 In his Statement, the Chairman, David Walker, indicates that the main focus of effort since October 1984 has been on establishing satisfactory controls and securing recoveries in the loan book. In the period, special regard has been paid to liquidity, and the group has held back from major initiatives even in the profitable bullion operations. But with such consolidation now achieved, it is time to accord greater attention to improving the return on capital. In this situation, preparations are now in train for the return of the group to private ownership, which will provide the best foundation for exploiting the commercial opportunities that lie ahead and for taking JMB into its next phase.

10 The Chairman's Statement also refers to the institution of legal proceedings alleging negligence against the previous auditors, Arthur Young, and JMB's intention is to claim substantial damages to recoup its loss.

11 December 1985

Johnson Matthey Bankers Limited

Press Notice

STATEMENT BY JMB ON FRAUD AND RELATED ALLEGATIONS

1 The Report and Accounts of JMB are published today, just over 14 months after the acquisition of the group by the Bank of England in October 1984. The Chairman's Statement indicates that the task of the new board was to put the business of the group back on a sound footing, and substantial progress has now been made. But the task of the new board has been complicated by the glare of publicity and a good deal of ill-founded comment in circumstances in which JMB has been seriously constrained in its ability to respond, in particular because of banking confidentiality. The aim of this press notice is to help put the allegations of fraud and impropriety that have been made in perspective.

2 The Chairman's Statement includes the following passage in respect of co-operation between JMB and the police:

> The new board of JMB faced a large task in reconstructing the bank's records and in seeking to establish the causes of the losses. The detailed and intensive enquiries which we ourselves had initiated led us to conclude in July that the Fraud Squad should be invited to carry out a preliminary investigation. It does indeed seem that some acts of fraud may have been committed against the bank, though the evidence available at present does not suggest that these account for more than a fraction of the losses sustained on the loan book; as we see them now, these losses are principally attributable to the very poor quality of lending undertaken in the past. But whatever the nature and extent of misfeasance that has, directly or indirectly, affected our business, the board feel most strongly that evidence of it must be definitively identified and vigorously followed up. The police have expressed to me their appreciation of the co-operation that they have had from our staff, many of them on secondment to us, in helping them to unravel the often complex transactions undertaken by some customers of the bank. The police will continue to have our unreserved support in their investigations. It is clearly in the interests of our shareholder, of the board, of our staff, indeed of all concerned with the integrity of our business - and, of course, of banking business generally - that malefactors be identified and brought properly and swiftly to book.

3 Allegations of impropriety or fraud relating to JMB have been made in the four categories set out below:

(a) fraud against the bank by customers before 30 September 1984;

(b) impropriety or fraud (before 30 September 1984) relating to transactions where any losses were sustained not by JMB but by others, in particular through apparent breach of Nigerian exchange control arrangements;

(c) impropriety or fraud as in (a) and (b), in which former directors or staff of JMB may have been implicated;

(d) impropriety since the change of shareholding on 1 October 1984 in the context of the efforts and procedures set in train by the new board and its agents to make recoveries from debtors.

4 There is clearly the possibility of links between (a), (b) and (c), but they each represent a different category of impropriety or fraud. The Fraud Investigation Group has enquiries in train on the basis of evidence of varying degrees of impropriety or fraud in each of the first three categories. But while the eventual outcome of the FIG enquiries remains to be seen, the board of JMB are confident that the very substantial provisions that they have made are full and sufficient. The information at present available does not suggest that the amounts that have, or may have, been lost as a result of fraud are significant in relation to the total scale of provisions that have now been made.

5 JMB itself has identified certain transactions by a few customers, apparently undertaken in some cases with the knowledge of the bank, designed to circumvent Nigerian exchange control. The Nigerian authorities were informed when evidence of these transactions came to light, and we will be giving them every assistance in getting to the bottom of the matter.

6 Each and every one of the suggestions of impropriety on the part of JMB or its agents since October 1984 has been very closely investigated by the board, and by our legal advisers, and we have of course given every assistance to the police in their own enquiries. We believe that there is no substance in any of the allegations that have been made, and we hope accordingly that those who have sought to propagate them will now desist. For our part, the board and management of JMB will continue vigorously to seek to make recoveries in respect of lending against which provisions have had to be made.

11 December 1985

Written Answers to Questions

Thursday 24 October 1985

NATIONAL FINANCE

Johnson Matthey

Mr. Sedgemore asked the Chancellor of the Exchequer (1) if he will set up an inquiry to examine the evidence in the letter to him from the hon. Member for Hackney, South and Shoreditch and enclosures of 4 October together with subsequent evidence relating to the conduct of members of the Bank of England, Mahmud Sipra, his solicitors and others in matters arising out of the Johnson Matthey banking collapse;

(2) if he will set up an inquiry to examine the conduct of *(a)* the Governor of the Bank of England, *(b)* directors of Johnson Matthey bank appointed by the Bank and *(c)* David Curtis and Mr. Thomason of Hambros Bank in relation to their activities concerning Johnson Matthey bank.

Mr. Lawson: The hon. Member's letter to me of 4 October, which was reported in the press, raised criminal and other allegations against the management of Johnson Matthey Bankers, their advisers Hambros Bank, and the Bank of England. The hon. Member also made the accusation that the police investigation of which I informed the House on 17 July, at column 320, was "a cover up". I referred the hon. Member's letter to the law officers and to the Governor of the Bank of England.

With the Governor's agreement the chairman of JMB has today sent the hon. Member a detailed letter denying the hon. Member's allegations in categorical terms. A copy is being placed in the Library of the House. As for the grave accusation of a "cover up", the hon. Member received earlier this week an equally categorical rebuttal from my hon. and learned Friend the Solicitor-General, and I am arranging for the text to be published in the *Official Report*. If there are any matters for the police to pursue I am confident they will do so. I see no need for an inquiry into any of the matters which the hon. Member has raised and I hope that, in the light of the very full replies which he has received, he will withdraw his allegations.

Following is the letter:

21 October 1985

Brian Sedgemore Esq MP
House of Commons
London SW1

Dear Brian,

Your letter of 4 October to the Chancellor of the Exchequer was copied to the Attorney-General and to the Governor of the Bank of England, because it raised matters falling within their respective responsibilities. In the continuing absence of the Attorney-General following his recent operation I am replying on his behalf.

I have of course taken serious note of your grave allegation that the preliminary police investigation into JMB is a cover-up, and that it is being constrained by less than full cooperation from JMB itself. The Controller of Fraud Investigation Groups within the DPP has discussed with Detective Chief Superintendent Squires (who is leading the investigation into JMB's affairs) your allegation that the Bank of England has "kept a lid" on the investigation by, in particular, restricting access to papers. I am informed that DCS Squires disagrees: he has no complaint to make of lack of cooperation from the present management of JMB. Up to now it has not been necessary for the police to seek access to the whole of JMB's papers, but whatever they have needed to see has in each instance been made freely available. I understand that Treasury officials have also been in touch with JMB, whose Chairman has reaffirmed JMB's full and willing cooperation with the police investigation.

I hope I do not need to assert to you that in the conduct of such an investigation the Police Service is wholly independent of the Executive, as is the DPP (who is subject only to the superintendence of the Attorney-General).

Your letter of 4 October also outlined allegations made by a Mr. Hussein that there had been an attempt on behalf of JMB to procure the execution of a back-dated agreement, which would have had the effect of giving JMB priority over other creditors of companies owned by Sipra, thereby defrauding them. I understand Mr. Hussein has been seen by the police who are looking into the matter.

I do not agree with your assertion that the criminal process is "wholly unsuited to find out what has happened". In the face of allegations that serious criminal offences have been committed I regard it as entirely appropriate.

I am copying this letter to the Chancellor.

Yours,
Patrick

Banking Supervision (Review Committee's Report)

4.23 pm

The Chancellor of the Exchequer (Mr. Nigel Lawson): With permission, I should like to make a statement.

In my statement on 17 December, I told the House that the Johnson Matthey Bankers affair raised important issues about our present procedures of banking supervision, and the legislative framework within which it is conducted. I announced a full review, which would consider whether any early changes in present supervisory procedures were called for in the light of the problems that had arisen in Johnson Matthey Bankers, and whether there was a need to review or amend the Banking Act 1979.

The review committee has now presented its report, which I have arranged to be published as a Command Paper and have laid before the House. I shall be considering the committee's proposals carefully. In the meantime, I have accepted the report as a basis for immediate consultation. Many of the recommendations do not require legislation. Some are already being implemented. But some of the committee's proposals do require fresh legislation. I therefore propose to publish a White Paper later this year, with the intention of bringing a Banking Bill before the House as soon as possible. The group of Treasury and bank officials which I set up under the review committee's terms of reference is continuing its detailed examination of the Banking Act 1979.

I am most grateful to the Governor of the Bank of England, who has chaired the review committee, and to its members, who comprised senior officials of the Bank of England and the Treasury, and a distinguished commercial banker, Mr. Deryk Vander Weyer.

A note by the Bank of England on events leading to the failure of JMB, the subsequent rescue by the bank, and its conduct of JMB's affairs is annexed to the bank's annual report and accounts, which have been laid before the House today.

The bank's account makes it clear that serious shortcomings in the management of JMB led to its collapse — over-rapid expansion of the loan book, heavy concentration of exposures, and lack of adequate control systems. JMB was also guilty of serious misreporting to the supervisory authority.

The circumstances described in the bank's report must inevitably raise questions about the role of the auditors, Arthur Young. The board of JMB, which is a wholly-owned subsidiary of the Bank of England, has today announced that it will be initiating legal action against Arthur Young.

The bank's account also explains its reasons for rescuing JMB. In mounting the rescue, I am satisfied that the Governor was acting properly within his discretion.

The board of JMB now estimates the company's losses at £248 million. Of this, £130 million has been met by JMB's original capital, reserves and provisions, and £50 million by a cash injection from Johnson Matthey plc, the former parent company. The rest of the losses are to be met from the indemnity of £150 million, split pound for pound between the Bank of England and a group of private sector banks and members of the London gold market. Potential claims on the indemnity to date thus amount to £68

[Mr. Nigel Lawson]

million, of which £34 million falls to the bank. Though in many instances recoveries will be only over the long term, JMB's present board of directors is satisfied that the total eventual calls on the indemnity will fall comfortably within the £150 million ceiling.

Since JMB is now its wholly owned subsidiary, the Bank of England stands fully behind it. On 22 November the bank placed a deposit of £100 million with JMB, which has since been converted into £100 million of additional capital to strengthen JMB's balance sheet. This will, of course, be fully reflected in the price the Bank of England receives for the sale of JMB back to the private sector, which it plans to conclude as soon as practicable.

The review committee has made 34 specific recommendations. Their implementation will require action by the Bank of England, by supervised institutions, by their auditors and by the Government. The committee proposes two fundamental changes in the present arrangements, and several important modifications. It has taken the view, which I share, that the JMB case exposes major shortcomings in the present legislative framework and supervisory procedures. I shall, in my statement, outline only the committee's main proposals. A full summary of its recommendations is annexed to its report.

The Banking Act 1979 — which was Labour legislation — draws a distinction between recognised banks and licensed deposit-takers. JMB was, and still is, a recognised bank.

Most of the Act's provisions, and of the bank's powers set out in it, relate to licensed deposit-takers. A dual system of supervision has resulted. Licensed deposit-takers have been subject to a more rigorous regime of supervision, whereas the supervisors have relied heavily on the integrity and co-operation of the management of recognised banks. With most banks, this confidence has not been misplaced. But the banking industry has expanded rapidly, and its activities have diversified. Recognised bank status—as we have seen with JMB—has not always guaranteed prudence and responsibility.

The committee recommends that the two-tier system be abolished and that the powers given to the bank under the Act should apply to all authorised institutions. I accept this recommendation. The committee recommends that all authorised institutions should, in consequence, be entitled to use banking names.

I also intend to tighten the criteria for authorisation, including the minimum net assets required.

The second fundamental change recommended by the review committee concerns bank auditors. In this context, I am grateful to the Institutes of Chartered Accountants of England and Wales and of Scotland for the co-operation that they have afforded the committee.

The committee recommends that there should in future be a regular dialogue between the supervisors and banks' auditors. I strongly endorse this proposal.

A banks' auditors are uniquely placed to monitor its control systems and assess its financial prudence. The accountancy profession at present considers itself prevented by a duty of confidentiality to the client from passing information to the supervisors. At the same time, the supervisors are themselves inhibited by the Banking Act from communicating supervisory information to third parties without the institution's consent.

This is clearly an unsatisfactory state of affairs. It is in cases where consent is not forthcoming that dialogue might be most necessary. That is why I accept the committee's recommendation that the constraints on contact between auditors and supervisors be removed.

I emphasise, however, that it is the directors and senior managers of banks who are responsible for the conduct of their business. They have duties both to depositors and to shareholders. This responsibility cannot be shuffled off to auditors or supervisors. The lesson of the JMB collapse is that banks must have in place adequate management and control systems. I therefore endorse the committee's suggestion that banks should appoint an audit committee and finance director where they do not already have them.

The committee has also made important recommendations on the staffing and organisation of the banking supervision division of the Bank of England.

The work of the supervision division has increased greatly in both complexity and volume in recent years, and the Bank of England now supervises more than 600 institutions. In general, it does a difficult job diligently and well. But in the case of JMB, the supervisors cannot escape criticism for failing to respond more quickly to the danger signals.

The committee has recommended that the staff of the division would benefit from wider commercial experience; that there should be more secondments in both directions between the division and commercial banks; that a significant cadre of experienced long-term banking supervisors must be built up; and that there should be more professionally qualified accountants in the division. It has also been suggested that more staff are needed.

The bank has already begun to implement these recommendations. The division is being strengthened both in numbers and in the range of expertise available. Some rearrangement of responsibilities has taken place within the division and further secondments to and from commercial banks have been arranged. To provide advice at a senior level, Mr. Sidney Proctor, chief executive of the Royal Bank of Scotland group, who retires from that position on 30 September, has accepted the Governor's invitation to serve on a part-time basis as an adviser on banking supervisory issues.

JMB's failure stemmed directly from a number of large, related exposures. The committee recommends—and the Bank of England has accepted — that in future no exposure to a borrower, or to closely related borrowers, should exceed 25 per cent. of the lender's capital base, other than in the most exceptional circumstances.

An effective system of banking supervision is essential, not merely for the protection of depositors but for the financial health of the economy as a whole.

The review committee's report brings out very clearly the lessons to be learnt from the collapse of Johnson Matthey Bankers. But more than that, it proposes a number of important changes to banking supervision in this country, which I am confident will greatly strengthen the system and make a repetition of the JMB affair very much less likely to occur. I commend it to the House.

Mr. Roy Hattersley (Birmingham, Sparkbrook): I wish at the outset to make it absolutely clear to the Government that the Opposition expect an early debate on this subject, for it raises the most serious questions about

relationship betwen the banks and the Bank of England, the Bank of England and the Treasury, and the Treasury and the House of Commons.

The Chancellor now proposes a Banking Bill to review the system of statutory regulation. I welcome that, and the Opposition will help its passage—that is, the passage of a Bill which offers adequate safeguards and supervision. I hope, however, that the Chancellor is aware that our co-operation depends on the inclusion of three essential ingredients.

The first is the abolition of the two-tier system of supervision and the extension to the banks of the information requirement now placed on licensed deposit-takers. The second is the power of the Bank of England, when it fears a bank collapse, to provide relevant information to other Government Departments. The third is the duty — not the right, as recommended by the working party — of auditors to warn the Bank of England if they have information about impending collapse.

However, the Chancellor will be aware that that is all in the future. Opposition members will not agree that the history of this matter can be swept under the Bank of England's carpet. Indeed, unless we fully understand and learn the lessons of this unhappy affair, new legislation will be no more successful than the old; for under present powers, the Bank of England should have detected, and prevented, the JMB collapse.

Why did the Bank of England not appoint an investigator under section 17 of the Banking Act in the autumn of 1983 or in early 1984, when it certainly knew that JMB was moving into desperate difficulties? Indeed, why did the Bank of England not know of the danger earlier? Is it not a fact that every bank must submit Q7 forms to the supervising authority listing the largest depositors, the amount of the loan book and the geographical spread of loans? Does the Chancellor agree that that information gave the Bank of England a most serious warning signal and that the Bank of England did not act on it?

It is not only the Bank of England that has such questions to answer. The Chancellor tells us that when he made his statement to the House on 17 December, he did not know of the £100 million loan to JMB. Does he now accept that he should have known and that the Bank of England should have told him? Perhaps more important, does he accept that when he found out, he should have corrected the mistaken impression that he inadvertently gave to the House?

The Chancellor cannot hide behind the fiction that the behaviour of the Bank of England is not a matter for him; nor can he take refuge in the pretence that public money was not involved. No one now accepts the arbitrary and artificial distinction which he chooses to make, since the Bank of England dividend is payable to the Treasury, and Bank of England money is, in a real and practical sense, within the public weal.

That raises the fundamental question which I hope the Chancellor will answer. Why, of all the companies that the Government and their agencies might have rescued, has this incompetent bank been singled out for special treatment. In short, why Johnson Matthey and Cortonwood? Why JMB and not Stone Platt, the textile machinery company which the Bank of England ditched in 1982?

With such a sorry tale of incompetence and concealment before the Chancellor, does he still retain any confidence in the Governor of the Bank of England, and does he expect us to retain any confidence in him?

Mr. Lawson: The right hon. Gentleman first asked for a debate. That is a matter which, as he knows, can be pursued through the usual channels.

Secondly, the right hon. Gentleman welcomed the proposed Banking Bill, and I am glad of that. He asked for an assurance that it would include the abolition of the two-tier system. I have already indicated in my statement that that will be a most important part of the Bill. I do not think that the right hon. Gentleman was concerned with financial matters at the time, but when the then Labour Government put forward the Banking Bill with the two-tier system that system was opposed by the then Conservative Opposition, particularly by my hon. Friend the Economic Secretary. The two-tier system was put in place by the then Labour Government against the wishes of the Conservative Opposition. It has proved to be a mistake, and we shall certainly be changing it.

The right hon. Gentleman then asked why the Bank of England did not get on to the situation of Johnson Matthey Bankers at an earlier date. I have already made it clear that the Bank of England, despite its excellent record in general of carrying out its supervisory duties, did not on this occasion act as promptly as it should have done. It did, to some extent, fall down on the job. I must say, however, that there was persistent late reporting and misreporting by JMB, so the Bank of England was provided with wholly inadequate information.

The right hon. Gentleman asked if I did not feel that I should have been told at the time about the £100 million loan. Yes, I do think that I should have been told at the time; and that is accepted by the Governor of the Bank of England and, indeed, by the bank generally. I think, however, that the point that the right hon. Gentleman went on to make is false—that I should have revealed this to the House as an additional exposure. It is important to distinguish between loans made by JMB prior to 30 September 1984—which included, as we now know, a large number of very bad and doubtful loans—and the £150 million indemnity to cover them, and the £100 million which was to provide JMB with effective working capital to continue after 30 September 1984 and stands to be recovered in full when JMB is sold back to the private sector.

The right hon. Gentleman then asked why JMB was rescued. I have already indicated quite clearly why the Governor, exercising his responsibilities, decided that, because of the combination of the risk to the London gold market — which is a very important market — and the effect on the banking system, it was right to rescue JMB.

In reply to the question whether I now have confidence in the Governor, I must tell the right hon. Gentleman and the House that I have the fullest confidence in the Governor of the Bank of England.

This is not the first occasion on which a bank has collapsed and a rescue operation has been mounted. Right hon. and hon. Gentlemen on the Opposition Benches and, indeed, the whole House will recall very clearly the secondary banking crisis some 10 years ago and the rescue operations that were mounted by the the then Governor of the Bank of England, backed by the then Chancellor of the Exchequer, the right hon. Member for Leeds, East (Mr.

[Mr. Lawson]

Healey). I have to say that no information of the kind in the Governor's report to the House and in the report that I have given to the House today and no action to tighten up on banking supervision was offered to the House at that time.

Mr. Terence Higgins (Worthing): Is my right hon. Friend aware that when an event of this size and seriousness occurs it is very important that it should be fully investigated so that the House can take a view on the reforms that need to be made? Therefore, we obviously need to study in detail the information now before us, and it is very important that the lessons should be learned. We are now in a position to do this as a result of the action that my right hon. Friend has taken. His proposals and the other remedies which he may feel to be appropriate are being implemented against the background of a situation in the City of London which is nothing short of a revolution. Therefore, it is important to ensure that we take an overall view of the problems which may arise in that context. Is my right hon. Friend satisfied that there is sufficient co-ordination between the Treasury and the Department of Trade and Industry, which is responsible for many other aspects of the City's operations? There is some danger, I fear, if there is not sufficient co-ordination and if the interrelationship of the various financial institutions is not taken fully into account when we carry out the reforms which are undoubtedly necessary in the light of this event.

Mr. Lawson: I am grateful to my right hon. Friend for his initial remarks about the particular case which is the subject of my statement today and about the action that the Government have taken.

On the wider issue of the City revolution, I welcome his statement that these reforms are essential if the City of London is to remain a world financial centre, particularly as far as the securities industry is concerned. It is obviously important that there are adequate regulatory systems and financial protection in place. He will know that the Government will be bringing forward, before very long, I hope, a financial services Bill, when these matters can and should be very fully and rigorously debated.

I am satisfied that there is full co-operation between my Department and the Department of Trade and Industry, as indeed there must be, and not only between those two Departments, but between them and the Bank of England.

Mr. Robert Sheldon (Ashton-under-Lyne): Will the Chancellor bear in mind the clear danger of rushing in with public money before the extent of the problem is realised —and, of course, this should have been realised much earlier? Will he contrast the treatment given to Johnson Matthey Bankers with the failure by a previous Conservative Government to come to the rescue of Rolls-Royce—the most important industrial company in this country, probably in Europe, and even conceivably in the world? They let that company go for sums of money rather less than this. Does that not show the bias of this Conservative Administration towards services in the City of London and away from industrial expenditure, which should be one of our highest priorities?

Mr. Lawson: That is a most extraordinary statement, because, as the right hon. Gentleman should recall, Rolls-Royce was indeed rescued by the previous Conservative Government. It is a thriving business. I hope that during the course of this Parliament we shall be able to return it successfully to the private sector.

Sir William Clark (Croydon, South): I am sure that everybody in the City and in financial circles generally will appreciate the fact that the Government are going to introduce a new Banking Bill. When will this legislation be brought forward? I have one caveat about such a Bill. In his statement, the Chancellor said that the lending authority—that is, a bank—should not expose itself to a borrower, or a series of borrowers who are connected, to the extent of more than 25 per cent. of its capital. Surely that is far too high a proportion, because a lending authority, such as Johnson Matthey Bankers, for example, could, with four borrowers, commit the whole of its capital. Would my right hon. Friend think again about the recommendations of the review committee and consider whether 25 per cent. is not perhaps too high?

Mr. Lawson: On the second point, my hon. Friend has to bear in mind that we have a very flexible discretionary system of banking supervision in this country. I am not proposing, nor is the review committee, that it should be replaced by a system of rigid rules. It is possible to have a system of rigid rules. The United States has such a system, but that does not prevent banks occasionally collapsing in the United States — for example, Continental Illinois, which was, of course, rescued. If there were to be rigid rules, the sort of matters to which my hon. Friend referred would have to be covered by them. This 25 per cent. rule is a general upper limit guideline. It does not mean that circumstances might not arise of the kind that my hon. Friend suggested, in which case, long before that, the supervisory authority would say that that was not in keeping with the supervision rules that it imposed informally and it would require the lending authority to reduce its exposures.

As to my hon. Friend's first question, we hope that we shall be able to bring forward legislation during the 1986-87 Session.

Mr. Brian Sedgemore (Hackney, South and Shoreditch): For the benefit of those members of the public who are not well versed in matters of high finance, will the Chancellor of the Exchequer distinguish between stupidity, incompetence and greed and fraudulent trading, fraudulent accounting and fraud? Bearing in mind the fact that in any language, other than Tory language, the conduct of Johnson Matthey Bankers, the auditors and the Governor of the Bank of England has coalesced into a fraud on the public, should not the Governor of the Bank of England resign under this Government before he gets the sack under the next Labour Government?

Mr. Lawson: That question is hardly worthy of any answer, although it is worthy of the hon. Gentleman. No prima facie evidence of fraud has so far been uncovered. The Price Waterhouse report turned up no prima facie evidence of fraud. However, if any prima facie evidence of fraud were to be turned up in further investigations, of course the appropriate action would be taken.

Sir Anthony Grant (Cambridgeshire, South-West): Will my right hon. Friend confirm that the strictures,

rightly levelled at the banking side of Johnson Matthey plc, do not apply to the industrial subsidiary located in my constituency which does some excellent work and gives valuable employment to my constituents? Is not the saving of that employment and the industrial side of Johnson Matthey plc a justification of the rescue operation?

Mr. Lawson: My hon. Friend is right in a number of respects. First, the parent company, Johnson Matthey plc, conducts industrial operations successfully and well in a number of constituencies, not just his. It would have been brought down completely had that rescue not been mounted. However, that was not the prime reason for mounting the rescue operation. It was for the reasons that I gave in my statement. The same goes for the bullion business of Johnson Matthey plc, which is a sound business, contrary to the impression given by a long and completely misguided campaign by the right hon. Member for Plymouth, Devonport (Dr. Owen), who is not in his place.

Mr. Ian Wrigglesworth (Stockton, South): In view of the comment that the Chancellor of the Exchequer has just made, will he explain why it was necessary to give a massive £150 million indemnity involving substantial public funds to keep the whole of that operation going? If the future of the gold market were not going to be rocked, because the bullion side of the business was viable, why was it necessary to save the whole of the institution? When he considers future banking supervision, will he take into account the views put forward by a number of people, when the subject was discussed previously? It was then said that the Bank of England is the wrong body to be responsible for the supervision of the banking system, as it is acting as an advocate for and a supervisor of the banking system, and that it should be contained in its role as a central bank and not carry out that supervisory role. Will the Chancellor of the Exchequer also explain why no charges are being brought and the fraud squad is not pursuing the matter further, when there has been such massive misreporting and misleading of the supervisory body by the bank's management?

Mr. Lawson: The answers to the hon. Gentleman's three questions are as follows. First, whether the Bank of England should continue to be the supervisory body was one of the matters considered by the review committee, which unanimously reached the conclusion that it should remain as the supervisory authority.

As to whether there was any danger to the gold market, I hardly think that the members of the gold market would have contributed to the indemnity, as they did, had they not thought that it was important to the London gold market that the bank should be rescued. That was the view of the Governor of the Bank of England and of those from the private sector who contributed to the indemnity.

Misreporting, even on the appalling scale that occurred in this case, does not constitute a fraud. That is a point of law.

Mr. Jonathan Aitken (Thanet, South): Although this affair is a most bizarre Alice-in-Cityland fable of unbelievable incompetence by the management of Johnson Matthey Bankers, does my right hon. Friend agree that considerable good may yet come out of it, because of the important reforms and changes to banking supervision in the legislation that he has announced in his statement? Does he further agree that, far from sweeping matters under the carpet, as the right hon. Member for Birmingham, Sparkbrook (Mr. Hattersley) appeared to be claiming, the Governor of the Bank of England deserves some credit for setting new standards of openness in this matter with the full record which has been published today in the Bank of England's annual report? Does not that candour compare favourably with the cover-up operation which the Labour Government carried out throughout the secondary banking crisis when details of the many bank rescues and lifeboat operations were completely concealed from the House of Commons by the then Ministers?

Mr. Lawson: My hon. Friend is correct with each of his points. I hope that good will come from, as he said, the appalling and bizarre record of incompetence and mismanagement by Johnson Matthey Bankers and the collapse. I believe that it will. I believe that we shall have a much better banking supervisory system than we have had hitherto.

Mr. D. N. Campbell-Savours (Workington): Is not the truth that there has been far too much socialising between JMB and Bank of England personnel and far too little supervising? If everything is being revealed, why does the Chancellor not publish the Price Waterhouse report? What is in it? Why cannot the public know its contents? Will it reveal the extent of the Bank of England's negligence? Why does everyone resist publishing that crucial document, which would enlighten the British public and reveal the full nature of the negligence of the Government, the Bank of England and JMB?

Mr. Lawson: I recommend to the hon. Gentleman that he reads the account given in the annual report of the Governor of the Bank of England, which was published today. As my hon. Friend the Member for Thanet, South (Mr. Aitken) said, he will see a great deal of information. It contains far more information than was ever provided by the Labour Government. The Price Waterhouse report was commissioned by the Bank of England to assist it in assessing the position in JMB. It contains details of the accounts of the customers of JMB, which, of course, cannot by law be published. To publish it would also undermine to some extent the suit——

Mr. Campbell-Savours: The cover-up.

Mr. Lawson: No, the legal action—that the Bank of England, through Johnson Matthey Bankers, proposes to take against the auditors, Arthur Young McClelland Moores and Co.

Mr. Tim Smith (Beaconsfield): My right hon. Friend mentioned the tough recommendations made in March to the Governor's committee by English and Scottish Institutes of Chartered Accountants. Many of those have been incorporated in the committee's report. Does my right hon. Friend agree that the opening up of the relationship between the Bank of England and individual banks' auditors lies at the heart of any improvement in banking supervision? Will he ensure that those recommendations are implemented as soon as possible — even ahead of any legislation — if necessary, voluntarily?

Mr. Lawson: I agree with my hon. Friend. Those points are at the heart of the matter. Some require legislation, because at the moment there is an iron curtain both ways between auditors and supervisors. The auditors,

[Mr. Lawson]

by their code of professional confidentiality, feel that they cannot reveal to the supervisors what they learn about a bank. Equally, under the Banking Act 1979, supervisors are not empowered to reveal what they discover to a bank's auditors. The iron curtain must be removed in both ways.

Mr. John McWilliam (Blaydon): Will the Chancellor tell the House whether the Governor of the Bank of England was aware of his intention to make a statement to this House on 17 December at any time before he made that statement?

Mr. Lawson: Yes, Sir.

Mr. Gerald Howarth (Cannock and Burntwood): Will my right hon. Friend confirm that those who made the ill-judged banking decisions have now been dismissed from Johnson Matthey and have nothing further to do with it?

Does my right hon. Friend agree with the report's assertions that it is the flexible nature of the supervisory regime in London that has made it the centre of the financial world, with the Bank of England now supervising more than 600 institutions, most of which are not British? Will he ensure that nothing is done to imperil the City's standing in that respect?

Mr. Lawson: I agree with my hon. Friend. The chairman, deputy chairman, managing director, deputy managing director and two other directors who had responsibility for the banking operations have resigned. I am, of course, referring to the old board.

Mr. James Lamond (Oldham, Central and Royton): Will the Chancellor answer a question which, rather surprisingly, has not been asked by his hon. Friends who allege that they are very interested in the taxpayers of this country? Will he tell me—in round figures, if necessary—exactly how much my constituents, as taxpayers, will have to find to meet the provisions in this statement?

Mr. Lawson: Nothing.

Sir Kenneth Lewis (Stamford and Spalding): Is my right hon. Friend aware that I support the package that he has put before the House to deal with this matter? However, I have a feeling that if this company had been wholly industrial and approached its bankers, they would have said that it was lost and, therefore, should get lost. The company would not have received support. It is a privileged community.

Will my right hon. Friend say to the banks generally that it would be a good thing if they could support industry in return for the support that they obviously receive?

Mr. Lawson: If my hon. Friend is under the impression that any bank that gets into difficulties will automatically be rescued, I am happy to take this opportunity to say that that is certainly not the case. The banking community should be well aware of that. In this particular case, for the reasons that I have already given, the Governor felt that it was right to mount a rescue.

Mr. Max Madden (Bradford, West): The Chancellor appears to be unduly nervous today about his statement, which may in part be due to his anxiety about the whereabouts of my hon. Friend the Member for Bolsover (Mr. Skinner), who has taken a great interest in these matters. I can tel him that, like so many other hon. Members, he is campaigning in the Brecon and Radnor by-election. I am sure that the right hon. Gentleman's statement will do nothing to answer the very serious questions that my hon. Friend and others have been asking.

Are we not told that people like the Chancellor take the view that all uneconomic units should die—that that which cannot create a profit should die? In view of that, why on earth was this bank propped up with public money? Will the Chancellor give a clear assurance that not a single penny piece of public money has been used to shore up that uneconomic bank?

Mr. Lawson: I have already made the position on public money very clear—not only on this occasion, but on a previous occasion. Currently, the exposure of the Bank of the England in terms of money that may be lost looks like being £34 million. However, we must take into account what the bankwill receive when it tells Johnson Matthey Bankers back to the private sector. There is also the question of what it might receive as a result of the legal action it proposes to take against the auditors Arthur Young.

On the hon. Gentleman's first point, I think that he is confusing my demeanour. It is not nervousness, but deep disappointment at the absence of the hon. Member for Bolsover (Mr. Skinner) from our proceedings.

Viscount Cranborne (Dorset, South): Does my right hon. Friend accept that his remarks about fraud will be widely welcomed, especially in view of recent events at Lloyds and in other parts of the City, which have far too often led to the clear indication in certain parts of the press that people who perpetrate white-collar fraud get away with it while blue-collar fraudsters and criminals do not?

Mr. Lawson: I have considerable sympathy with my hon. Friend's sentiments. I hope that nothing that is said in this House will give the impression outside that the appalling conduct of those responsible from the happenings at Johnson Matthey Bankers is in any way typical of British banking.

Mr. Stuart Bell (Middlesbrough): In response to the question asked by my right hon. Friend the Member for Ashton-under-Lyne (Mr. Sheldon) on 17 December, the right hon. Gentleman said that only £1 was invested in Johnson Matthey by the banking department of the Bank of England together with an indemnity of £75 million from the banking sector. He told my hon. Friend the Member for Sedgefield (Mr. Blair) that he was informed the following day that there was a £100 million deposit with Johnson Matthey. Why has he waited six months to give the House that information? Does he agree that he should have given a full personal statement to rectify that error once it had been brought to his attention? Does he not owe the House an apology?

Mr. Lawson: I do not accept any of that. I have been open with the House since December last year when I made a statement, although I was under no pressure to do so. There was certainly no request for a statement from the Opposition. Opposition Members have not asked a single question about Johnson Matthey or banking supervision——

Mr. Madden: What about my hon. Friend the Member for Bolsover?

Mr. Lawson: I accept that there were one or two questions from the hon. Member for Bolsover, but there has been no question from the Labour Front Bench. As for the hon. Member for Bolsover, he is not even here.

I made that statement and also set in motion the review of the supervisory system. As a result, we shall get a better supervisory system — not only through legislation, but because of the changes that the Bank of England is introducing. I should have thought that the hon. Gentleman would welcome that.

Mr. Eric Deakins (Walthamstow): Is the Chancellor satisfied that resignation is a suitable punishment for directors responsible for such financial mismanagement and incompetence? What sort of example will that set for people in the rest of the economy?

Mr. Lawson: It is not just a matter of resignation. The shareholders in the Johnson Matthey parent company have lost 70 per cent. of their money — well over £200 million. Of all the money that has been put behind the staggering losses of bad debts, 86 per cent. is private sector money.

Mr. Jack Straw (Blackburn): Just who was the Chancellor trying to kid when he told my hon. Friend the Member for Oldham, Central and Royton (Mr. Lamond) that not a penny piece was at risk for the taxpayer? On our reading of his statement, it is likely to cost up to £134 million from the public purse. That is the extent of the risk. It is well over half the amount of money that was taken from beneficiaries of child benefit. If no public money is at risk, why is the Chancellor making this statement in his capacity as Chancellor, and where will the £134 million come from?

Mr. Lawson: The hon. Gentleman has got his figures completely wrong. The £34 million is indeed money that is lost in the sense of recovering bad debts; but, as I said earlier, against that must be set the money that will be recovered when Johnson Matthey is sold. The money that is then recovered will, as I said in my statement, include the £100 million additional capital that has been put in. That will be paid first. Therefore, currently £34 million is the risk, but money will be recovered from the sale of Johnson Matthey Bankers, and money may also be recovered from the legal action against the auditors.

Johnson Matthey Bankers

3.51 pm

The Chancellor of the Exchequer (Mr. Nigel Lawson): With permission, Mr. Speaker, I should like to make a statement. I told the House on 20 June that if further investigations into the affairs of Johnson Matthey Bankers were to turn up any evidence of fraud, appropriate action would be taken. Investigations have been continuing since then. Although, strictly speaking, they have not so far established prima facie evidence of fraud, they have revealed serious and unexplained gaps in the records of Johnson Matthey Bankers, including the possibility of missing documents relating to substantial past transactions on certain accounts that are the subject of large losses.

In the light of that, Johnson Matthey Bankers has today requested the Commissioner of the City of London police to conduct a preliminary inquiry with a view to establishing whether any criminal offences may have been committed. The result of the inquiry will be reported to the Director of Public Prosecutions, who will advise what, if any, further action should be taken. The House will, of course, be kept informed.

Mr. Roy Hattersley (Birmingham, Sparkbrook): The Chancellor of the Exchequer was wholly right to inform the House of this latest development in the Johnson Matthey affair at the first opportunity, and I thank him for that. Obviously, it is not possible to speculate about the outcome of the police inquiry — [HON. MEMBERS: "But."] It is, however, essential to clarify the procedure which now follows. Will the Chancellor of the Exchequer confirm that two prosecutions may now result from the unhappy affair: first, regarding the auditors, about which he told the House a month ago, and now Johnson Matthey Bankers? What is more, because of their mutual mismanagement, the Bank of England and the Government are involved in the whole episode. It grows increasingly difficult to answer the question why Johnson Matthey Bankers was bailed out in the first place, and so quickly.

Does the Chancellor of the Exchequer agree that the fullest revelation of all the facts is essential? Will he promise that after the police inquiries there will be a general inquiry into the whole Johnson Matthey Bankers' scandal, either by a Select Committee of the House or under the Tribunals of Inquiry (Evidence) Act 1921?

Mr. Lawson: I am grateful to the right hon. Member for Birmingham, Sparkbrook (Mr. Hattersley) for his initial welcome. He referred to the two matters which are now under way as if they are somehow similar. In fact, they are very different. There is the prospect of civil action by JMB, which is now a wholly owned subsidiary of the Bank of England, against the auditors Arthur Young McClelland Moores and Co. Secondly, there is the separate preliminary police inquiry.

The right hon. Gentleman asked why Johnson Matthey Bankers was bailed out. I gave a full explanation of that when I made my statement on 20 June, and the matter was covered fully in the annual report of the Bank of England. As for what might happen in future, I think that it is better at this stage to wait and see.

Sir William Clark (Croydon, South): Is my right hon. Friend aware that his statement will be very welcome, so

that the whole affair can be cleared up once and for all? Does he agree that if the Bank of England had not intervened in the Johnson Matthey affair there could have been a loss of confidence in the City, which would have been detrimental to the invisibles sector of the economy?

Mr. Lawson: My hon. Friend is right. There were obvious dangers to the London gold market especially, which was a special and important feature of the case. It is striking how open the Government have been in revealing to the House details of this matter, in sharp contrast to what happened under the previous Labour Government during the lifeboat incident.

Mr. Richard Wainwright (Colne Valley): Will the Chancellor of the Exchequer explain to the House why it is only now that he is able to tell the House that serious and unexplained gaps in the records have come to light, when various skilled teams of investigators have been engaged in the Johnson Matthey investigation over the past six months? How much longer does he think it will take possibly to produce prima facie evidence?

Mr. Lawson: The fact that the documents were missing was not established until quite recently. Since the Bank of England took over Johnson Matthey it has stopped further out-flows and has been working to establish the full extent of the bad debts, which I reported to the House on 20 June. It has been engaged also in getting Johnson Matthey Bankers back into a shipshape and saleable condition, so as to protect taxpayers' and the Bank of England's money and that of the indemnifiers. The inquiry is not the only matter in which the Bank of England has been engaged, but I am satisfied that it is diligently pursuing the inquiry with the aid of its advisers. I am sure that it is as anxious as the House to have a prosecution for fraud if any evidence of fraud should be found.

Sir Anthony Grant (Cambridgeshire, South-West): Is my right hon. Friend aware that the deplorable goings on at Johnson Matthey Bankers have caused the most acute embarrassment to many of my constituents who work successfully and honourably with the chemical division of Johnson Matthey? Will he emphasise that the two companies are quite separate, and in so doing wish every success to those who work in Johnson Matthey chemicals?

Mr. Lawson: I did so when my hon. Friend properly raised the matter on 20 June, and I gladly do so again now.

Mr. Dennis Skinner (Bolsover) *rose*——

Hon. Members: Hear, hear.

Mr. Skinner: Is the Chancellor of the Exchequer aware that if the Attorney-General had acted on 12 November 1984 when I asked him a question about the fraud squad's investigation of this matter there is a fair chance that some of the tracks that have probably since been covered up would have been found and explored thoroughly by the fraud squad?

The right hon. Gentleman will be aware that in the Crown Agents' affair very few people were trapped at the end because there was too long a delay. In the London and Counties Security scandal, Gerald Kaplan managed to get to America because of the delay. The result is that he has got off scot-free. In other words, he has obtained an amnesty. If the right hon. Gentleman compares the Johnson Matthey Bankers' affair with the Slater Walker fiasco, and all the others that arose at about that time, he will find that most of those involved got off scot-free. Against that background, is he not open to the charge that, because he has delayed matters and refused to answer my questions and those of my hon. Friends, people such as James Firth, a director, whose son was employed by one of the largest borrowers from Johnson Matthey, have been able to cover up all their tracks? The borrower is a personal friend of the Prime Minister and of the Secretary of State for Trade and Industry.

Is it not a scandal that the Chancellor has come to the House eight months after Johnson Matthey's exposure on 30 September? The result is that we will be lucky to get hold of any of the culprits, yet there are so many people to pick on. Why does the right hon. Gentleman not act against the Governor of the Bank of England? Why is the Governor not charged with the fact that he allowed so much neglect to take place? What about Michael Arnold, who worked for the auditors and apparently could not discover anything throughout 1984? One of those auditors is now in charge of looking after the NUM's funds. What a scandal this is.

Is it not a fact——

Mr. Speaker: Order. The House knows that the hon. Member for Bolsover (Mr. Skinner) has taken a special interest in this matter, but he must not make a speech.

Mr. Skinner: Is it not a fact that, by being so laggardly, the Chancellor and the Attorney-General, with the connivance of the Prime Minister, will allow these people to get off scot-free while miners have been locked up in gaol for doing absolutely nothing?

Mr. Lawson: I resent and reject the hon. Gentleman's allegations. I had hoped that he would welcome my statement.

Mr. John Maples (Lewisham, West): Does my right hon. Friend agree that one of the most difficult decisions that a central bank has to make from time to time is whether to rescue a particular financial institution? It is, by contrast, extremely easy for the Opposition to cast doubt on those decisions in ignorance of the full facts.

Mr. Lawson: My hon. Friend is correct, but, strictly speaking, that is not the issue before the House. This is a serious matter. It concerns the fact that the Bank of England, through Johnson Matthey Bankers, has reached the point where sufficient suspicion has arisen through the missing documents to lead the Bank of England to feel justified in asking the City fraud squad to make a preliminary inquiry.

Mr. Robert Sheldon (Ashton-under-Lyne): Is it not clear that the rescue of Johnson Matthey Bankers, by comparison with a large number of firms which have been allowed to go to the wall, represents an error of judgment by the Chancellor? Does the right hon. Gentleman agree that Johnson Matthey Bankers has shown itself to be the unacceptable face of capitalism, whereas the Chancellor's actions have shown themselves to be the unacceptable face of Government intervention?

Mr. Lawson: The right hon. Gentleman is wrong on both counts. First, the decision to rescue JMB was not my decision, but that of the Governor of the Bank of England. Secondly, it was not an incorrect decision. In my judgment, the Governor of the Bank of England was correct in taking that decision.

Mr. Anthony Beaumont-Dark (Birmingham, Selly Oak): Does my right hon. Friend accept that most of us will think that he was right to make this statement, because the invisible earnings of the City of London are important to our balance of payments? Does my right hon. Friend accept that what has happened at Johnson Matthey is a scandal which should be investigated, wherever it goes, and whatever its results? Bearing in mind the City revolution to come, the loss of confidence in the City by events such as the Johnson Matthey incident and the fact that Lloyd's has cast a great cloud over many people's views of the City's reputation, should not the same strictures be applied to Lloyd's, as a police investigation would bear heavily upon many people involved in some of the disgraces there?

Mr. Lawson: My hon. Friend will know that investigations into Lloyd's are going on. The prosperity and future of our people are threatened by the unacceptable face of Socialism. Whereas we are acting properly against what the right hon. Member for Ashton-under-Lyne (Mr. Sheldon) called the "unacceptable face of capitalism", the unacceptable face of Socialism is publicly embraced by the Leader of the Opposition.

Mr. Brian Sedgemore (Hackney, South and Shoreditch): Is the Chancellor aware that Mr. Michael Hepker, the chairman of a public company, Sumrie Clothes Ltd., who today left the country, has been leading the Bank of England auditors, Graham Mark and Robin Collier, up the garden path ever since the collapse of Johnson Matthey in relation to a £1·5 million loan made to Ravensbury Investments, an offshore Isle of Man company, which loan involved a whole series of frauds, including a fraud on Johnson Matthey? Will the right hon. Gentleman confirm that on 29 June 1982 Eric Ellen, the director of the International Bureau of Maritime Fraud, went to see Ian Fraser, a director of Johnson Matthey, to tell him about various proven misdemeanours in which Mr. Mahmud Sipra, who controls the El Saeed empire which led to the collapse of Johnson Matthey, had been involved? Will the right hon. Gentleman confirm that, on 12 December 1982, he telephoned Mr. Fraser to tell him that Mr. Sipra was caught up in a £3 million fraud and that it was ridiculous to continue to lend him money, only to be met with the reply by Mr. Fraser, "You chaps are all the same. You don't give anyone a chance."? Will the Chancellor give a guarantee that he will come to the House next week, when I hope to present further details of fraud at Johnson Matthey?

Mr. Lawson: If the hon. Gentleman has any relevant evidence, I hope that he will immediately make it available to the police.

Mr. Eric Cockeram (Ludlow): Will my right hon. Friend accept that his assurance that if any fraud is uncovered the matter will be brought to the attention of the Director of Public Prosecutions is little comfort, in view of the repeated lethargy of that Department? I remind my right hon. Friend that fraud at Lloyd's was uncovered more than 12 months ago, yet no action has been brought by the DPP.

Mr. Speaker: Order. Wide questions promote wide answers.

Dr. Oonagh McDonald (Thurrock): Is the Chancellor aware that his statement makes nonsense of the Prime Minister's reply to me last Thursday, which was reinforced in her Monday letter to me, when she said that she saw no purpose in an inquiry into the relationship between Johnson Matthey and companies to which loans had been made? Does not everything that the Chancellor has said today underline the need for such an inquiry? What will the right hon. Gentleman do to shake the Prime Minister's complacency about Johnson Matthey?

Mr. Lawson: There is no question of complacency on the part of my right hon. Friend the Prime Minister, myself, any member of the Government or the Governor of the Bank of England. We have acted throughout on all the evidence that has been made available. It was impossible to act before there was any evidence. Now that further facts have come to light, the Bank of England and Johnson Matthey Bankers, without any delay, have called in the police, who will report to the Director of Public Prosecutions.

Mr. John Stokes (Halesowen and Stourbridge): Disregarding much of what the Opposition have said, is my right hon. Friend aware that the honesty and integrity of the City of London is at stake? We look to my right hon. Friend to help us in every possible way.

Mr. Lawson: I agree with my hon. Friend that the honesty and integrity of the City of London are of the first importance. As I made clear in my statement of 20 June, it would be wholly wrong to assume that the shambles, and worse, at Johnson Matthey Bankers was in any way characteristic or typical of banking in the City of London. It does no good to this country to pretend otherwise.

Mr. Laurie Pavitt (Brent, South): Is the right hon. Gentleman aware that, apart from the large companies which were caught, a large number of small businesses are affected? I know of the tragedy of a small concern in Norfolk which had been built up over 30 years and which has gone to the wall. Does the Chancellor's announcement offer any hope that, after a lifetime of work, these small businesses will be rescued from bankruptcy?

Mr. Speaker: Order. That question has nothing to do with Johnson Matthey.

Viscount Cranborne (Dorset, South): Now that my right hon. Friend has set such a good example in dealing with white collar fraud, can we expect him to encourage the responsible authorities to promote similar investigations into the Lloyd's insurance market?

Mr. Speaker: Order. That question is no good, either.

Mr. D. N. Campbell-Savours (Workington): May I ask the Chancellor to give an assurance that every penny of public money expended on rescuing that bank will be returned to the public purse before the company is again privatised? May we now have a copy of the Price Waterhouse report?

Mr. Lawson: As I made clear to the hon. Gentleman earlier, the Price Waterhouse report contains details which, because of the law relating to banking confidentiality, cannot be revealed. It also bears upon the legal action which the Bank of England and Johnson Matthey Bankers contemplate against Arthur Young McClelland Moores and Co. On the hon. Gentleman's point about money being returned before privatisation, the money that will be received by the Bank of England as a

result of the privatisation of Johnson Matthey Bankers will play an important part in the recovery of funds which have been expended.

Mr. Tam Dalyell (Linlithgow): Did it come to the Chancellor's ears from around the gold market and elsewhere in the City before Christmas that there was a likelihood of fraud being involved? On what date, before or after Christmas, were Sir Robert Armstrong, the Prime Minister and the Chancellor warned of the likelihood of fraud in the Johnson Matthey Bankers case?

Mr. Lawson: I received no such warning at any time. The Bank of England discovered the documents to be missing last week.

Mr. Robert C. Brown (Newcastle upon Tyne, North): As it becomes increasingly apparant that a large sum of public money has been involved in fraud, will the Chancellor give the House an assurance that if, after the fraud squad's inquiries, the Director of Public Prosecutions reveals that the villians have fled, he will dismiss the Governor of the Bank of England, and resign?

Mr. Lawson: No, Sir.

Mr. Hattersley: Does the Chancellor agree that the exchanges of the past few minutes confirm the need for a general inquiry? At some point, must he not answer the question why, when my hon. Friends below the Gangway suspected fraud six months ago, the Bank of England suspected it only yesterday?

Mr. Lawson: The right hon. Gentleman's colleagues below the Gangway suspect fraud on every occasion, whether or not there happens to be any evidence of it.

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CCBG

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

11 December 1985

N D Ward Esq
PS/Secretary of State
for Northern Ireland
Northern Ireland Office
Whitehall
London SW1A AZ

NBPM.

Dear Neil,

WHITE PAPER ON BANKING SUPERVISION

Thank you for your letter of 9 December.

The proposal that the Bank of England should be free to disclose supervisory information to Departments other than Treasury has led to a good deal of disquiet amongst the banks, which they have expressed to the Bank of England during the consultative process. The Chancellor feels that to amend paragraph 12.5 in the way your Secretary of State suggests would give the impression of a much wider loop-hole in traditionally tight banking security than would be needed to meet the exceptional circumstances in which this power would be used. The Chancellor thinks that these amendments, taken together would be unduly provocative, particularly since the use of the power will necessarily be discretionary, rather than tightly defined in statute. The Chancellor is, however, content to replace "in imminent danger of collapse" by "in serious difficulties". He would prefer not to include the reference to local knowledge and expertise, or to delete the word "major".

The Chancellor notes that you would like to see some further amendments to the present Banking Act, and has asked Treasury and Bank officials to consult yours in the drafting of instructions.

I am copying this letter to the Private Secretaries to Members of EA Committee, Murdo Maclean, Michael Stark and John Bartlett.

Yours sincerely

Rachel Lomax

RACHEL LOMAX

ECON. POL: Domestic Monetary Policy: Pt 15.

File DA
cc BG

10 DOWNING STREET

From the Private Secretary

10 December 1985

BANKING SUPERVISION WHITE PAPER

The Prime Minister is content with the Chancellor's foreword to the Banking Supervision White Paper, which you sent me with your letter of 9 December.

I am sending a copy of this letter to John Mogg (Department of Trade and Industry) and to John Bartlett (Bank of England).

(David Norgrove)

Mrs. Rachel Lomax,
HM Treasury.

DA

RR3.98

cc BG

cc BS

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

9 December 1985

David Norgrove Esq
10 Downing Street
LONDON
SW1

MT

Dear David,

BANKING SUPERVISION WHITE PAPER: CHANCELLOR'S FOREWORD

... I attach a draft of the Chancellor's foreword to the Banking Supervision White Paper, which, as the Prime Minister knows, we are hoping to publish on 17 December. The printing deadlines are now extremely tight, and to be sure of publishing on time, we need comments by tomorrow morning at the latest.

I am coying this to John Mogg (DTI) and John Bartlett (Bank of England).

Yours ever

Rachel

RACHEL LOMAX
Principal Private Secretary

Prime Minister!
A couple of very tiny suggestions in para 8.
Content?

DRN
9/12

(This is the Chancellor's own drafting.)

RR3.97

CHANCELLOR'S FOREWORD TO BANKING SUPERVISION WHITE PAPER

An effective system of banking supervision is as important as the banking system itself. For without it there will not be the confidence on which sound banking depends - from the confidence of the individual depositor that his money is safe to confidence in Britain as one of the foremost financial centres in the world.

2. The circumstances of the collapse of Johnson Matthey Bankers and its rescue by the Bank of England in October 1984 thus raised issues going far wider than the affairs of JMB itself. Accordingly, in December 1984 I set up a Committee under the Chairmanship of the Governor of the Bank of England to look into our system of banking supervision and make recommendations.

3. The Leigh-Pemberton Committee's Report, published in June 1985, made it clear that while the JMB debacle represented a wholly atypical lapse in a system of supervision that has had a good record over the years, and which compares well with the experience of financial centres overseas, there nevertheless remained serious weaknesses both in the implementation of banking supervision in the UK and in its statutory framework, the Banking Act of 1979. The rapidly-developing nature of banks and the banking system makes it all the more important to address these weaknesses speedily and effectively, without at the same time hobbling British banks with excessive regulation.

A typo.

4. I therefore announced on 20 June 1985 that a White Paper would be published later in the year, with a view to bringing forward new banking legislation as soon as practicable. In the six months which have followed, the Bank of England has held discussions with the banking industry and other interested parties on the basis of consultative papers. The Government have carefully considered both the Leigh-Pemberton Committee's recommendations and the outcome of consultations. This White Paper now sets out the Government's proposals for both legislative and non-legislative changes.

5. The latter are every bit as important as the former, for at the heart of effective supervision lies the organisation, ability and motivation of the supervisors. Substantial improvements have already been made by the Governor of the Bank of England and more are envisaged. A new Board of Banking Supervision will cement these changes into place. Under the proposals set out in this White Paper, the supervisors will become increasingly professional in their approach, forcefully directed from the top.

6. But at the same time the Bank of England, which the Government believe should continue to be the supervisory authority for British banks, cannot do its job without an adequate statutory framework. The Government has accordingly decided to strengthen this in a number of important ways, which are summarised in Chapter 1 of this White Paper and thereafter discussed at length. They cover in particular the provision of information, the role of bank auditors, and the problem of large ~~expenses~~ exposures.

A typo

7. I am conscious, however, that banking supervision can no longer be considered in isolation. As the Leigh-Pemberton Committee pointed out, the growth of financial conglomerates poses particular problems for regulators. The Government are urgently considering these problems in the context of their interlocking legislative proposals for banking supervision, building societies and financial services. It is essential that, taken together, the new arrangements provide effective supervision, capable of dealing with the whole of the rapidly changing financial services sector.

8. Finally, there remains the ever-present problem of finanical fraud. The Government is determined to do all in its power to eradicate [this cancer] fraud, and has already taken action to that end. But the most important deterrent obstacle to serious financial fraud is effective supervision. The banking supervisors require that banks are managed by fit and proper persons, and that they conduct their business prudently. The proposals in the White Paper strengthen the supervisors' powers to achieve this, and thus greatly reduce the scope for banks to be managed incompetently or dishonestly - and there is always a risk that the one will lead to the other. They will ensure that better internal controls further reduce

overblown

opportunities for fraud. The proposed dialogue between supervisors and auditors will provide an additional important defence. London's pre-eminence as a world banking centre is based on freedom and probity. We are determined to preserve both.

9. Together with the measures contained in this session's new legislation on building societies and financial services, I believe the proposals in this White Paper will provide a sound basis for the supervision of rapidly developing financial markets. It is of the first importance that they should succeed.

09. XII

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From: THE PRIVATE SECRETARY

EBG

NORTHERN IRELAND OFFICE
WHITEHALL
LONDON SW1A 2AZ

Mrs R Lomax
Principal Private Secretary
Treasury Chambers
Parliament Street
SW1P 3AG

NBPM.

9th December 1985

Dear Rachel,

WHITE PAPER ON BANKING SUPERVISION

Thank you for your letter of 2 December seeking comments on the draft White Paper. I am sorry not have been able to reply sooner although officials have been in touch with yours to alert them to a small number of points which we believe are important.

Mr King has now had an opportunity to see the draft White Paper which he generally welcomes. However he thinks the current drafting describing the circumstances in which the Bank might disclose information to other Secretaries of State is unduly cautious and restrictive. Our motivation for seeking a power to enable the banks, with the permission of the Treasury, to disclose information to the Secretary of State stems from a very-strongly held view that the supervisory process will continue to be inadequate unless bank supervisors regularly seek, obtain and act on local knowledge. There is little point in allowing disclosure when to use the White Paper example, an institution is in "imminent danger of collapse". That is far too late, and in our view runs against the interest both of the wider banking community and the local investor. We would therefore ask that paragraph 12.5 be amended ... along the lines of the attached draft.

The current drafting of section 16 to 19 of the Banking Act concerning disclosure raise similar issues. In our view section 19(a) is too restrictive and we would wish to see it amended specifically to permit disclosure where a serious criminal offence has been committed or was suspected rather than at the later stage of criminal proceedings. Perhaps the sense of this as a possibility could be reflected in paragraph 12.8 of the White Paper, or perhaps our officials could discuss this further, during the drafting of instructions.

A copy of this letter goes to the Private Secretaries to Members of EA Committee, Murdo Maclean, (Chief Whip), Michael Stark (Cabinet Office), and John Bartlett (PS/Governor).

Yours Sincerely,
Neil Ward.

N D WARD

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12.5 Second, the Review Committee recommended in its Report that the Act's existing restrictions should be relaxed to enable the Bank of England, with the consent of the Treasury, to disclose information to other Government Deparments (except the Revenue Departments) where it considers it to be in the interests of depositors or in the public interest. This recommendation takes account of the authorities' experience on a number of occasions since the Act came into force. While the Government recognise the concern raised by this recommendation, it is necessary that the law should allow for disclosure in those exceptional circumstances when the interests of depositors or the public interest requires a Government Department other than the Treasury to be informed of the facts of a case. The kind of circumstances in which this might be used is if for instance, an institution with a local deposit base in Scotland, Wales or Northern Ireland, or a British Bank with branches abroad, was in danger of collapse or where local knowledge and expertise might assist the Bank of England in their dialogue with an institution and/or its auditors. In the first case it might well be in the public interest for the relevant Secretary of State to be informed; and in the second case, if the Foreign & Commonwealth Office could be told, action might be possible to protect the employees and premises of the bank's offices overseas, if there was a risk of reprisals against those offices. The Government therefore propose to implement the Review Committee's recommendation. There will be no question, however, of the routine disclosure by the supervisors to any Government department.

revised & new text.

* *

ECON. POL: Domestic Monetary Policy: Pt 15.

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cc BG
archive.

December 6th 1985

Mr. Norgrove

Since I shall not be visiting London until mid January, I thought it might be useful to set out some thoughts on the present fiscal and monetary conditions.

Fiscal conditions are still perceived by the market to be still suspiciously loose - at least in terms of their expectations. Towards the end of last year the market rightly spotted the doubling of the rate of growth of public spending in real terms in 1984-85 (excluding special sales of assets), and although the Autumn Statement shows a slight decline in the level for 1985-86 and holding thereafter, we have had enough experience with over-runs, especially by the local authorities and demand driven programmes, to take such forecasts with a grain of salt. The political pressure for, and economic sense of, substantial tax cuts suggest that the public sector's financial deficit is unlikely to be further reduced even as a fraction of GDP.

Note: there is a very good case for judging our fiscal stance in terms of the financial deficit rather than the PSBR. The financial deficit does not count special disposals of assets as though it were a revenue receipt or expenditure reduction. It regards the disposal correctly as a transfer only.

Monetary conditions are clearly rather tight relative to the experience of the past four years or so, and relatively to what the market expects in the future. The evidence is, first the slow rate of growth - indeed

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over the past months the virtual stagnation - of Mo. Secondly there is a sharp downward slope in the yield curve. Short interest rates are about 11.5 per cent, whereas the yield on long term gilts is less than 10 per cent. This is the opposite of normal' conditions where the short term interest rate is usually about 1 or 2 per centage points less than the long rate. (In the United States shorts are about 7.5 whereas longs are 10.). This implies that people expect short interest rates on sterling financial assets to fall in the near future to levels well below the existing long rates, and a 'normal' sustainable pattern of long rates paying a reward of 1 or 2 per cent above short rates for the illiquidity of being in long assets. Thirdly, and much more dubious evidence, the exchange rate has remained relatively strong and still above all the purchasing power parity calculations of the pundits.

A Regan-Volker Policy ?

The combination of a tight monetary and loosish fiscal policy combined with substantial tax cuts looks superficially like the United States policy since the 1981 measures. But, apart from the sheer magnitudes involved, appearances are deceptive. The greater-than-normal upward slope of the US yield curve suggests that people expect that interest rates will remain high or increase (and the opposite is true in Britain). Such expectations are a consequence of views about the continuation of the deficit and about the likely monetary reaction to an outbreak of further inflation. Indeed we have no need to hit inflation hard with an associated appreciation of the currency by manipulating a tight monetary policy. Our inflation is already circa 5 per cent.

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Stable Prices Ahead ?

If monetary growth (Mo) is held at its present level (i.e. virtually zero) for a period of two or three years, then it is likely that inflation will fall to about zero before the end of the 1980s and perhaps even by 1988.. At last we shall have price stability ! You may think, however, that it is best to approach such a nirvana rather more gradually and ease monetary policy in 1986 as suggested in our target for Mo. I would lean towards the latter policy and combine it with whatever can be done to tighten controls on public spending so that we avoid embarassments similar to those of December 84 to January 85. But I know that is easier said than done.

Alan Walters

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cc B/G

10 DOWNING STREET

From the Private Secretary

6 December 1985

Dear Rachel,

WHITE PAPER ON BANKING SUPERVISION

The Prime Minister has seen your letter to me of 2 December and the draft White Paper on Banking Supervision.

She had two comments to offer for your consideration.

First, it will be important for businesses with low capitalisation also to have adequate allocation of responsibilities, prudent management and strong internal controls. Small businesses will of course be subject to the same supervision and scrutiny as larger businesses, but it is for consideration whether, for example, in paragraph 7.14, the White Paper should reflect the need for attention to proper controls in small as well as large businesses.

Secondly, the definition of "an individual customer" will need very careful consideration (paragraph 10.4).

On a more general point, the Prime Minister has asked whether the Treasury and other relevant departments are confident that the arrangements now being put in place for supervision of banks, other financial institutions, brokers, conglomerates, etc., are comprehensive - that there are no gaps through which particular kinds of activity or business can fall. She also wishes to have confirmation that for every kind of institution it will be possible to point to an individual or a body which will have - and will feel - a firm responsibility for monitoring and regulating it. Who for example under the new system would have been responsible for spotting and doing something about the problems in the tin market before they reached the present position?

I am copying this letter to the Private Secretaries to Members of E(A), Murdo McLean (Chief Whip's Office), Michael Stark (Cabinet Office), and John Bartlett (PS/Governor).

Yours ever,

David.

DAVID NORGROVE

JA

Mrs Rachel Lomax
H M Treasury

CONFIDENTIAL

CCBG

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
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TELEPHONE DIRECT LINE 01-215 5422
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JU823
Secretary of State for Trade and Industry

6 December 1985

CONFIDENTIAL

Mrs R Lomax
Principal Private Secretary to the
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1P 3AG

NBPM.

Dear Rachel,

My Secretary of State has now seen the text of the White Paper circulated with your letter to David Norgrove of 2 December. His main concern is that the proposals in the White Paper and the arrangements he has in mind for the financial services sector are consistent. This is most important not least because the supervisory systems will overlap. He is broadly content with the text but has one or two particular concerns.

First on Chapter 8 dealing with auditors and supervisors, he would prefer a wider formulation to deal with the problem of confidentiality restraints. He suggests deleting paragraph 8.2(iv) and replacing it:-

> "The necessary provisions will be made to facilitate dialogue between auditors and supervisors"

This formula reflects our view that the confidentiality problem goes somewhat wider than the original text would allow. The Secretary of State has also asked me to point out that paragraph 8(2)(v) is inconsistent with the statement at paragraph 15(12) of the White Paper on Financial Services in the United Kingdom published in January. Officials are in touch and seeking to resolve this difficulty.

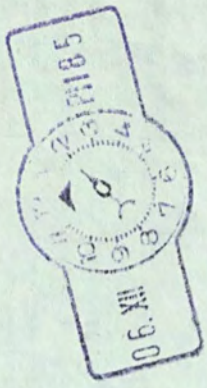
On Annex I paragraph 5, (Consumer Credit Act), we are in the process of seeking the views of the Director-General of Fair Trading, but we do not anticipate any points of difficulty as to the principle of what we are trying to do.

I am copying this letter to recipients of yours.

Yours ever,
Michael

MICHAEL GILBERTSON
Private Secretary

ECON POL : Domestic Monetary Policy



PRIME MINISTER

DRAFT WHITE PAPER ON BANKING SUPERVISION

You have already commented that the draft White Paper starts in too complacent a way and I have told the Treasury this. They are looking at the opening paragraphs and say that the Chancellor's foreword will also help to create the right initial impression. The foreword will come to you for urgent approval on Monday.

In the document itself, I suggest you need read only paragraphs 8.2 - 8.7. These discuss the relationship between auditors, supervisors and clients. This was the main area, aside from the Banking Commission, which was left to be sorted out after your meeting.

A note giving Policy Unit comments is below.

I suggest the following comments to the Treasury:

i) Refer again to the need to make the opening of the White Paper less complacent-sounding;

ii) Businesses with low capitalisation will also be expected to have adequate sub-division of duties and internal controls (paragraph 7.14);

iii) The definition of "an individual customer" will need very careful consideration (paragraph 10.4).

It would also be worth asking the Treasury to confirm that they are confident that the institutional arrangements now being put in place for supervision of banks, financial institutions etc. are comprehensive - that there are no gaps through which particular kinds of activity or business can fall; and secondly that for every kind of institution it will be possible to point to an individual or a body which will have, and will feel, a firm responsibility for monitoring and

regulating it. (Who for example under the new system would have been responsible for spotting and doing something about the problems in the tin market before they reached the present awful position?).

David Norgrove
5 December 1985

BEMBFS

4 December 1985

MR NORGROVE

DRAFT WHITE PAPER ON BANKING SUPERVISION

We feel that the document suffers from a degree of blandness, and that the drafting needs to be tightened in a number of places.

We suggest that there should be a reference in the opening paragraphs to the need for the banking supervisory system to be effective in the light of the expected changes in the City ("Big Bang" and Financial Services Bill) and indicating that the proposed improvements have been planned with this end in view.

A memorandum of detailed comments is attached. Particular attention is directed to paragraphs 1.5(vii), 7.14, 10.4 and 12.7.

David Hobson

DAVID HOBSON

3 December 1985

BRIAN GRIFFITHS

c David Willetts

DRAFT WHITE PAPER ON BANKING SUPERVISION

This is much better than the earlier material which was circulated.

Auditors

The argument here is likely to centre on the need for bilateral exchanges between supervisors and the auditor, as opposed to trilateral exchanges when the bank client is in the picture and may also be present. The profession is likely to doubt whether a requirement for bilateral exchanges is necessary, having regard to the possibility - referred to in Annex 4c(ii) - of bringing in a third party, such as a non-executive director. No-one likes such requirements, as they tend to undermine the relationship between auditor and client, and open up opportunities for further limitations on professional confidentiality. Some would think this a slippery slope.

Ministers are said to want the provision, so perhaps it should be left in the White Paper so that we can see what happens. It has been rendered as innocuous as possible, if it is necessary to break the confidentiality principle.

Board of Banking Supervision

This follows the Policy Unit views, and is welcome.

Other Points

1.1/1.2: Rather feeble as an introduction. It leaves the implication that more deficiencies will become apparent; it is not clear where.

1.5 (i)&(ii): The new Board has a sensible rôle, laid down in Chapter 5. The supervision division was poorly staffed and badly managed, and can no doubt do with a shake-up.

1.5 (vii): I doubt whether "the absence of routine inspection" matters. Bank of England supervisory clerks inspecting banks' books as a matter of routine are not needed. The point to be made should be that there is a need for communication between supervisors and auditors which appears to be precluded under current legislation. This communication is likely to improve the quality of both supervision and audit.

1.5 (viii): The new criminal offence seems to follow Section 393 of the Companies Act 1985, which deals with "knowingly or recklessly misleading an auditor". It was originally introduced in the Companies Act 1976.

6.2: This certainly suggests that the right hand did not know what the left hand was doing, and that no-one could see the wood for the trees. Hopefully the new arrangements (6.3 to 6.5) will help to improve matters.

7.14: Do we need to wait until some more outfits go bust before increasing the minimum capital? Small financial institutions sound fine as being in line with Government policy of encouraging small business, but few with capital as low as £1 million will have sufficient staff to provide adequate sub-division of duties and internal control. Unless they can meet this requirement, they should be merged or closed down. This needs to be brought out in the document, as we don't want to have to experience further failures.

10.4: It is not clear what constitutes an "exposure to an individual customer". It seems that JMB may not have appreciated the inter-relationship between various exposures

to related parties. Careful definition of what constitutes "an individual customer" will be needed if it is intended to embrace related parties beyond a parent/subsidiary relationship.

12.7: The facilities for interchange of information between supervisory bodies are likely to be useful, but one question is left unanswered: where, in dealing with financial conglomerates, is the ultimate supervision to be exercised - the Bank, the SIB, an SRO, or elsewhere? Unless this is clear, buck-passing and indecisiveness may be the order of the day.

David Hobson

DAVID HOBSON

SP/011

COVERING CONFIDENTIAL

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

D Norgrove Esq
Private Secretary to
The Prime Minister
No 10 Downing Street
London
SW1

2 December 1985

Dear David

WHITE PAPER ON BANKING SUPERVISION

You will recall from my letter of 20 November that the Chancellor intends to publish a White Paper on banking supervision during the week beginning 16 December, and to make a Statement on the day of publication.

I enclose a copy of the text of the White Paper, subject to the addition of the Chancellor's Foreword and to some further relatively minor amendments. I should be grateful for any comments by close on Thursday 5 December, so that printing deadlines can be met.

I am sending copies of this letter and of the White Paper to the Private Secretaries to Members of EA Committee, Murdo Maclean, (Chief Whip), Michael Stark (Cabinet Office), and John Bartlett (PS/Governor).

Yours ever
Rachel.

MRS R LOMAX
Principal Private Secretary

ECON POL: Domestic Monetary Policy: Pt 14

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hlie. DSG.

bc Professor Griffiths

10 DOWNING STREET

From the Private Secretary

2 December 1985

WHITE PAPER ON BANKING SUPERVISION

The Prime Minister has seen your letter to me of 29 November, with the draft White Paper on Banking Supervision. She is content that this should now be circulated to 'E' Committee.

The Prime Minister did not have an opportunity to read the draft in detail, and she may wish later to offer further comments. But her immediate reaction to reading the summary was that the tone does not seem to match the perceived gravity of the situation. The first two paragraphs, for example, struck her as complacent.

On a more detailed point, she has asked whether the new criminal offence described under the indent "Supervisory Information and Statistics" has been discussed with the Attorney General and the Lord Chancellor.

I am sending a copy of this letter to John Bartlett (Governor of the Bank of England's Office).

David Norgrove

Mrs. Rachel Lomax,
H.M. Treasury.

JB

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PART 14 ends:-

DN to PM 29.11.85

PART 15 begins:-

DN to HMT 2.12.85

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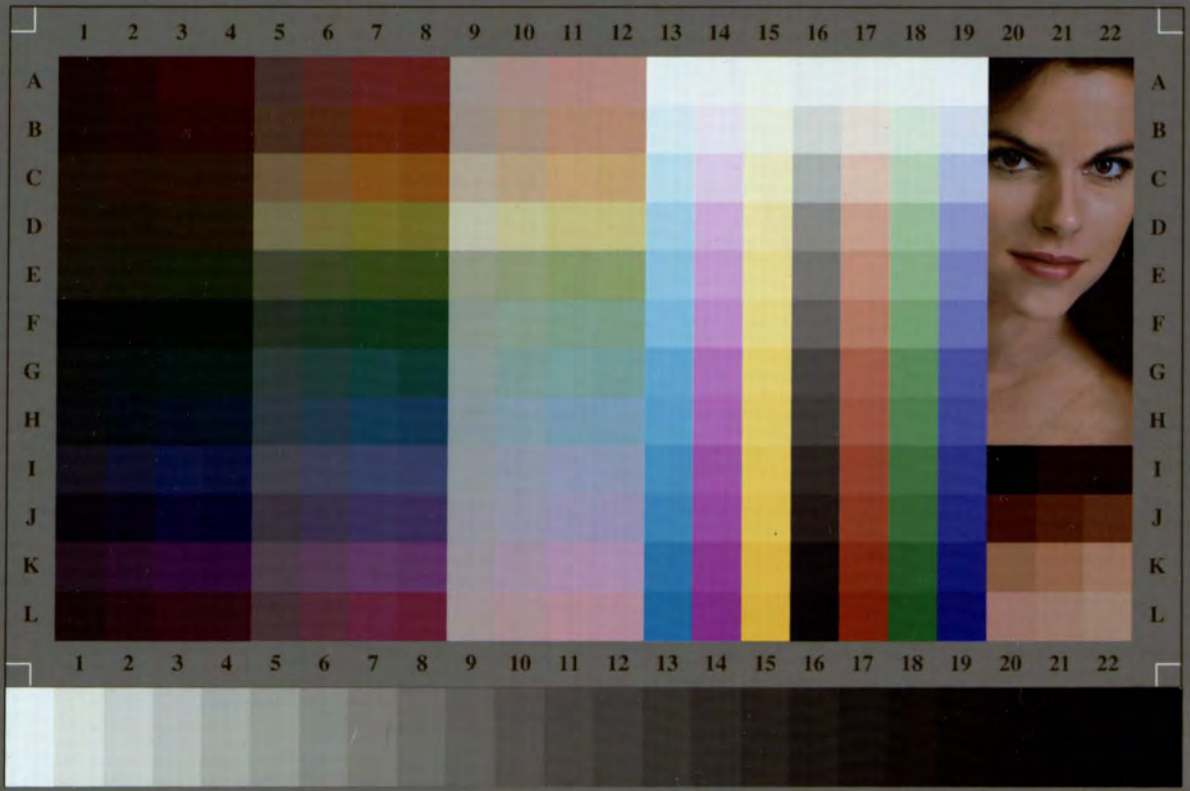

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