Part 28

SECRET.

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Economic Strategy

Pay and Prices Monthly Economic Report

Economic Project

Folder: Monthly Monetary Assessment March 1990 (a - ac)

ECONOMIC POLICY

Part 1: May 1979

Part 28: December 1987

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
20.1.88							
25.5.88							
6.6.88							
12.7.88							
18.7.88							
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10.2.89							
27.7.89							
24.1.90							
7.3.90							
21.3.90							
26.3.90							
18.4.90							
24.4.90							
15.6.90							
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Dd 8398386 2M 11/83 JET

PART 28 ends:-

HMT to BP 28.9.90

PART 29 begins:-

BP to Mrs Hogg 6.12.90

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BHP
2/10

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

28 September 1990

Barry Potter
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1

Dear Barry

UK INTERNATIONAL EXPENDITURE

You asked how UK international expenditures compared with those of other major countries.

... I attach a note which attempts to do this. I hope it is useful.

Tancred Tarkowski

T TARKOWSKI
Private Secretary

FROM: MRS S N FLINT - AEF1
DATE: 27 SEPTEMBER 1990
Ext: 4897

MR TARKOWSKI

cc: Mrs Brown - AEF1
Mr Rew - AEF1

UK INTERNATIONAL EXPENDITURE

You asked for figures on the UK's total expenditure internationally and also for comparative figures for France, West Germany, the US and Japan.

2. Shown below are total figures for UK expenditure overseas in 1989. Approximate figures for France and Germany's EC contributions and also net official development assistance for all 4 countries are given. Comparative figures for the other items do not appear to be available. IF division here, the FCO and CSO do not have access to any such figures and suggested that they would not be available within the UK. I must stress that the figures given below are from a variety of different sources, and there is no guarantee that the figures are directly comparable. The net EC contributions for other countries are estimates, based on 1988 figures. The most reliable, directly, comparable figures are those for official development assistance or oda.

3. UK EXPENDITURE

	1989 £m
Net contribution to EC	2300
[Of which aid:]	[138]
Other aid [1]	1364
Assistance to E Europe	3
International subscriptions[2]	379
Export Credit	604
Military[3]	54
Military grants[4]	25
Social Security benefits[5]	537
	5266

1. Excludes EC aid. Includes bilateral aid, multilateral assistance including contributions to international organisations such as the European Development Fund and agencies of the UN to provide assistance to developing countries, also subscriptions to the International Development Association and regional development banks.

2. Includes subscription to the European Investment Bank and subscriptions to cover the administrative expenses of various international organisations.

3. Contributions to the military budget and pension scheme of NATO and its agencies.

4. Cash grants for military purposes and the value of goods and services of a military nature provided without charge to overseas countries and international organisations by the UK government.

5. National insurance, retirement and war pensions paid to overseas residents, net of contributions received from overseas residents.

4. The UK figures for the net contribution to the EC and total aid are not directly comparable on an international basis. UK figures for EC contributions include total receipts to the private sector, figures for which are not available internationally. The OECD's Development Assistance Committee has agreed that the only internationally comparable standard for measuring aid is official development assistance (oda). Only some of the total UK aid programme is concessional enough to be classed as oda.

UK EXPENDITURE COMPARABLE INTERNATIONALLY	1989	£m
Net EC contribution	2100	
Net oda	1340	
oda as % of GNP	0.31%	

1989	£m

WEST GERMANY

Net EC contribution	3900
Net oda 2568	
oda as % of GNP	0.41%

FRANCE

Net EC contribution	900
(a) net oda (incl DOM)*	3871
(b) net oda (excl DOM)	2665
oda at (a) as % of GNP	0.78
oda at (b) as % of GNP	0.54

* Includes French territories abroad which are classed as being part of France.

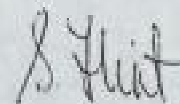
JAPAN

Net oda	4644
oda as % of GNP	0.32

UNITED STATES

Net oda	3970
oda as % of GNP	0.15

5. I am sorry that I am unable to provide a wider-ranging comparison but I hope these figures will be useful.



MRS S N FLINT

fst.sb/docs/ic2.29.6

B.F.
wants PU.
advice.
BHP 29/6

CC PU

Treasury Chambers, Parliament Street, SWIP 3AG

B H Potter Esq
PS/Prime Minister
10 Downing Street
LONDON
SW1A OAA

29 June 1990

Dear Barry,

THE BERMUDA PROTECTION AND INDEMNITY (P&I) ASSOCIATIONS

You wrote to Julie McClatchey at the Inland Revenue on 30 May about some tax concerns of the Bermuda P&I Association which have come to the Prime Minister's attention. The Financial Secretary has been in correspondence with the Associations (less formally, "Clubs") for some time now.

The Clubs' tax position has recently been under enquiry, and the Revenue's present view is that the Clubs should be charged here, as they have not been hitherto, on profits of business carried on through a UK agency. But the Financial Secretary understands that this is not a change of practice on the Revenue's part, but the result of a re-evaluation of the Clubs' position prompted by the emergence of new facts.

The background is that the Clubs, originally UK-based, have been Bermuda-resident for some time now, but have continued to carry on much of their day-to-day activity through representatives here. Following recent developments in insurance case law, the Clubs thought it appropriate to seek authorisation of the DTI to carry on insurance business here, and this in turn drew the Revenue's attention to their activity here and its possible tax implications.

The Clubs' advisers have put it to the Financial Secretary, as they have to the Prime Minister, that a UK tax charge would put jobs and revenues here at risk. The Financial Secretary understands, however, that the Clubs enjoy substantial commercial advantages from their representation here, as do a number of other Clubs which operate in a comparable way. He also gathers that the Revenue have indicated a willingness to settle on the basis of a charge which is quite modest in the context of the Clubs' affairs as a whole, and which has proved acceptable to the other Clubs.

fst.sb/docs/ic2.29.6

The Financial Secretary would not discount altogther the net risk of adverse economic effects. But he judges it to be outweighed by the substantial disadvantages of amending the Finance Bill as the Clubs themselves propose. He has seen the specific words the Clubs' advisers have in mind, and he finds them very obviously ad hoc, designed to exempt a particular small group of potential taxpayers without tackling any evident mischief. Quite apart from the immediate loss of yield, and the rise of manipulation that might be opened up, the Financial Secretary would foresee a very unwelcome encouragement for other concerns carrying on internationally-mobile activity here to press for a similar exemption.

He has, however, suggested to the Clubs a possible alternative change in the law which would not exempt them altogether, but would bring the UK tax charge more securely into line with the commercial reality of their business. General insurance business is taxed, as a rule, on the overall balance of profit from underwriting and from investing premiums and reserves. For the sort of business the Clubs do, the result is commonly an underwriting loss offsetting and investment profit, with only the net amount being chargeable. In the case of mutual concerns like the Clubs, however, case law requires that only the investment profits are charged, disregarding any underwriting loss. Although the Revenue have taken this aspect into account in framing a suitable basis for an agreed settlement, the Financial Secretary feels that the Clubs may see attraction in amendments on the face of the legislation to ensure that the charge takes account of both their underwriting and investment activity.

The Financial Secretary has not at this stage offered any commitment to amend the law to this effect, and has indicated that no action is to be expected in the remaining few weeks of the Finance Bill's passage. But he feels that his suggestion is a constructive one which may well seem to the Clubs an appropriate response to their concerns.

Yours sincerely,

S J FLANAGAN
Private Secretary

Econ Pol Strategy Pt 28

C.F.

MR POTTER for information

27 June 1990

THE BERMUDA PROTECTION AND INDEMNITY ASSOCIATIONS

You will know that the Treasury is not prepared to introduce a new clause to the Finance Bill which would deal with the specific situation of the Bermuda P&I "Clubs". I also understand that the Revenue is not prepared to withdraw the protective assessments for 1983/1984 so the Clubs will have to annotate their accounts for that period which will bring the issue out into the open.

However, those who advise the Clubs met the Financial Secretary recently and have an offer of further discussions which is to be confirmed in writing. They hope that this "letter of comfort" will specifically say that the aim of the discussions is the ultimate clarification of the position in next year's Finance Bill. The lack of such an assurance would very likely be seen as a clear signal that there had been a change of fiscal policy which would cause them to take their business away from London.

Howell Harris Hughes

HOWELL HARRIS HUGHES

P.F.
– cf enclosed HMT reply
to my letter.
BHP
15/6

MR POTTER

15 June 1990

THE BERMUDA PROTECTION AND INDEMNITY ASSOCIATIONS

You wrote to the Inland Revenue on 30 May about the problems raised by the assessment levied on the P&I Clubs and also asking whether the Treasury would give sympathetic consideration to a clause in the Finance Bill which would clarify the situation for the future.

I understand that new clauses for the Finance Bill come forward next Thursday but that the Financial Secretary has indicated that he does not wish to legislate on this point.

So there will continue to be a good deal of uncertainty about the tax status of the Clubs and I understand that the ship owning fraternity see this as a partial re-run of the Green Paper on Residence in the UK. They say that many of them left New York in rather similar circumstances in the 1960s and that a number of individual ship owning businesses - and not just the Clubs - might leave London now. As you will see from the attached note, they are likely to get a warm welcome from the new Greek government.

I know that there has been a good deal of lobbying on their behalf and the Prime Minister may not wish to pursue this point, but those concerned are conscious of the interest which she took in the Green Paper discussion on Residence two years ago.

Howell Harris Hughes

HOWELL HARRIS HUGHES

MEMORANDUM

12th June, 1990

Our Ref: DMC/CH/MT

U.K. Tax Position of Bermuda P & I Clubs

Intelligence gained last week at the 1990 Posidonia Maritime Exhibition in Piraeus.

A number of developments are now taking place in Greek political and maritime circles which are directly relevant to the taxation issue.

The elections in May brought to power in Greece a government formed by the conservative New Democracy party. If we ignore the various coalition governments of 1989, it is the first non-Socialist government in Greece since the Socialists came to power in 1981. Whereas the Socialists' relationships with the Greek maritime community were distant, New Democracy already has close connections with that community and is taking steps to establish effective working links with the shipowners. For sound domestic economic reasons the government's aim is to bring back under the Greek flag that predominant part of the Greek beneficially owned fleet which is presently registered offshore. To do this the government is, we understand, prepared to offer substantial incentives, the details of which were being discussed informally over last weekend between the Minister of Finance and certain prominent shipping figures. Furthermore, the Prime Minister, Mr. Mitsotakis, has retained for himself the portfolio of the Merchant Marine Ministry, so great is the importance that he attaches to it. This is an unprecedented step and its significance has been widely recognised in the maritime community.

These positive moves by the Greek government are already being compared unfavourably with the position here in the U.K. where the government is perceived by the foreign shipowners as, at best, uninterested in and, at worst, as hostile to them. The present uncertainties regarding the tax position of the U.K. P & I Clubs are widely known in Greece and a number of shipowners with a London presence are currently receiving strong advice from their English lawyers and accountants either to diminish the scale of their London operations or withdraw from the U.K. completely. The Inland Revenue's attempt to widen its tax net by advancing arguments of the type pressed against the Bermuda P & I Clubs is engendering in foreign maritime interests a lack of confidence in the U.K. at least as great as that triggered by the Inland Revenue consultative paper on domicile of July 1988.

D.L. Martin-Clark
Chairman,
Thomas Miller & Co.

C. Harris
Chairman,
Charles Taylor & Co.

file KK
ccpu

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

30 May 1990

Dear Julie,

THE BERMUDA PROTECTION AND INDEMNITY ASSOCIATIONS

The Prime Minister's attention has been drawn to the proposed tax treatment of those Protection and Indemnity Associations based in Bermuda. She understands that the Inland Revenue has issued a tax assessment on their investment income for 1983-84 and that previously such income had been regarded as not liable to tax.

The Prime Minister is concerned that, if her understanding is correct, this change in practice could jeopardise jobs and revenues in the city in a number of areas which provide advisory and administrative services.

The Prime Minister wonders whether the Treasury should give sympathetic consideration to a clause in the Finance Bill which would clarify the position.

I am copying this letter to Tancred Tarkowski (HM Treasury).

Yours,

Barry

(BARRY H. POTTER)

Ms. Julie McClatchey,
Chairman's Office,
Board of Inland Revenue.

CONFIDENTIAL

Prime Minister
You need only read the P.U note itself. An esoteric issue — but there is no point in damaging the City through outrageous tax practice. Moreover there is a clear hint that the UK might change the practice, if courts find in favour of Revenue. Content to pursue 'X' with the Treasury?
BGP 25/5

(4)

MR POTTER 25 May 1990

THE BERMUDA PROTECTION AND INDEMNITY ASSOCIATIONS

The Prime Minister may be interested in a tax issue with potentially important implications for London as a shipping and finance centre.

Protection and Indemnity Associations ('P&I Clubs') are the means by which ship owners insure themselves against third party liabilities to which they are exposed as ship operators. They work on a mutual, non-profit making basis. Three are in Scandinavia, one in Japan, one in the USA, six in the UK, two in Luxembourg and three in Bermuda. The three Bermuda Clubs left London in 1970 because of the problems of exchange control. This was done with Treasury and Bank of England agreement and the Bermuda managers made contracts with the previous London managers for the continuing provision of professional services. The UK P&I Clubs pay corporation tax on their investment income (but not on any surplus in one year) but the Bermuda Clubs have not received any assessment for that until this year. It was assumed that they were not liable to do so because the management function was carried on in Bermuda not in London.

The Inland Revenue has this year issued an assessment on the investment income of the year 1983/4 arguing that the Clubs are liable because their London managers' representatives are in practice branches or agencies of the Clubs themselves, through which they trade. The Clubs rebut this assertion and it will be tested in the courts but, whatever the outcome, there is concern that the Clubs' directors and managers will react to the attempted reversal of their 20 year freedom from involvment in a UK tax system by going elsewhere. That threatens 500 jobs and revenues in excess of £30m per annum; but the real issue is the uncertainty which the situation creates for all those businesses which provide advisory and administrative services for overseas customers. The financial services industry in particular is concerned that the tests of trading through a branch or agency in the UK are far less clear than those that are applicable to the traditional 'mind and management' test and that they will be a disincentive to buy London services.

In a letter to Mr Heseltine of 6 February the Chancellor said that "if it turns out that the clubs do have to pay tax here as their business is currently conducted, then I will of course be prepared to consider the case for a change in the law in their favour. But it would be premature to do so while the current legal position and the precise consequences in terms of tax due remain unsettled". That legal process could take several years with damaging business consequences. The interested parties have therefore submitted for the consideration of the financial secretary a clause for inclusion in this year's Finance Bill. It is set out in Annex A.

When, in 1988, the Inland Revenue issued a Green Paper on 'Residence in the UK' it caused considerable concern because of its likely effect on the position of non-domiciled UK residents in particular. Greek ship owners, amongst others, were thought likely to leave the United Kingdom if the proposals were enacted and I believe that the Prime Minister was seriously concerned about the damage which the UK economy would suffer in consequence. This is a rather similar issue and she may feel that the Treasury should be asked to give sympathetic consideration to the idea of a clause in the Finance Bill which would define the future position of the Clubs in particular and, by inference, all those who provide advisory services to foreign companies from London.

Annex B is a fuller note on the legal issues.

Howell Harris Hughes

HOWELL HARRIS HUGHES

Yes - PF

proposal if won in the Courts would damage U.K business seriously. We should need to ensure it in this years Finance Bill or in any event - put a clause in this F.B. to clarify the position of

ANNEX A

"Where a person or body of persons not resident in the United Kingdom carries on a business of mutual insurance which is general business within the meaning of the Insurance Companies Act 1982 the provisions of the Tax Acts shall apply to profits or gains derived from assets in respect of which a profit on their sale would form part of the profits of that business as if such profits or gains were derived from a trade carried on by the person or body of persons as a trade separate from its business of mutual insurance."

ANNEX B

The Bermuda P&I Clubs and the Inland Revenue - Fact Sheet.

Issue

Are the shipowners' mutual protection and indemnity associations which are resident in Bermuda subject to UK taxation on their world-wide investment income on the basis that, by virtue of the fact that certain day-to-day aspects of their operation are sub-contracted to insurance professionals in London, they are trading in the UK through a branch or agency?

Protection and Indemnity Associations

Protection and Indemnity Associations - commonly known as P&I clubs" - are the means by which the world's Associations shipowners insure themselves in respect of the third party liabilities to which they are exposed as ship-operators, including claims for pollution, collision, dock damage, wreck removal, cargo loss and damage, custom fines and death of or injury to crew, passengers, stevedores and other persons. There are 16 or so such Associations in the world, covering collectively over 90% of world deep-sea shipping. This note is concerned only with the three associations that are resident in Bermuda.

History of the Bermuda based Associations

The three Bermuda-based Associations are the following:-

The Standard Steamship Owners Protection & Indemnity Association (Bermuda) Limited.
The Steamship Mutual Underwriting Association (Bermuda) Limited.
The United Kingdom Mutual Steam Ship Assurance Association (Bermuda) Limited.

They were established in Bermuda in 1970, 1974 and 1969 respectively. They were largely composed of shipowners who had previously been entered in UK resident associations. These UK resident associations suffered from the major commercial disadvantage that they were subject to exchange control. That meant that most of the premiums received by them had to be held in sterling and were therefore subject to any decline in the international value of that currency. As, even in those days, more than 80% of the shipowners concerned were nationals of countries other than the UK and the majority of claims were incurred in non-sterling currencies, this constraint was regarded as insupportable. Hence, with the consent of the Treasury and the Bank of England, the shipowners in effect transferred the business to Bermuda, where new associations were established as exempt companies, subject neither to exchange control nor to any but nominal local taxes.

Structure	Each of the Bermuda Associations engaged an independent firm of managers in Bermuda to provide the necessary administration. The managers in turn contracted with the previous managers of the UK resident associations or, in the case of the Steamship Mutual Association, with the UK-based association itself, for the provision of support services.
Mode of operation - financial	A Protection and Indemnity association is composed of members who are all shipowners or ship operators. All the members are insured by the association. In this respect an association resembles a co-operative. Since, generally, it does business only with its members, it operates on a non-profit making basis. For each underwriting year it tries to achieve a result whereby premiums plus investment income equal claims plus expenses. An exact balance is impossible to achieve; if in one year there is a surplus, it is either returned pro rata to the members insured for that year or taken to reserves lest there be a deficit in a following year. If a deficit arises in a given year, that is met either by a transfer from reserves (if there are any) or by an additional levy pro rata on the members for that year.
Mode of operation - structural	The policy of the association is determined by its Board of Directors who are elected from and by the shipowner members. This Board will meet at least quarterly in various shipping and commercial centres around the world, including Bermuda, but not in the UK. Although, as stated above, the Board makes all decisions of policy, the day-to-day work of running the association is delegated to the managers in Bermuda. They exercise, - subject always to the policies laid down by the Board and to its supervision and control - the Directors' powers, for example, to accept entries into the Association, to reimburse members for payments made by them in settlement of claims against them insured by the association and to invest the funds of the association pending their disbursement. The managers themselves engage specialist professional firms in London and in certain cases elsewhere to perform much of the preparatory work involved in agreeing terms and conditions for the entry of ships in the association and also the handling of claims brought against the members, often in conjunction with the other correspondents of the association, surveyors, lawyers and other consultants. The London firms have no power to accept entries into the association nor to pay claims and expenses on behalf of the association, the decisions in this respect being taken always by the

Bermuda managers. They have no involvement whatever with the investment of the association's funds. Management of the Association's investments takes place wholly outside the UK. The three London firms employ about 500 people between them.

Market share

The three Bermuda associations together represent about 45% of the world's Protection and Indemnity market. The ships insured with them come from over 80 different countries and have a gross register tonnage of about 180,000,000. Last year the cost of claims shared by the members of these associations amounted to about US$400,000,000. Last year the Bermuda managers paid the London firms approximately US$30,000,000 for the services they provided and that figure will rise substantially this year.

The Revenue's review of 'the P and I sector'

The Inland Revenue are currently embarked on a review of what it calls 'the Protection and Indemnity association sector'. In its earlier stages this review covered certain associations resident in Luxembourg which have their management subsidiary companies located in the UK. In its subsequent review of the Bermuda associations, the Revenue have regarded their position as analogous to that of the Luxemburg associations. In adopting this approach the Revenue are choosing to ignore the crucial difference in structure between the two sets of associations; whilst the management companies of the Luxemburg clubs are based in the UK, the management of the Bermuda associations is based in Bermuda and draws on the UK only for certain defined services as already described.

Revenue awareness of the position

The operational structure of the Bermuda associations has been discussed with the Revenue on more than one occasion over the past twenty years, the last such occasion being in 1981/83 in relation to the Revenue paper on Taxation of International Business. No objection was taken to the arrangements on any such occasion and no assessments had ever been issued against the associations or their managers until the 20th February this year, on which date the Revenue issued assessments for the 1983/84 year in order to prevent any claims for tax in respect of that year becoming time-barred.

Licences under the Insurance Companies Act

The Revenue have ascribed their recent interest in the Bermuda associations in part to the fact that during 1988 the associations obtained from the Department of Trade and Industry a licence under the Insurance Companies Act 1982. This move was in no way related to any change in the associations' methods of operation. It was simply a precaution taken in the light of the judicial interpretation of the Insurance Companies Act in cases decided in the early 1980s which interpreted the statute in a way not previously anticipated by the insurance industry or, indeed, the DTI. There was considerable discussion with the DTI on the question whether or not the associations should seek a licence under the Act; eventually, the associations accepted the advice of the DTI to seek a licence, but reserved their position as regards the legal necessity of so doing.

The position in law

It is accepted law in the UK that mutual associations are not taxable on their underwriting surpluses. In the case of UK resident associations, they will however be taxable as UK residents on their investment income. In the case of associations not resident in the UK such as the Bermuda associations, the law is much less certain; there are no statutory provisions or legal precedents that cover the point precisely. Eminent tax counsel jointly advising the Bermuda associations have stated that, in their view, the Inland Revenue's claim for corporation tax against the P&I Clubs is extremely doubtful. They conclude that there are a number of formidable hurdles that the Inland Revenue would have to surmount and that it is unlikely that the Inland Revenue would surmount them all.

The consequences

If the Revenue proceed with their assessments against the Bermuda associations, the likelihood is that three consequences will flow:-

Legal contest

1. The associations will contest the assessments with all the strength at their command.

Loss of invisible exports

2. The associations will require their managers in Bermuda to cut the London connections and buy from elsewhere the services they presently buy from London. A direct consequence will be the loss of invisible export earnings generated by the three London firms, together with the tax revenues of some £6 million to which they currently give rise. Considerable redundancies in those firms will be inevitable. In this connection the largest of the London firms has already received notice to terminate its appointment.

Adverse reaction of the international shipping and trading community

3. Foreign enterprises will be counselled to curtail the services they presently buy from London or to cease to buy them altogether. Foreign enterprises needing services such as London can provide will strike the UK from their list of possible options. The reassurance that the international community drew from the government's recent decision to shelve the Revenue's consultative paper on "Residence in the United Kingdom" will be lost.

The financial consequences for the UK are likely to be very serious. A report entitled 'Impact on the UK Economy of the Inland Revenue's Move against the Bermuda Protection and Indemnity Associations' points out that the present approach of the Inland Revenue is widely perceived as representing a significant reduction in the range of activities that can be performed in the UK for foreign clients without exposing them to UK tax. In consequence, foreign enterprises will increasingly lose confidence in the UK as a supplier of services to the extent that in the longer term up to £1.4 billion p.a. of overseas earnings could be put at risk. Thus the Revenue's approach is clearly seen as detrimental to London's position as an international services centre, and of substantial benefit to competing venues abroad.

14th March, 1990

FILE MJ 11 (A-D)

SUBJECT CC MASTER

NOTE FOR THE RECORD

ECONOMIC SEMINAR: 17 APRIL

Opening the seminar, the Chancellor said there was little room for manoeuvre on monetary and fiscal policy. There had been a downturn in business activity: but the level of retail demand was still high. The RPI figure for April at 10 per cent or so reflected high mortgage interest payments and the introduction of the community charge. But the underlying rate of inflation was also rising, with food prices particularly buoyant.

The growth in the monetary aggregates was still too high though the increase in MO had now stopped accelerating. The exchange rate was too low and also vulnerable - for example to adverse RPI or trade figures. The normal policy response in such circumstances would be to raise interest rates: politically he recognised it would very difficult to do so.

Sir Terence Burns said that the most difficult problem was to interpret conflicting signals in the statistics. Tight monetary policy was achieving a slowdown in demand but it was proving to be a much longer haul than expected. The economy was surprisingly resilient and the underlying inflation rate was creeping up. Personal sector demand had proved particularly and unexpectedly stubborn.

The following points were made in discussion:

i) The Exchequer and equities market had responded surprisingly quickly to the announcement of a public expenditure overspend for 1989/90. The markets would move adversely if there were evidence of greater spending in prospect for 1990/91 or in the plans over the survey period. The exchange rate could fall sharply if there were indications that public spending was being increased.

B

ii) There had been a prolonged if lagged effect from the deregulation in financial markets. Despite high interest rates, the private sector was still willing to acquire more debt. Some switching from high cost to low cost borrowing through second mortgages was playing an important part in sustaining debt levels. Indeed some households first rescheduled their debt in this way to lower its cost, then increased their debt so as to bring payments back to their previous levels.

iii) It was now desirable to consider further stronger measures to limit the growth in credit, particularly to the personal sector. Possible mechanisms included inviting in commercial bankers and encouraging them to restrain lending; discouraging the advertising of credit and ensuring that the ban on promoting credit to minors was effective; and restricting the conditions and terms of second mortgages.

iv) It would also be useful to review various reforms of monetary policy, including the use of reserve asset ratios, special deposits, and a limited role for temporary over-funding. The treatment of write-off of commercial banks' debt for tax purposes should also be investigated.

v) National savings could also make a contribution. They formed a useful weapon in the armoury which it might be appropriate to use in certain circumstances.

vi) There could be attractions in linking any changes to the operation of monetary policy, particularly any which the Government had previously rejected, to the decision to join the ERM. The possible timing of a decision to join the ERM would need to be considered further. But the early autumn was a possible candidate.

C

vii) The treatment of the community charge in the RPI was making the headline RIP figures worse. It was important to reconsider how the RPI was constructed, perhaps to bring it into line with European practice, and whether the existing RPIAC should be replaced. This could be linked in public statements with the decision on the ERM and any changes to the conduct of monetary policy.

viii) More generally the economy's present difficulties reflected the long period of sustained growth. Latterly demand growth had exceeded the capacity of the economy to respond. Officials may have taken too optimistic an interpretation of the available economic data over the last two or three years.

ix) In present circumstances, it could be that any sustained fall in the exchange rate might not be reversed simply by changes in interest rates. Clear resolution on fiscal policy, particularly on public expenditure, might also have to be demonstrated.

x) Ideally, the Government should aim to hold the planning totals for public spending over the present survey period. For the forthcoming survey Departments should be required to put forward options for cuts in their programme, if they wished to put forward further bids. Re-examination of baselines was also desirable. The key areas were the community charge, health, education and defence. Progress on housing might have to be slowed down and HATs abandoned. Transport projects such as new rail links in London, could only be accommodated by phasing and cutting back elsewhere.

Summing up the discussion, the Prime Minister said that the Treasury should prepare a further report on the various ideas on restraining the growth of credit and reform of monetary policy.

A possible policy package which had emerged would involve the changes to the conduct of monetary policy, to the construction of the RPI and a decision to join the ERM being announced in the autumn. Further work should be undertaken on options, mechanisms, timing, etc., of any decision to join the ERM.

BHP

Barry H Potter

24 April 1990

c: economic (MJ)

SECRET Ale

DCA

10A

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

23 April 1990

Dear John,

ECONOMIC SEMINAR: FOLLOW-UP WORK

My letter of 17 April to you set out a number of ideas which the Prime Minister and Chancellor agreed should be examined as possible ways of discouraging the growth in demand for credit.

The Prime Minister considers that there is a further approach which could also usefully be explored.

Under this proposal, policy would operate through the links between clearing bank reserves and money and credit, and then to GDP. Monetary policy would be directed at the rate of growth of the Bank of England's balance-sheet. In essence, the Government would aim to constrain the growth in the Bank's reserve assets and, through that mechanism, clearing bank reserves and hence their balance sheets and capacity to increase the supply of credit.

The Bank's reserve assets would also be redefined and narrowed so as to exclude commercial bills. (This change would be designed to prevent clearing banks from expanding their balance sheets by encouraging firms to issue commercial bills, which could then qualify as reserve assets, rather than taking out loans.)

The ideas are described more fully (and no doubt more accurately) in an IEA publication 'Money, Credit and Inflation' by Gordon Pepper.

I would be grateful if you could arrange for this approach to be considered alongside the other ideas on which work has already been set in train.

Yours ever,

Barry

(B.H. POTTER)

John Gieve, Esq.,
HM Treasury.

SECRET

CONFIDENTIAL

JD

File

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

18 April 1990

Dear Tancred,

ECONOMIC SEMINAR AND NATIONAL SAVINGS

As noted in my letter of 17 April, National Savings was discussed under the general heading of measures to limit the growth in credit.

The Prime Minister said that the role of National Savings should not be ignored. They remain a useful weapon in the Government's armoury for encouraging savings and discouraging consumer spending. They could be useful in attracting savings away from building societies, thus reducing their asset base and, in principle, capacity for further lending.

Further issues of National Savings, as and when appropriate, should not be ruled out.

I am copying this letter to Carys Evans (Chief Secretary's Office, HM Treasury).

Yours ever,

Barry

BARRY H. POTTER

Tancred Tarkowski, Esq.,
HM Treasury.

CONFIDENTIAL

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

17 April 1990

Dear Tancred,

SEMINAR ON THE ECONOMY

Following today's seminar attended by the Prime Minister, Chancellor of the Exchequer, the Chief Secretary, Sir P. Middleton, Sir T. Burns and Mr. Scholar, I thought it would be helpful to set down the main proposals for further work which emerged.

I should be grateful if you could ensure that no copies of this letter are taken without your permission and that the letter is seen only by those with a strict need to know.

The proposals can be grouped under five headings:

(a) the public expenditure/fiscal position;

(b) growth of credit, especially consumer credit;

(c) construction of the RPI;

(d) the community charge;

(e) exchange rate mechanism.

On (a) the public expenditure/fiscal position, my letter of 5 April to Carys Evans recorded the Prime Minister's view that the Chief Secretary should write to Cabinet colleagues describing the severity of the public expenditure position for this year and the very difficult situation for the forthcoming Public Expenditure Survey.

At today's meeting, it was agreed that the Chancellor should lead at Thursday's Cabinet in describing the severe difficulties on public spending; the link to, and wider implications for, fiscal policy; and the inter-relationship with monetary and interest rate policy. The Chancellor would copy to the Prime Minister tomorrow evening the draft speaking note he would propose to use at Thursday's Cabinet.

On (b) credit, following a long discussion, it was agreed that the Treasury should examine ten possible measures which might contribute to the tightening of the availability of credit from banks and building societies particularly to the personal

sector. These are as follows:

- Summon heads of the retail banks and building societies and make clear to them the need for restraint on consumer lending. The mode (whether led by the Prime Minister plus the Chancellor, or the Chancellor plus the Governor), and the format, (dinner, seminar, etc.) are to be considered by the Treasury and options, and proposed approach, reported back to the Prime Minister.

- Restrictions on mortgage lending. This might be achieved by limiting the qualifying purposes for which second mortgages would be granted. It would probably be too draconian to stop such lending altogether; but the idea of requiring interest rates closer to normal overdraft rates, where such second mortgages were directed to consumer expenditure, should be investigated. Building societies could be asked to look again at the multiple of salary and the proportion of the security that they were lending.

- Restricting the marketing of credit. Could TV advertising of credit be stopped and junk mail drops be further restricted or discouraged? A possible role of the Advertising Standards Authority should be explored.

- Amending the favourable write-off of personal sector debt by banks for tax purposes. The present practice should be reviewed (though it was recognised that such write-offs were relatively unimportant in terms of determining banks' tax liability).

- Review again the write-offs of other debt, including sovereign debt dealt with under the Matrix. The review could extend to the wider tax position of the banks.

- The introduction of reserve asset ratios for banks

- Re-examination of a monetary base approach, (as an alternative approach to reserve asset ratios).

- Over-funding on a modest scale (by postponing the buying in of debt). This could be linked with vigorous efforts to convert conventional into index-linked gilts.

- Raising the minimum percentage of outstanding debt on credit cards to be met each month. At present this was 5 per cent. Could it be doubled or increased even more?

- Reinvigorating National Savings. (See my separate letter.)

On (c) the Retail Price Index, work should continue on whether community charge capping and transitional relief could be handled in a way that would reduce the expected rise in the April Index. Whatever the outcome of that work, officials should prepare an assessment of what the April Index would have been, if it had been constructed on the basis used until 1986, i.e., so that community charge and rent rebates would have been included. Officials should also investigate what a consumer price index derived on a base broadly comparable with German practice, would show for April. More generally, options for restructuring the RPIAC, and for bringing the RPI more into line with corresponding indices in Europe should be investigated. This could take the form of a Community initiative to produce a standard index or a UK initiative to revise its own index to bring its concepts more into line with European practice. One possibility would be to link any change in the construction of the RPI with the actual or proposed joining of the ERM.

On (d) the community charge surcharge, the Prime Minister was keen to proceed with investigation of her proposal for an extra community charge to be levied on all those with incomes above £50,000 per annum, possibly with a second extra community charge to be paid by those with incomes above £100,000 per annum. The practicalities of this, including the level of the charge; the year in which it would be paid; and the year's income to which it would relate should be investigated urgently. It would be helpful if a paper on this could be circulated in time for consideration at the wider Ministerial meeting on the community charge scheduled for 26 April.

Finally, on (e) the ERM, Sir Peter Middleton undertook to provide a paper on options, mechanisms, difficulties and possible dates of joining the ERM.

I am copying this letter to Carys Evans (Chief Secretary's Office).

Yours ever,

Barry

Barry H. Potter

Tancred Tarkowski, Esq.,
H.M. Treasury.

PRIME MINISTER

MEETING WITH THE CHANCELLOR ET AL ON THE ECONOMY

You are meeting the Chancellor for a bilateral at 1045 on Tuesday morning. At 1115 the Chancellor will be joined by the Chief Secretary, Sir Peter Middleton, Sir Terry Burns, and Michael Scholar for a seminar on the economy.

Bilateral Meeting

The agenda for the bilateral is as follows:

(i) A Ministerial matter;

(ii) The Community Charge;

(iii) ERM.

On item (i), I understand there is a Ministerial matter which you wish to discuss with the Chancellor.

On item (ii), the Comunity Charge, you may like to make the Chancellor aware in broad terms of the outcome of your discussion with Mr. Patten yesterday, and get his initial response to your proposal for a Community Charge surcharge.

It may be helpful to describe your discussion with Mr. Patten under the following headings:

(a) Fairness: the proposed Community Charge surcharge as a transitional extra charge for those who tend to have gained most from the shift from rates to the Community Charge; and the use of the extra revenue to provide for improvements in the transitional relief scheme for those on low to middle income who have lost.

(b) The cash limit/target approach for each authority: this would be combined with more extensive capping that will

cover all the big spenders on a multi-year basis, plus grant bonuses for those who meet or do better than their target.

(c) The need to consider extra AEF: despite the above measures, if Community Charges are to be at a politically tolerable level next year, extra AEF will be needed. The Chancellor needs to take this into account in formulating a strategy for this year's PES round.

You will wish to ascertain the Chancellor's response to your proposal on the surcharge. Does he consider it practicable? Could the necessary legislation be introduced in this year's Finance Bill? Has the Chancellor any improvements or modifications to the scheme to suggest?

On item (iii), ERM, the main issues for the bilateral will be the principle of joining before the next election; the options on timing; the appropriate exchange rate; and the broad strategy (revaluation, use of interest rates) after entry.

Seminar on the Economy

There are two main papers:

(iv) A note on the RPI and the Community Charge provided by Sir Peter Middleton (Flag A), and

(v) An annotated agenda for the main discussion on the economy (Flag C).

On the RPI, Sir Peter Middleton's conclusions can be summarised as follows.

- There are great obstacles to any short-term change in the construction of the RPI.

- There are three possible changes to the treatment of the Community Charge in the RPI-covering capping, transitional relief and rebates. Their maximum effect, taken together, might be to reduce the RPI by 0.4%. But it would go against

established principles which the Government itself has endorsed within the last few months. The changes would overturn the advice of the present RPIAC. And they would put at risk the position of Indexed Gilts.

- There is a case for taking both mortgage interest payments and the Community Charge out of the RPI. But this would need to be pursued over a longer period of time.

A note from Andrew Turnbull (Flag B) concludes that it would also be tactically wrong to go ahead with any of the short-term changes to the RPI discussed above.

On item (v), the economy, an annotated agenda is at Flag C. Also relevant is the latest monthly monetary assessement (Flag D), and a valedictory note from Paul Gray (Flag E).

In essence, the present position is as follows.

(a) There is evidence of industry, particularly manufacturing, slowing down.

(b) But the personal sector remains buoyant - indeed there are signs of minor increase in activity and confidence.

(c) The narrow monetary aggregate (MO) is above its target range; wider monetary measures (M4) continue to grow rapidly.

(d) Developments on inflation and the labour market are not encouraging.

The critical point on inflation is the pace of the slowdown. There is no reliable evidence of any turning point on inflation yet in prospect: despite the increased corporate sector deficit and heavy corporate borrowing, there are no indications of profit margins being squeezed or wage settlements reined back. Both must happen if underlying inflation is to come down.

The policy issues are set out from paragraph 10 onwards in the Treasury annotated agenda. The note identifies the possible

policy responses if the outcome is above or below the Treasury forecast.

The paper and extant evidence may be judged to suggest that there is more of an upside risk, i.e., that the economy is not slowing down quickly enough. Paragraph 14 identifies the possible monetary policy responses - higher interest rates, the imposition of credit controls and setting a reserve asset ratio requirement for the banks. (The City would no doubt add overfunding.) All of these options are regarded as flawed - either politically attractive or economically ineffective.

The final section of the paper presents the ERM as a better way forward.

BHP

BP

12 April 1990

jd c:bilateral

chex.kf/jg/35

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

12 April 1990

Barry Potter Esq
10 Downing Street
LONDON
SW1

Dear Barry

ECONOMIC SEMINAR ON 17 APRIL

... I attach an annotated agenda for the Prime Minister's seminar on Tuesday together with some charts which she may find useful as background.

Yours,
JG.

JOHN GIEVE

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C

AGENDA FOR PRIME MINISTER'S SEMINAR

BACKGROUND

Present Position

Recent indicators show some weakening of business sector demand:-

- the CBI industrial trends survey of manufacturers suggest a depressed order book, although the export order book looks much more encouraging;

- the same survey confirms that investment expectations are weak; manufacturing investment is expected to fall in 1990;

- commercial vehicle registrations in the three months to February are considerably lower than a year earlier. This has been a reasonably good coincident indicator of total business investment in the past;

- emerging evidence from the monthly CBI survey is that manufacturers are holding excessive stocks, perhaps because demand is weaker than expected.

2. Surprisingly the indicators of personal sector demand are rather more mixed:

- retail sales growth rose sharply in February, following higher December and January figures than we might have expected given other indicators. In the three months to February the growth of retail sales was a little stronger than it had been through most of 1989;

- and yet consumer confidence fell to a new record of low levels in March probably reflecting the increase in mortgage rates;

- car registrations were very sharply down in the three months to February compared to a year earlier (although in part this may reflect company sector expenditure);

- although the housing market remains very weak with turnover still low, house prices seem to have stopped falling;

- indeed there are some signs of a strengthening of prices in the South-East and some growth of mortgage commitments by building societies, despite the rise in mortgage rates.

3. The monetary indicators continue to show a worrying resilience

- MO growth remains above its target range and has been growing above 6 per cent in recent months. The recent mortgage rate rise should mitigate this but the recent growth of MO is not consistent with any significant slow down in the underlying rate of inflation;

- M4 growth continues at 16 to 19 per cent; and bank lending growth remains very buoyant at over 20 per cent;

- the exchange rate is now 8½ per cent lower than in March last year and 5 per cent below its average level through 1986 to 1988.

4. The general tendency for demand and output growth to be faster than expected continues. Non-oil output growth for 1989 as a whole is estimated at 3¼ per cent - still above the probable underlying growth rate. It slowed sharply through 1989 and by the end of the year may have been growing at around 2½ per cent. However initial estimates to GDP have tended to be revised up subsequently.

5. Recent inflation figures have been extremely disappointing. The month-by-month figures persistently turn out higher than

indicated in our monthly profile. The RPI less mortgage interest for instance has risen from 6.1 throughout November to February to 6.3 per cent in March. Part of the rise is due to unusually rapid food price inflation and is an EC wide phenomenon. But it's difficult to avoid the impression that general marketed retail price inflation has picked up a little. The same message is evident in the producer output price inflation figures which have also edged up in a worrying way in recent months.

6. Developments in the labour market are also disappointing. Recent pay settlements are running about 2 per cent higher than a year ago. The slow down in growth means that productivity growth will be particularly slow this year and the published figures in unit labour costs are likely to look alarming.

7. The visible trade balance has now clearly begun to improve. Export growth is very strong during 1989 and manufacturers regained much of the share of world trade which they lost as a result of domestic capacity pressures in 1988. Imports have been virtually flat over the past year as domestic demand growth has slowed.

8. The improvement in the current account has been less marked however because of a sharp deterioration in invisibles in the second half of 1989. In part this reflects temporary factors - unusually high contributions to the EC budget and high insurance payments - but they also reflect a continuation of adverse trends in the travel and transfers balance and high interest payments on overseas investment in the UK.

9. The main features of the budget forecast are familiar:

- slow growth in 1990;
- falling domestic demand in 1990 compensated in part by strong growth of net exports;
- a PSDR in 1990-91 of £7 billion, similar to that recorded in 1989-90;

- an immediate prospect of a sharp worsening of inflation mainly because of a number of special factors - the March mortgage rate rise and the very high levels of community charge set by local authorities - budget revalorisation measures and surprisingly high food price inflation.

- there is not much prospect for improvement in the underlying position in the months ahead; and on a slightly longer time horizon much depends on whether slack consumers demand growth squeezes retailers and producers margins. This is now necessary with unit labour cost rising sharply;

- inflation is expected to fall much faster by mid 1991 (to around 5 per cent) as the big community charge effect drops out along with the mortgage rate rise of March 1990.

Issues for Policy

10. If the economy performs as set out in the forecast will it be acceptable? Despite short run difficulties, by the second half of 1991:

- output growth will be picking up;

- inflation (actual and underlying) will be falling;

- there will be scope for lower interest rates, including mortgage rates.

11. But clearly there are risks both ways:

- business and consumer spending may turn down sharply;

- inflationary pressures may remain strong for longer.

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12. Is the risk of a sharper slow down more manageable?

- although unemployment would rise, possibly sharply for a time, underlying inflationary pressures would ease faster;

- the current account deficit would decline quickly;

- and there would be scope for bigger and earlier reductions of interest rates.

13. Is it a much bigger danger if the economy continues to be stronger than expected?

- underlying inflation could continue to creep up throughout the year and make it more difficult to achieve a satisfactory reduction by mid-1991;

- there would be less scope for lower interest rates and less help from the mortgage interest payments effect in the RPI.

- it could mean no improvement or even a deterioration in the growth of MO and missing the target for the second year in a row;

- it would be bad for the current account and probably the exchange rate;

14. If the economy remains strong we could be faced with a difficult choice:

- whether to increase interest rates; this could help to dampen demand but put up the inflation rate in the short term. And increased political unpopularity could cause the exchange rate to weaken rather than strengthen;

- whether to consider other measures; for example credit controls. But it is difficult to see much long term benefit without reintroducing foreign exchange controls;

- introducing non interest-bearing reserve asset ratios for the banks; we think this would be largely cosmetic and could drive some business offshore. It would work by raising interest rates for borrowers, but might act as a disincentive to the expansion of credit and affect the climate;

15. There is still a widespread perception that we are boxed in and willing to exercise too much discretion. This would change once we enter the ERM. In contemplating an early decision to join we need to consider whether:

- sterling is at an acceptable level;

- there is a case for joining with wide margins initially;

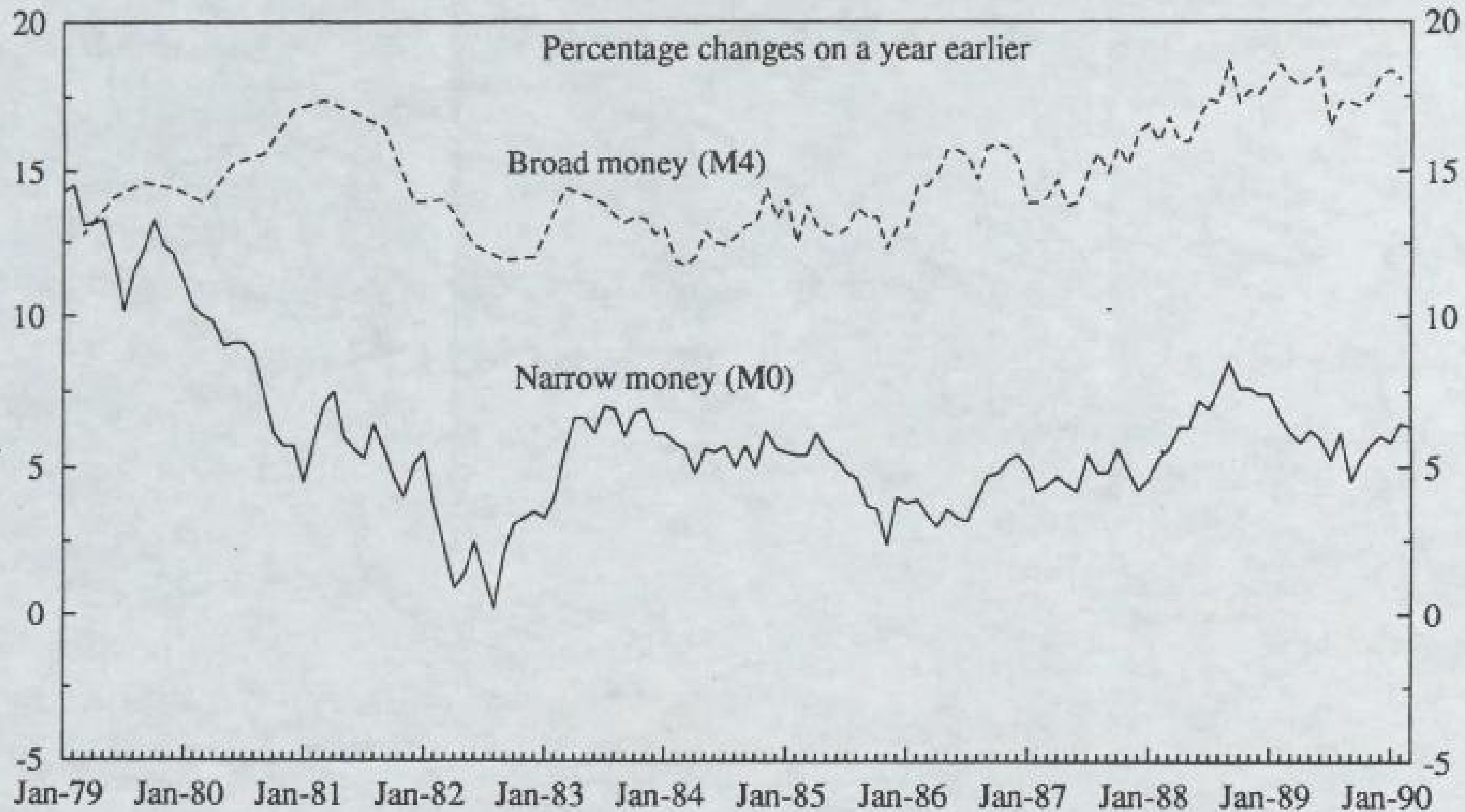
- joining the ERM immediately might help strengthen sterling for a given level of interest rates, and therefore tighten monetary conditions without raising interest rates;

- we would be prepared to realign upwards if there was persistent upward pressure on sterling;

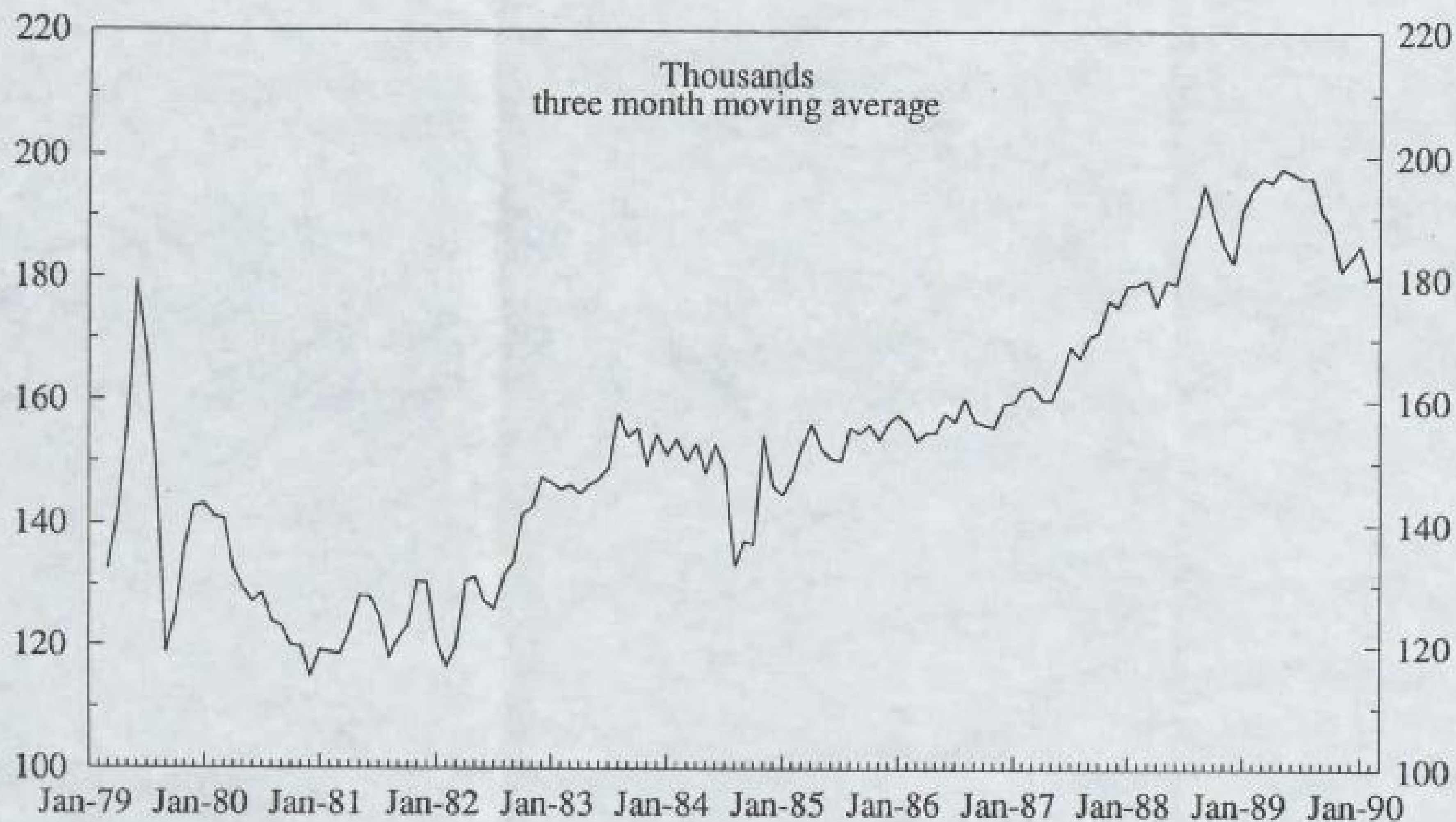
- we would be prepared to raise interest rates if we were subject to downward pressure on sterling.

10 April 1990

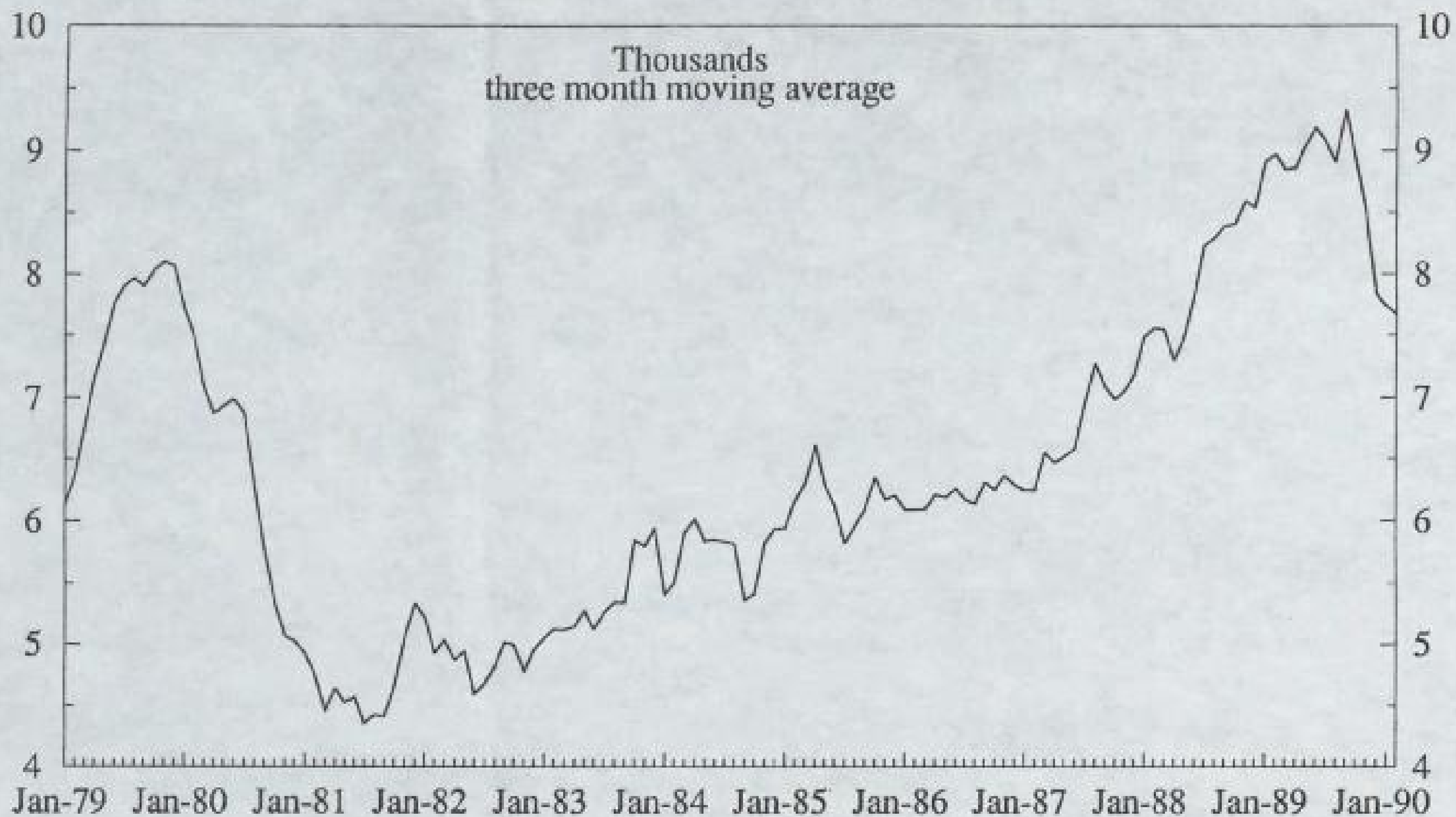
Growth rates of monetary aggregates



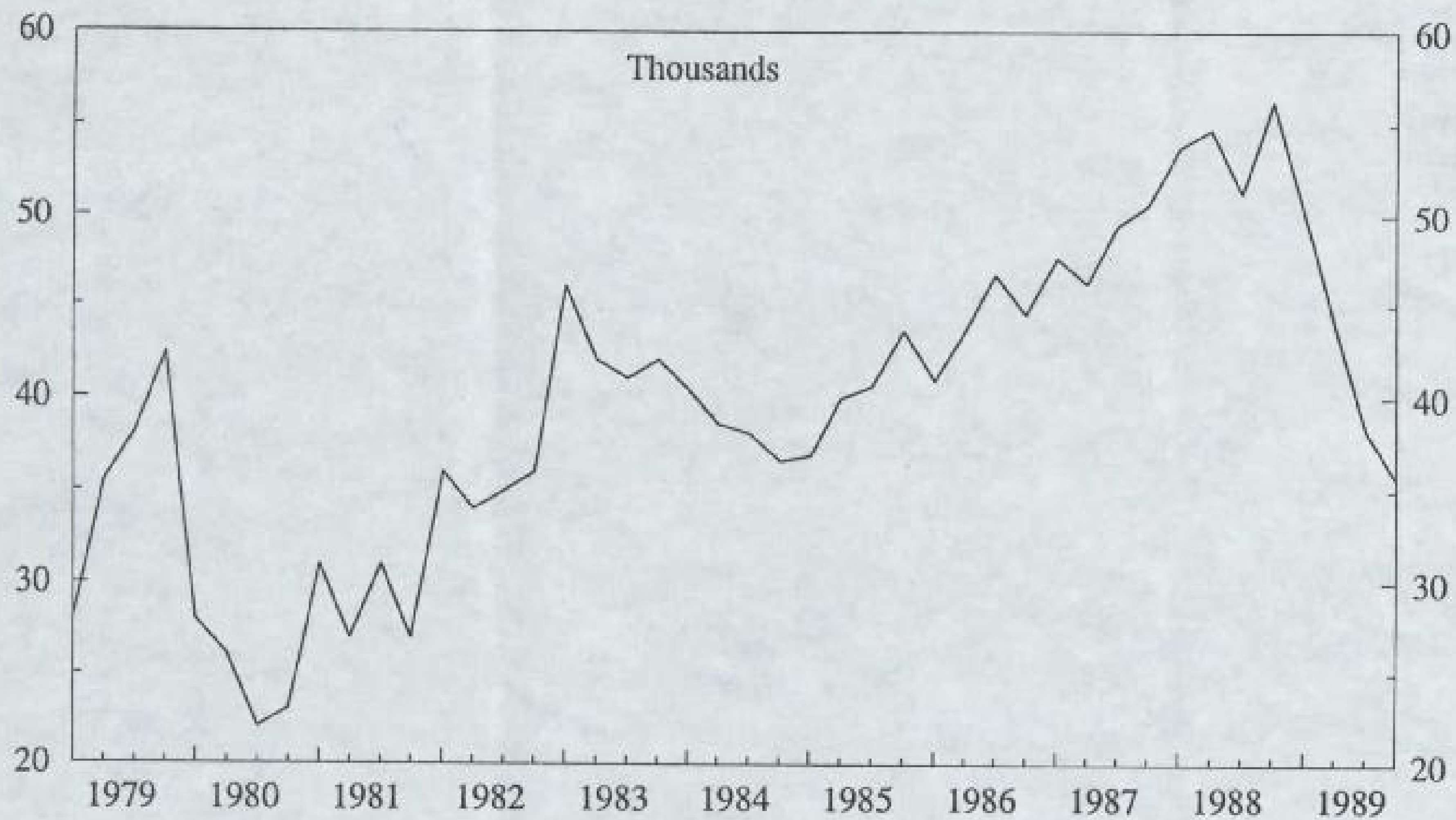
New car registrations



Goods vehicle registrations

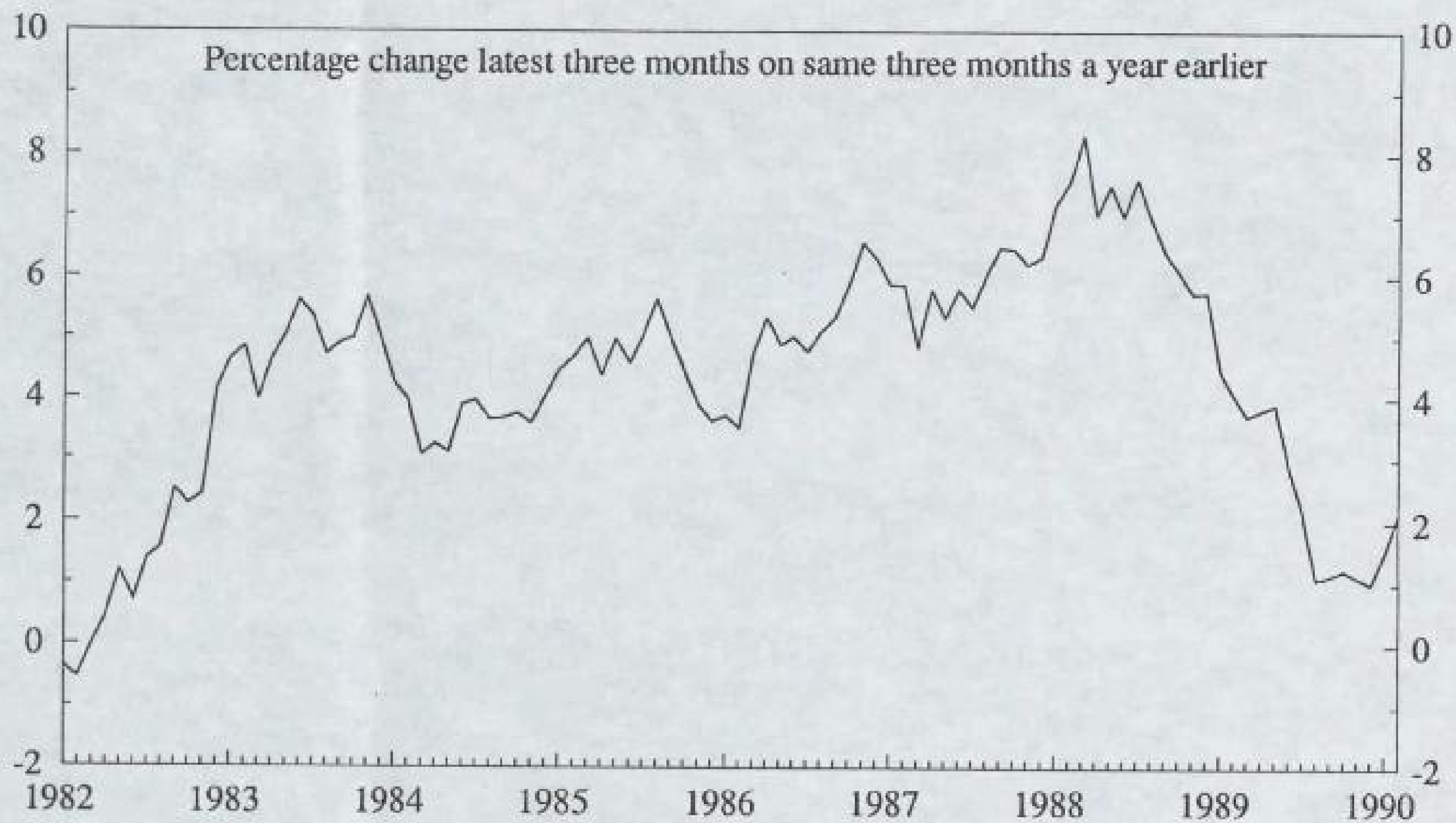


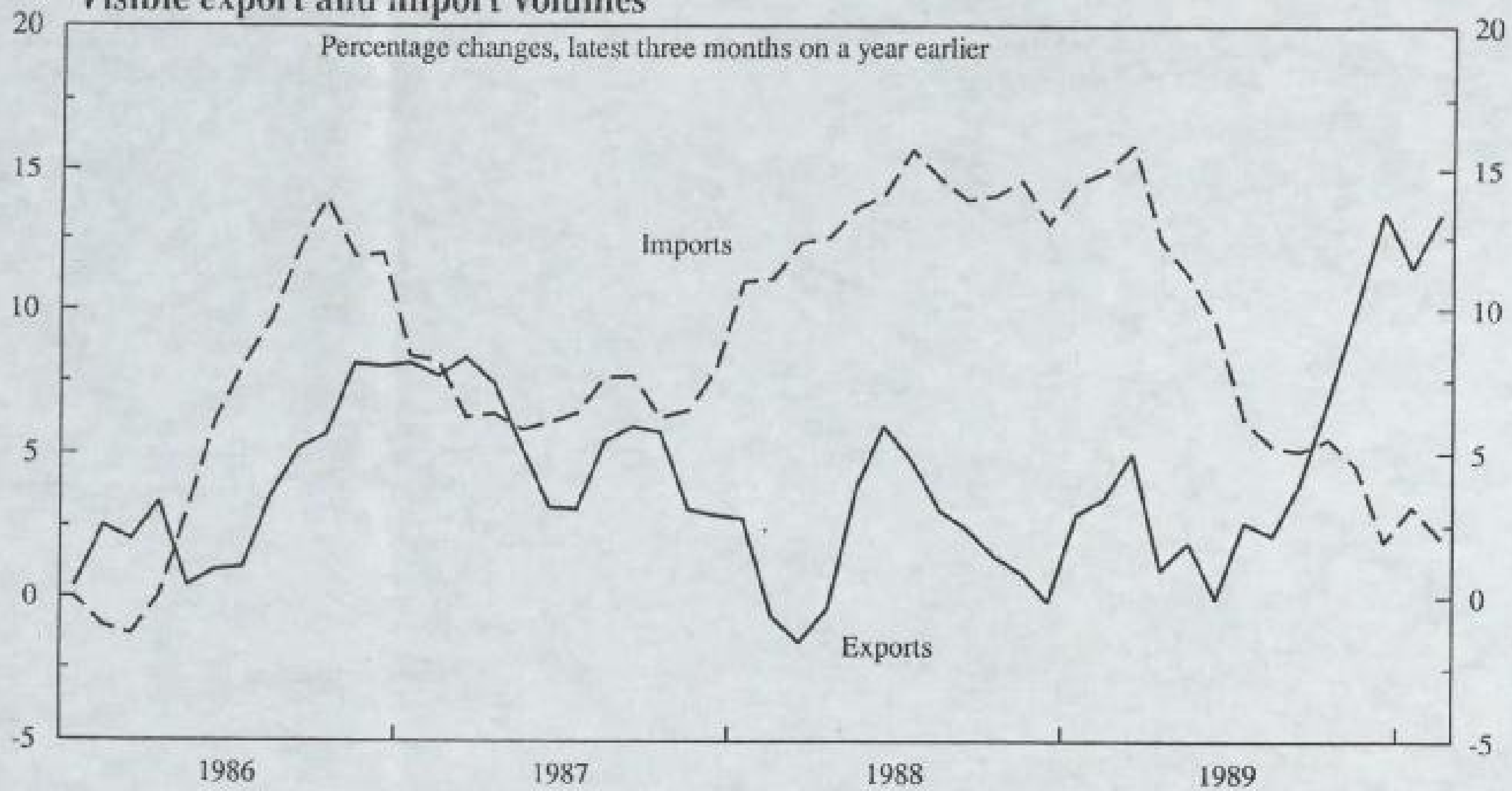
Private sector housing starts

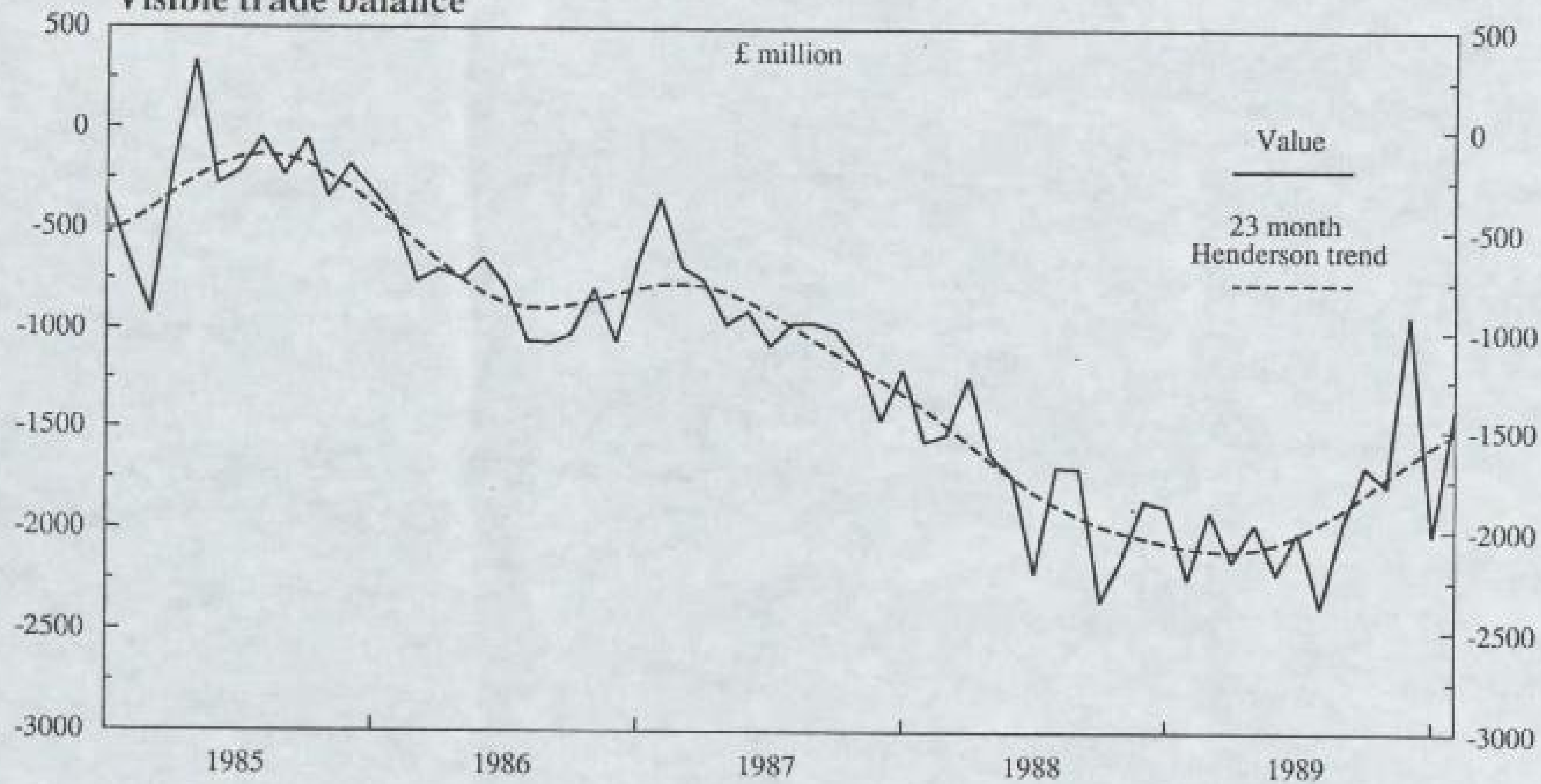


EC/Gallup survey consumer confidence index.

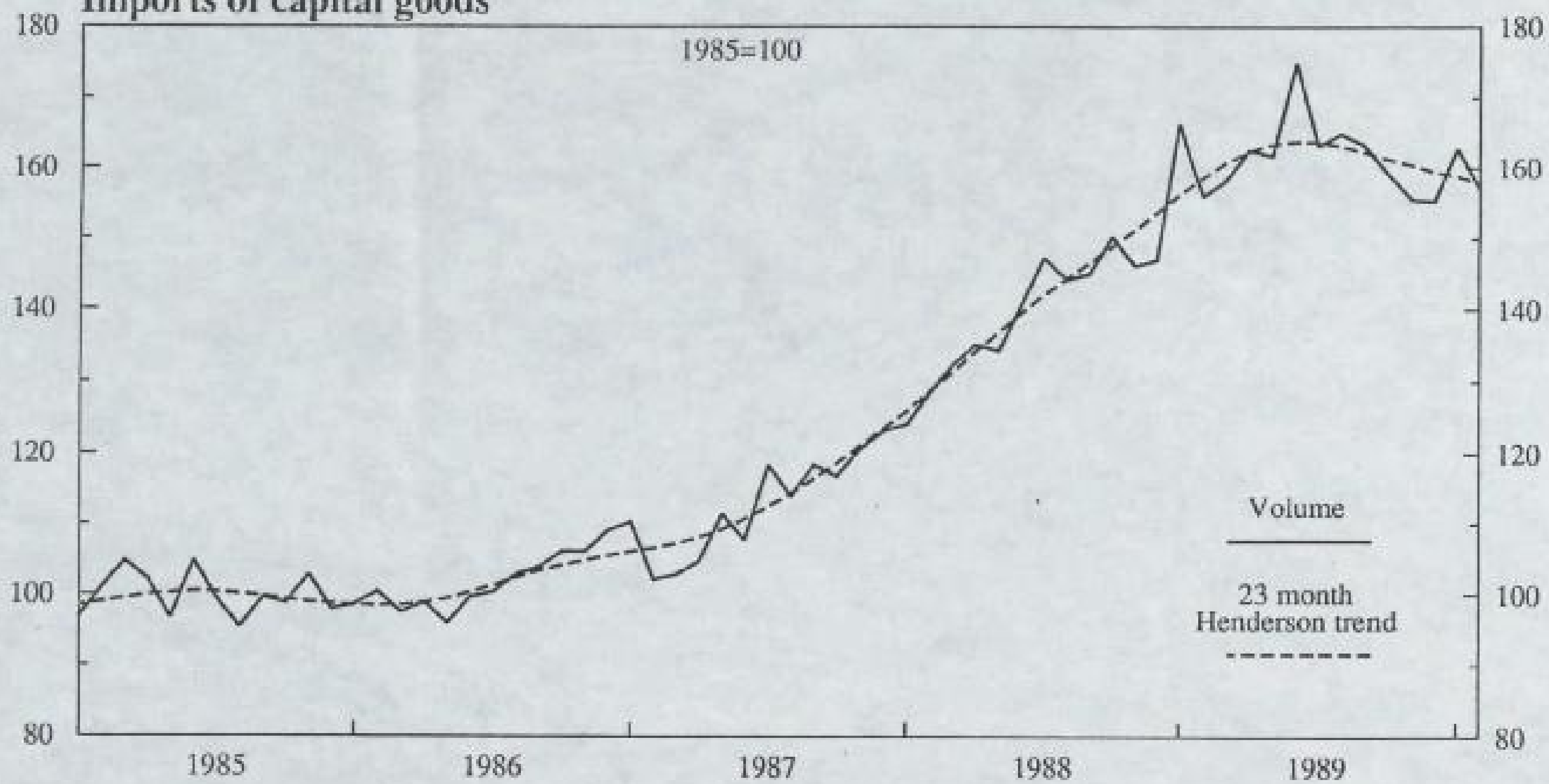
Retail sales growth

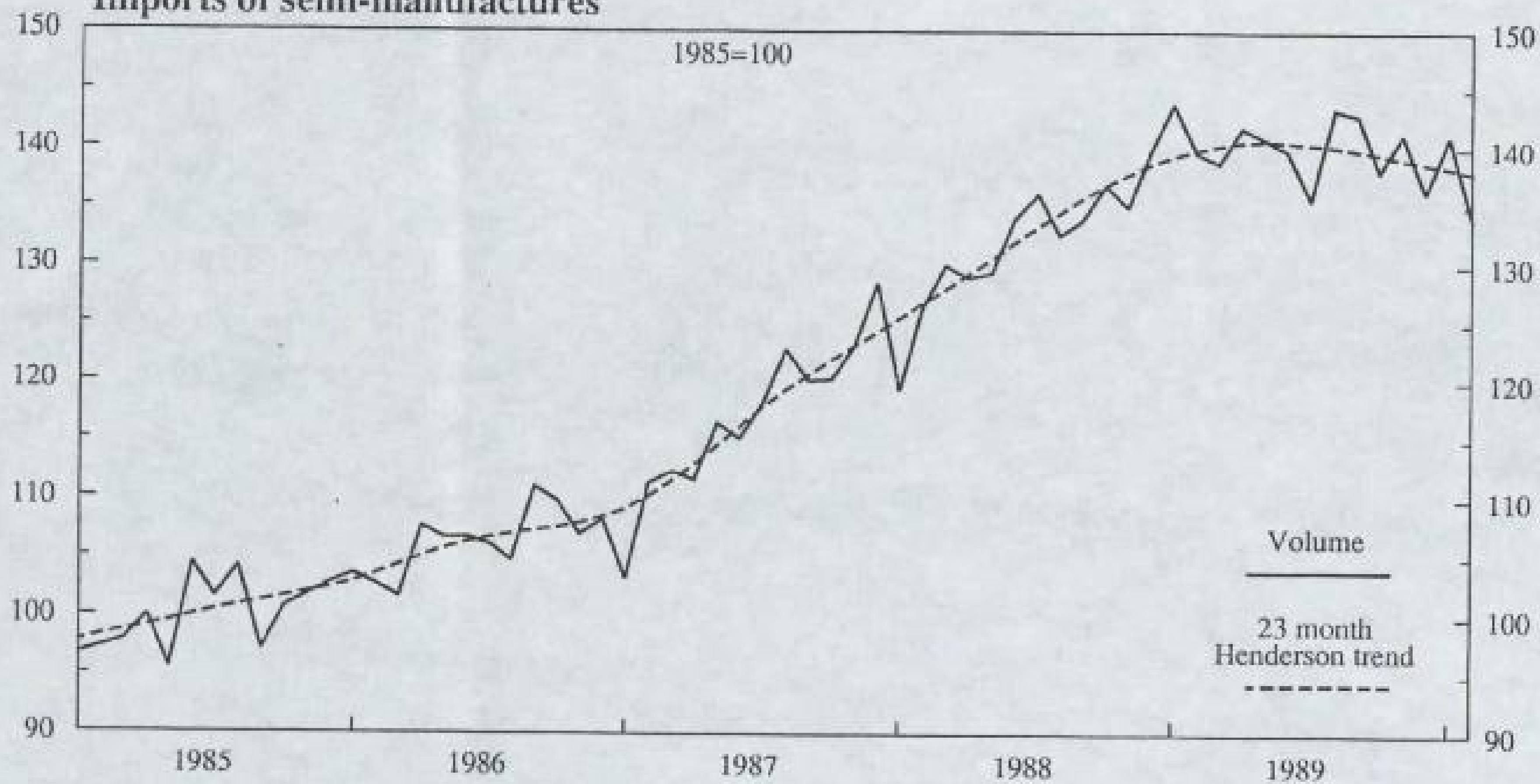



Visible export and import volumes
Percentage changes, latest three months on a year earlier
Imports
Exports
20
15
10
5
0
-5
1986
1987
1988
1989

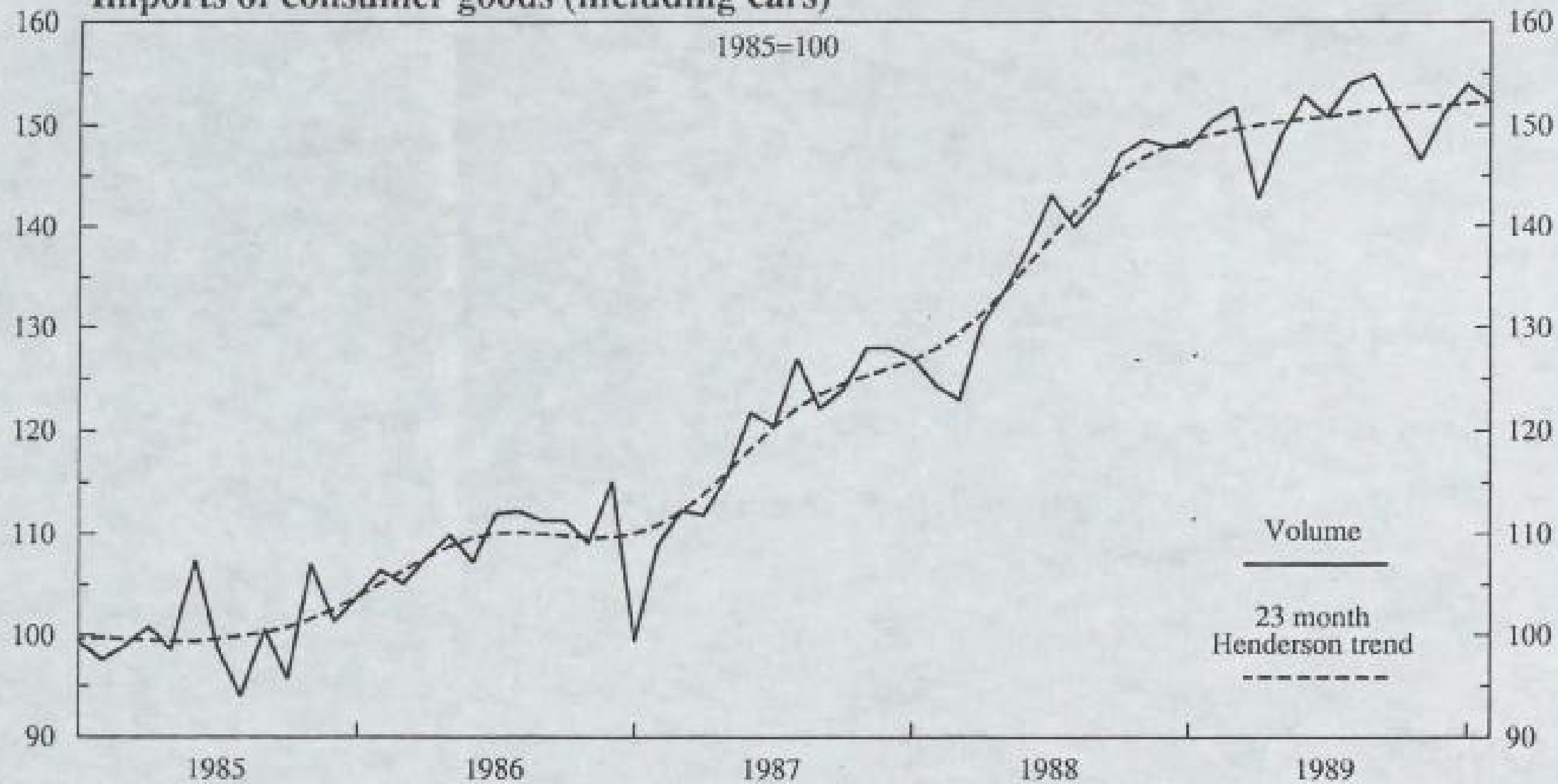


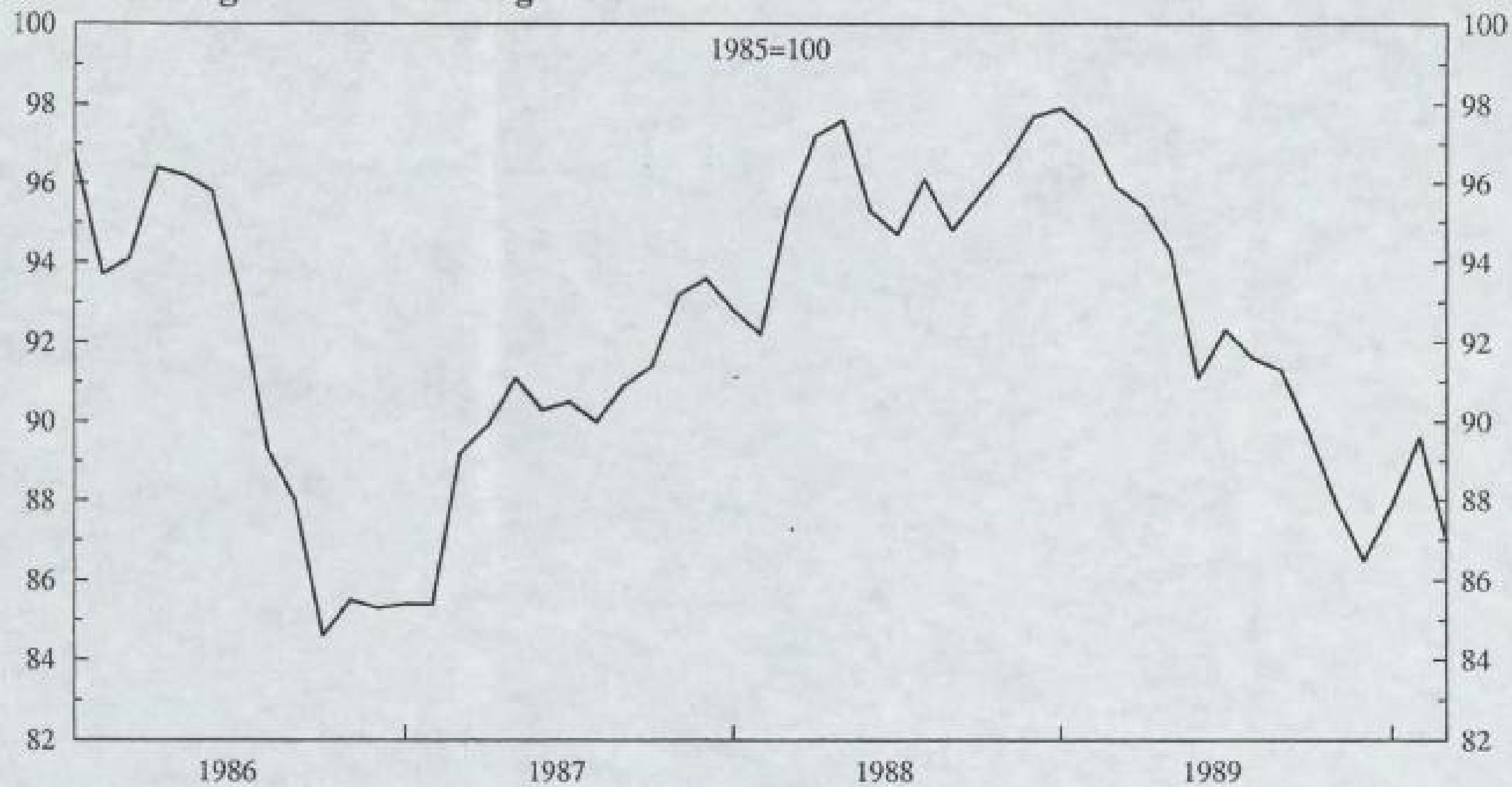
Visible trade balance
£ million
Value
23 month
Henderson trend
500
0
-500
-1000
-1500
-2000
-2500
-3000
1985
1986
1987
1988
1989


Imports of capital goods
1985=100
180
160
140
120
100
80
1985
1986
1987
1988
1989
Volume
23 month
Henderson trend



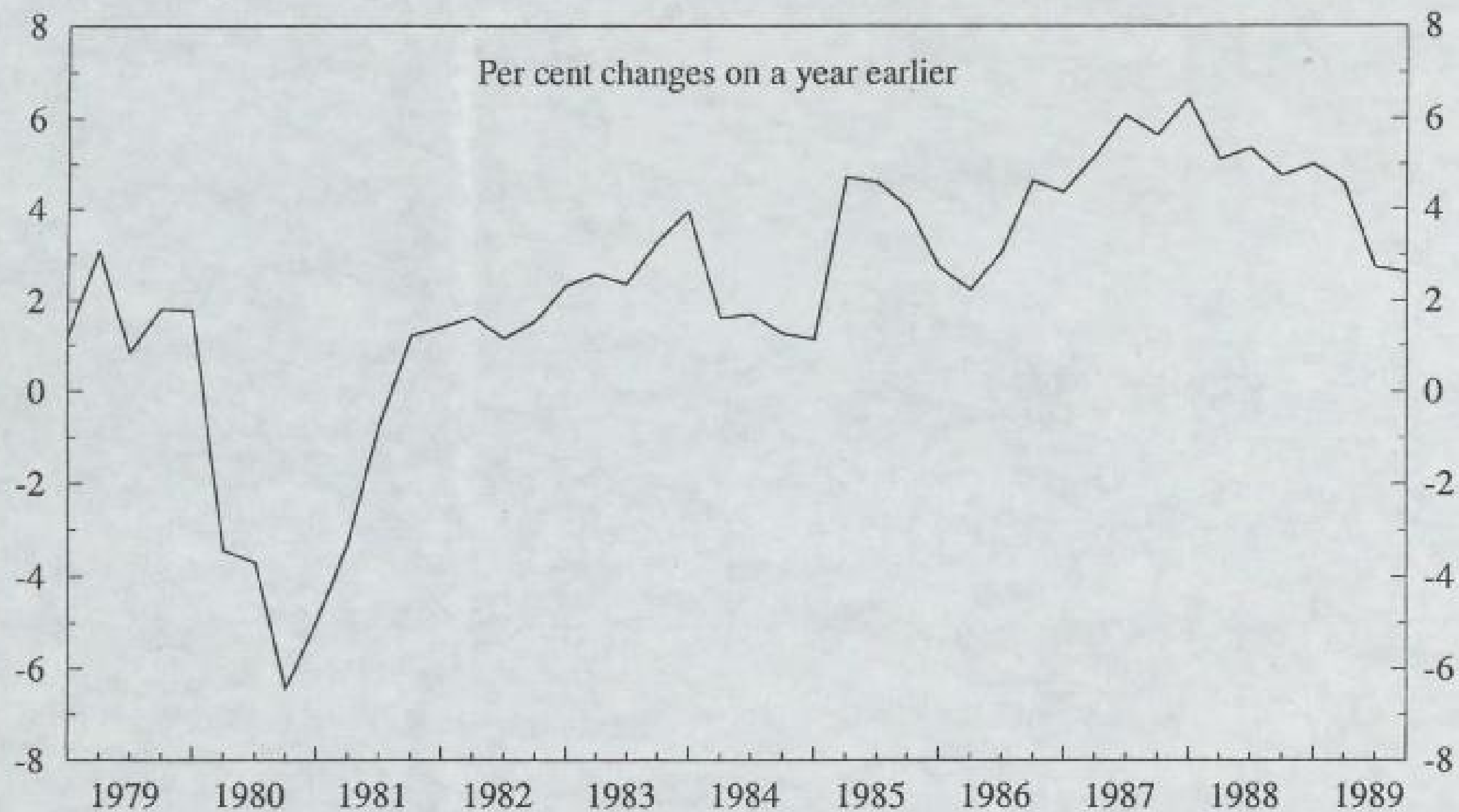
Imports of semi-manufactures
1985=100
150
140
130
120
110
100
90
1985
1986
1987
1988
1989
Volume
23 month
Henderson trend


Imports of consumer goods (including cars)
1985=100
160
150
140
130
120
110
100
90
1985
1986
1987
1988
1989
Volume
23 month
Henderson trend



Sterling effective exchange rate
1985=100
100
98
96
94
92
90
88
86
84
82
1986
1987
1988
1989

Non-oil GDP(O) growth



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MONTHLY MONETARY ASSESSMENT: MARCH 1990

Summary Assessment

While signals from the real side of the economy are not unanimous, their balance is that the economy probably continues to slowdown. Recent figures however suggest a slight recovery in the personal sector, offset by continued slowdown in company spending. The message of the monetary indicators remains less comforting, with the resilience of MO's growth rate consistent with some recent buoyancy in consumption. International prospects for interest rates and inflation remain potential threats.

Main Points

MO's twelve month rate was 6.3 per cent in March, (February 6.4 per cent). MO is projected to fall within the 1-5 range by the end of the year. (paras 34-36)

M4's twelve month growth in February was 18.1 per cent. M4 lending increased more strongly than last month, by 1.4 per cent (£7.3 billion); its 12 month rate rose to 20¾ per cent from 20½ per cent. Company borrowing increased sharply. (paras 38, 45, 49)

Sterling's effective rate is 87.9, ¼ per cent higher than at the last Assessment and 8 per cent below its level in March 1989. (para 32)

Internationally, interest rates have risen in Japan and are likely to rise in Germany. No change is expected in the US. (para 5)

Retail sales rose sharply in February, by 2½ per cent. But consumer confidence dropped to record lows in March following the mortgage rate rise. (para 11)

RPI inflation fell to 7.5 per cent in February but is expected to be higher in March. Excluding mortgage interest payments inflation was 6.2 per cent in February having previously stuck at 6.1 per cent for four months in a row. (para 19)

House prices have levelled out, although the 12 month change continues to fall, with prices now at the same level as a year ago. Housing market activity seems to have picked up slightly. (paras 23-24).

ANNEX: PROFITABILITY IN MANUFACTURING

MG2 Division

6 April 1990

Monetary developments

Latest outturns available at time of:

	Sept Report	Jan Report	Feb Report	Mar Report
Monetary aggregates (12 month % growth)	**(Aug)**	**(Dec)**	**(Jan)**	**(Feb)**
MO (sa)	6.1	6.0	5.8	6.4*
M4	17.3	18.2	18.4	18.1
M5	16.8	17.9	17.9	17.7
Bank & building society lending	21.9	21.2	20.4	20.7
Interest rates (%)	**28 Sep**	**8 Feb**	**8 Mar**	**5 Apr**
3 month interbank	14.3	15.1	15.2	15.2
20 year gilt-edged (par yield)	9.8	10.6	11.3	11.4
Yield gap	4.5	4.5	3.9	3.8
UK real 3 month interbank	7.1	8.1	7.2	6.9
Equity dividend yield (all share)	4.2	4.4	4.7	4.9
IG yield (2001) assuming 5% inflation	3.6	4.0	4.2	4.3
3 month UK interest differential with				
Germany	6.8	7.0	6.8	7.0
US	5.3	6.8	6.8	6.8
World basket	5.4	6.1	6.1	6.2+
Exchange rate				
$/£	1.61	1.69	1.64	1.64
Yen/£	226	244	248	259
DM/£	3.03	2.82	2.79	2.79
ERI	91.2	89.1	87.7	87.9
Oil adjusted ERI**	98.7	94.3	94.0	95.0
Asset prices				
FT-A Index (% pa)	23.2	8.2	3.5	4.5
FT-A Level (July 1989 peak: 1239)	1166	1164	1117	1111
Halifax house index (% pa)***	14.2	2.8	3.0	1.6

* March 6.3 per cent (estimate)

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

*** 12 month growth rates shown are for August, December, January and February. March 0.0 per cent. See table 11 for further details

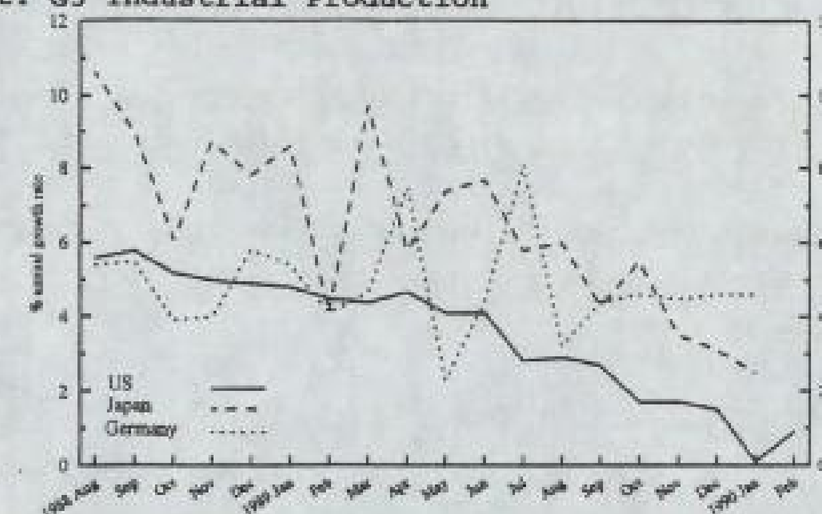
\+ estimate

A. EXTERNAL DEVELOPMENTS

Activity and Inflation

1. Activity in the US may now be picking up a little; employment growth in February was unexpectedly strong, capacity utilisation in manufacturing rose, and industrial production increased by 0.9 per cent (but was still less than 1 per cent higher than a year earlier). GNP in 1989Q4 has been revised up slightly - the annual growth rate is around 2½ per cent. Although Japanese industrial production rose by only 2.5 per cent in the year to January, underlying growth there remains strong - GNP increased by 4.7 per cent in the year to 1989Q4. German industrial production rose by 4.6 per cent in the year to January and revised GNP figures show 3.6 per cent growth in 1989Q4 on a year earlier.

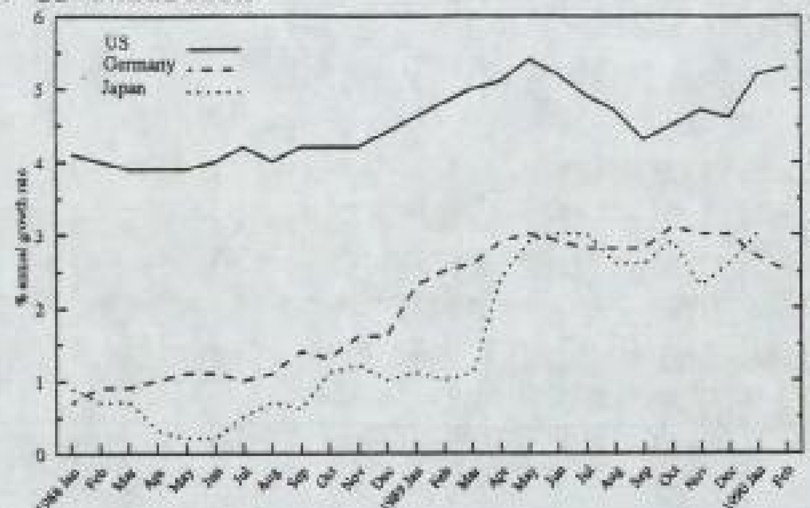
Chart: G3 Industrial Production



2. Inflation showed little change in February in the major economies, after January's increase. German consumer price inflation fell to 2.5 per cent in February from 2.7 per cent in January; producer price inflation edged up from 1.6 per cent to 1.7 per cent. US consumer price inflation increased slightly from 5.2 per cent to 5.3 per cent. Producer prices changed little overall in February - non-energy goods prices rose while energy goods prices fell back after January's sharp rise; the overall twelve month rate dropped to 5.1 per cent from 5.8 per cent in January, largely reflecting a

sharp rise in prices a year ago which has now dropped out of the calculation. Japanese wholesale prices increased by 0.1 per cent in February and were 3.5 per cent up on a year earlier (January 3.7 per cent).

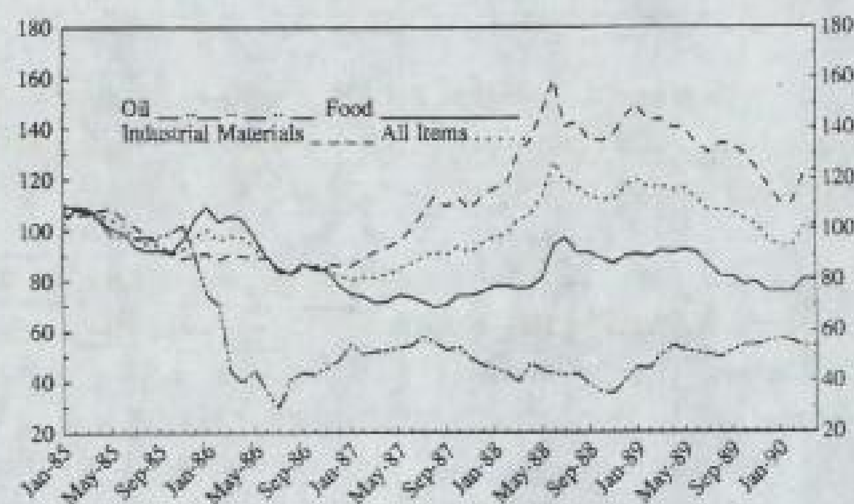
Chart: G3 Inflation



Commodity Prices

3. **Non-oil commodity prices**, measured in SDRs, have risen by about 3 per cent since the last Assessment. Metals, food and non-food agricultural prices were all slightly up. **Oil prices** have fallen on continued Kuwaiti over-production, with Brent down from just under $19 barrel at the last Assessment to $18.

Chart: Commodity Prices



Current Accounts

4. The US fourth quarter current account deficit fell to $20.6 billion due to improved net IPD receipts. The total for 1989 was $106 billion (2.0 per cent of GNP), down from $127 billion (2.6 per cent of GNP) in 1988. The Japanese current account was temporarily in deficit in January due to higher oil prices and various seasonal influences. The US deficit and Japanese surplus are expected to increase slightly as percentages of GNP in 1990, but the German surplus should fall as resources are diverted to the reconstruction of the GDR.

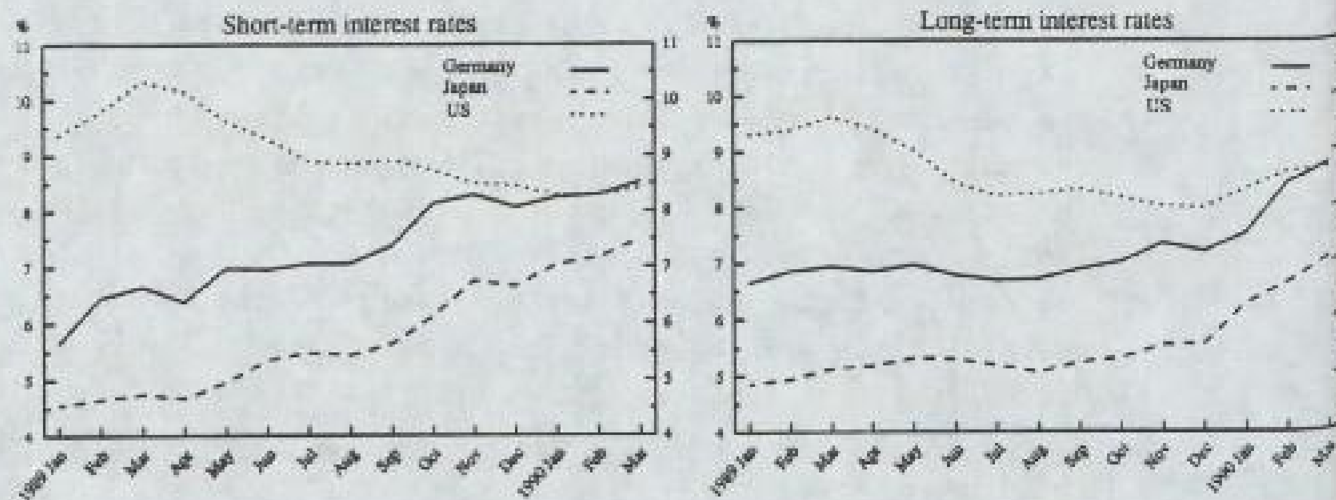
Financial Markets

5. Japanese official interest rates rose by 1 per cent on 20 March to 5.25 per cent, after continued intervention had failed to stop the yen's slide. But the Japanese markets' initial reaction was that the rise may not be sufficient. Short term market interest rates had risen in advance of the well advertised rise in the official rate, and at 7.5 per cent are less than ½ per cent higher than at the last Assessment. In the US, short-term interest rates are little changed since the last Assessment, and no change is expected in official rates. In Germany market rates have fallen a little, reflecting, perhaps, confidence in the authorities' insistence that inflationary pressures arising from German re-unification will be controlled. But further increases in German official interest rates are still likely before the end of the summer - perhaps when ostmarks become convertible for deutschemarks.

6. Bond yields are hardly changed in the US or Japan since the last Assessment. But in Germany they have fallen around ½ per cent, reinforcing the view that financial markets now have greater confidence in the authorities' determination to avoid inflation.

7. Share prices in the US have risen a little since the last Assessment - up about 1 per cent (chart 14). But in Japan they have fallen another 19 per cent and are about 28½ per cent below their peak of December last year. The sharp fall reflects an end to the expectation of continuing capital gains which had been necessary to keep up interest in Japanese equities at negligible yields. Confidence has been hit by the prolonged public wrangle between the BoJ and the Ministry of Finance about monetary policy and by higher bond yields worldwide. If prices stabilise near current levels, no reaction is expected from the BoJ. Nor are the macroeconomic effects arising from the fall in asset holders' wealth expected to be significant: investment trusts have large reserves; and the exposure of financial companies is, on the whole, small. Currently, the main worry is that a consequential fall in land prices would affect the security backing many corporate loans.

Chart: Long Term and Short Term Interest Rates

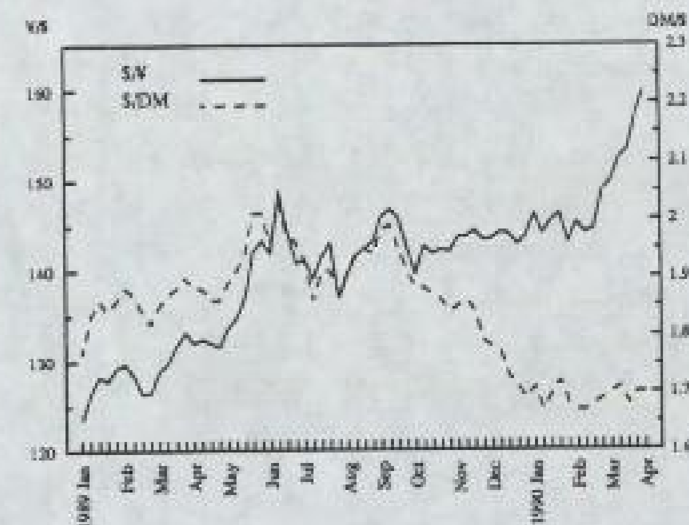


Dollar

8. The dollar has been out of the spotlight, falling ¼ per cent to DM1.70 but rising 4½ per cent to Y158 since the last Assessment. The deutschemark strengthened briefly as the East German election results were seen as accelerating the path to German re-unification, but eased later on concern

about the Baltic states. The yen was adversely affected by the weakness in Japanese equity prices and the postponement of the expected rise in Japanese discount rate which, when it came, failed to relieve the pressure. Amidst continuing market uncertainty and the absence of any apparent results from the Brady/Hashimoto talks, the yen fell below Y160 before a minor recovery on hopes that G7 might agree a support package for the yen. Japan and the US intervened in support of the yen - Japan selling $3 billion and the US buying $¼ billion worth of yen. The ERM traded inside its margins with the lira consistently at the top.

Chart: G3 Exchange Rates



B. DOMESTIC ACTIVITY AND INFLATION

9. Overall, the economy seems to be growing slowly at present. But it is not clear whether demand growth is slowing further or, on the contrary, starting to pick up again. The FSBR forecast projects a small fall in the level of domestic demand in 1990. But strong net export growth means that real GDP is forecast to grow at 1 per cent. Retail price inflation is forecast to rise sharply in March and April, but thereafter to fall to 7¼ per cent in the fourth quarter of 1990 and 5 per cent in 1991Q2.

10. In 1989, GDP growth was 2¼ per cent. Non-oil GDP(O) grew by nearly 3¼ per cent but it slowed rapidly during the year, and in the second half was only 2.7 per cent higher than a year earlier - about the same as the economy's sustainable rate of growth. The growth of the GDP deflator for 1989-90 as a whole is now forecast at 6¾ per cent, down from 7 per cent in the Autumn Statement - largely reflecting lower than expected quarterly outturns to date for consumer prices. But the forecast for money GDP growth is unchanged from the Autumn Statement forecast at 8½ per cent. It is projected to slow to 7½ per cent in 1990-91.

Demand

11. Retail sales in February were nearly 2½ per cent higher than in January. In the latest 3 months, they were over 2 per cent higher than a year earlier, and 1¼ per cent higher than in the previous three months. Both figures represent an increase compared with the end of last year. Part of the February rise looks to be a seasonal pattern in food sales, but the increase also reflects higher sales of household goods - a sector recently in the doldrums. These figures by themselves suggest that retail sales growth may have picked up since December. But other monthly indicators do not support this.

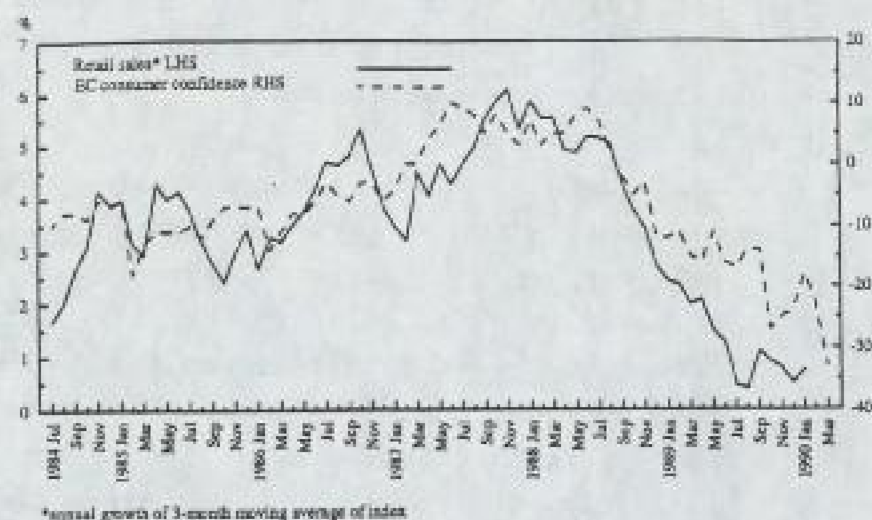
- The EC/Gallup consumer confidence index for March fell sharply from the already depressed February level to a new record low following the mortgage rate increase (see chart below).

- John Lewis's sales in the six weeks ending 10 March, were only 5 per cent higher in value terms than a year earlier, implying lower sales volumes (more recent figures are distorted by the difference in the timing of Easter in 1989 and 199). Food sales were 9½ per cent higher (reflecting at least in part high food price inflation) but department stores' sales rose only 1¼ per cent. Other major retailers also seem to think that spending was weaker in February than indicated by the official figures.

- The CBI/FT distributors' survey showed the balance of retailers reporting sales in February higher than a year earlier down from January's erratically high figure, though this survey has not been a reliable indicator.

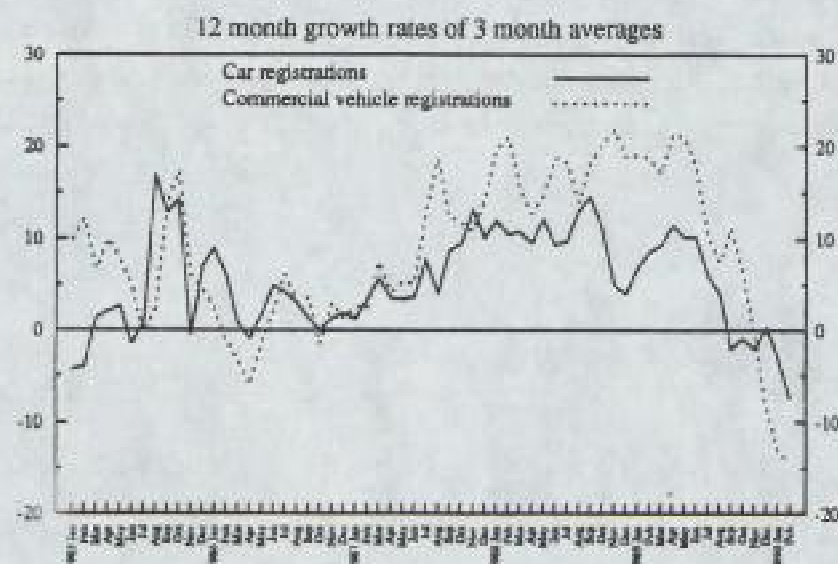
12. The FSBR forecast projects virtually no change in consumers' expenditure during 1990, with a rise of ½ per cent between 1990Q4 and 1989Q4. The savings ratio, which is thought to have risen by 1¼ percentage points during 1989, is expected to rise another ½ per cent during 1990. But the projected slowdown in consumption growth largely reflects lower real income growth.

Chart: Retail Sales and Consumer Confidence



13. **Total car registrations** continue to fall: new car registrations in February were 15½ per cent lower than a year earlier. In the latest three months they were nearly 8¾ per cent lower than a year earlier, and ¾ per cent down on the previous three months. Within the total personal sector registrations were 19 per cent lower in February than a year earlier, and companies' registrations 12½ per cent lower.

Chart: Car and Commercial Vehicle Registrations

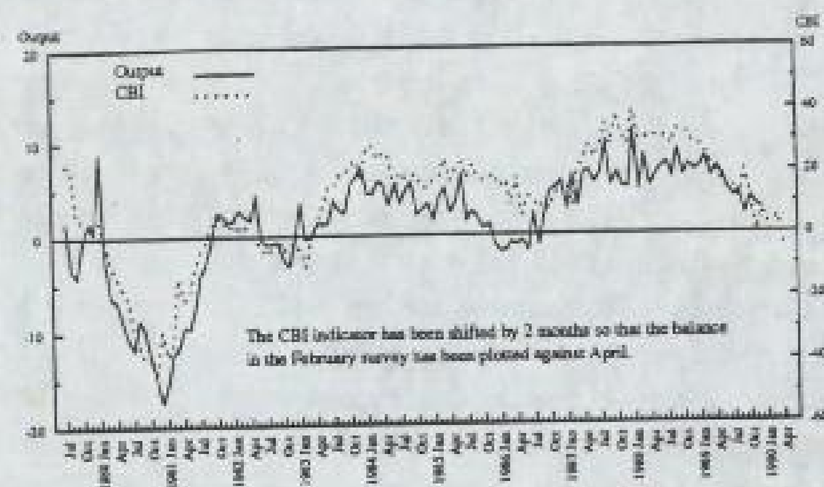


14. **Commercial vehicle registrations** were 10 per cent lower in the three months to February than in the previous three months, and 14½ per cent lower than a year earlier. Apart from this there is no news on company sector spending so far in 1990. **Business investment** fell in the fourth quarter of 1989, which also saw the first signs of significant **destocking** by manufacturers. It could be that firms have started to react to the pressure on their profits in the second half of last year (see also Annex). ICCs' financial deficit is estimated at £23½ billion in 1989 (subject at this stage to wide margins of error). If confirmed, this would be three times are large as in 1988. The ease with which firms are able to finance this deficit (rather than being forced into action to reduce it) will be crucial to the adjustment of the economy as a whole. The latest CBI survey suggests firms expect little change in output over the next few months. Total order books fell again, while export order books increased from an already high level (table 7). The proportion of firms reporting stocks higher than adequate rose significantly in the March CBI survey.

Output

15. **Manufacturing output** fell by ¼ per cent in January, and in the latest three months was less than 2 per cent higher than a year earlier. There has been no trend recently in manufacturing output - in the latest three months it was slightly lower than in the previous three, and it has been more or less unchanged since the start of 1989. **Energy and water output** fell 2½ per cent in January and in the latest three months was 1½ per cent lower than a year earlier. The halt to the recovery in output is said to be due to storms in the North Sea and the mild weather in January, with lower than usual energy demand. **Total industrial production** therefore remains weak and in the latest three months was only 1 per cent higher than a year earlier.

Chart: Manufacturing Output and the CBI Survey



16. Construction orders fell again in January. Total new orders in the latest three months were 10 per cent lower than in the preceding three months and 17 per cent down on a year earlier. Private housing orders fell particularly sharply and remain on a strong downward trend; in the latest three months they were 40 per cent down on year earlier. Public housing orders picked up a little in January (probably orders from housing associations). Private industrial and commercial orders remain low, down 10 per cent on a year ago. Construction output itself remains weak. Despite rising over 2 per cent in 1989Q4, it was still below its level in the first half of 1989, although 2½ per cent higher than a year earlier.

Trade Flows

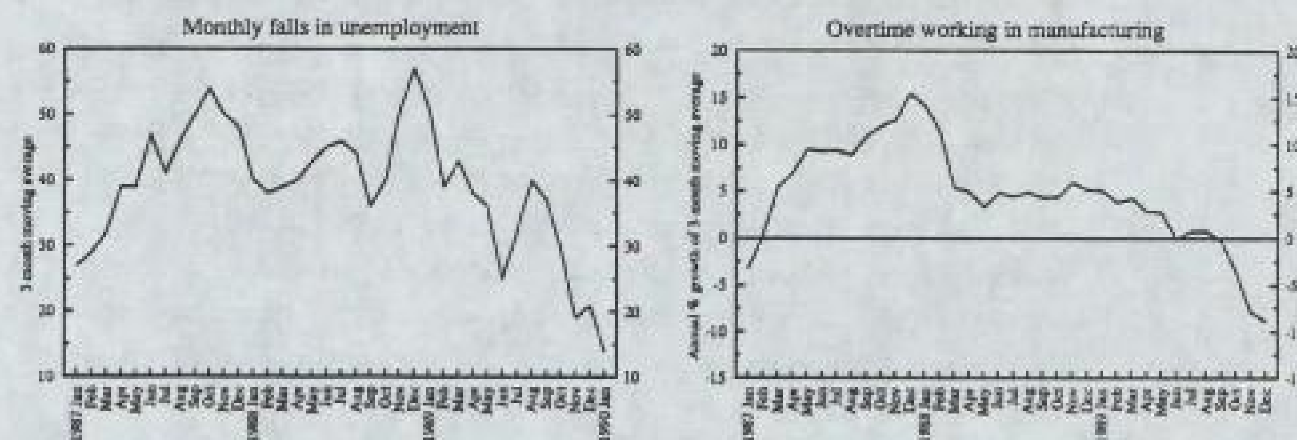
17. Trends in trade volumes remain favourable. In the three months to February, export volumes (less oil and erratics) were 3½ per cent higher than in the previous three months and 11 per cent higher than in the same period a year earlier. Import volumes (less oil and erratics) fell by 1 per cent and were only ½ per cent higher than a year

earlier. The latest figures are further evidence that the current account deficit is narrowing: in the three months to February the deficit was £4.6 billion compared with £5.9 billion in the previous three months. While the balance of invisibles was negative in 1989Q4, this reflected an erratic concentration of net outflows, and some recovery is expected.

Labour Market

18. The labour market statistics now seem to be reflecting the slow-down in demand and output growth through 1989. Seasonally adjusted adult **unemployment** fell by 2,000 in February, with the slowdown now affecting all regions, and the trend of **vacancies** continued downwards. **Overtime** working in manufacturing remains significantly lower than in most of 1989 despite a slight rise in January, and manufacturing employment fell. But revised estimates of whole economy **employment** show stronger growth than previously thought - in the year to September 1989, employment rose by over ¾ million. This would not be significantly slower than the rapid growth over the previous three years.

Chart: The Labour Market



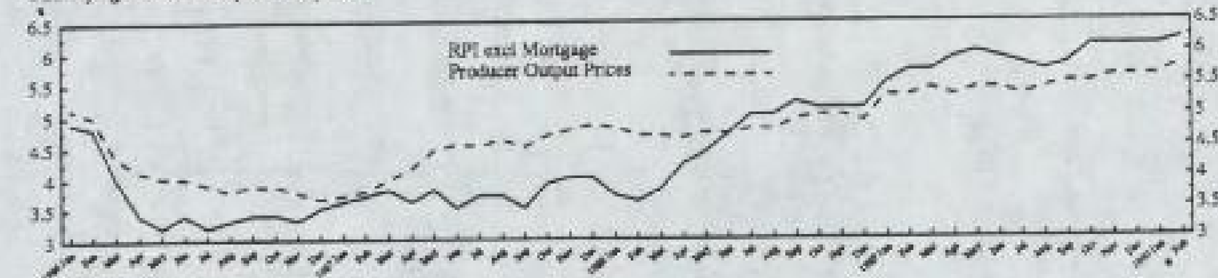
Retail Prices, Producer Prices and Earnings

19. **All-items RPI inflation fell by 0.2 per cent in February to 7.5 per cent, as last February's mortgage rate rise dropped out of the calculation. But underlying inflation rose: RPI inflation excluding mortgage interest payments** increased to 6.2 per cent, having stuck at 6.1 per cent for the previous four months. Food price inflation rose sharply again and there were significant increases in the prices of DIY materials and insurance premiums. There was also a small rise in 'mainly retailed items' inflation, from 4.9 per cent in January to 5.0 per cent in February: this has hardly varied from 4.9-5.0 per cent since May last year.

20. All-items inflation is forecast to rise by 0.6 per cent in March to 8.1 per cent mostly because of the rise in mortgage rates. In addition, the latest increase in domestic gas prices will start to impact, and some further rise in food price inflation is likely. Excluding mortgage interest payments the twelve month rate may rise to 6.3 per cent. The index in April will also be affected by the introduction of the Community Charge and increases in rents and some public sector utility prices.

21. **Manufacturing input price inflation (excluding food, drink and tobacco)** fell by 1½ per cent in February to 0.9 per cent, reflecting falls in the prices of metals and other imported materials. But **output price inflation** picked up from 5.5 per cent in January to 5.6 per cent in February. This surprising: a pick up would be more likely in January when many manufacturers review their price lists. Nevertheless, upward revisions to both the December and January figures mean that the February outturn cannot be discounted as erratic.

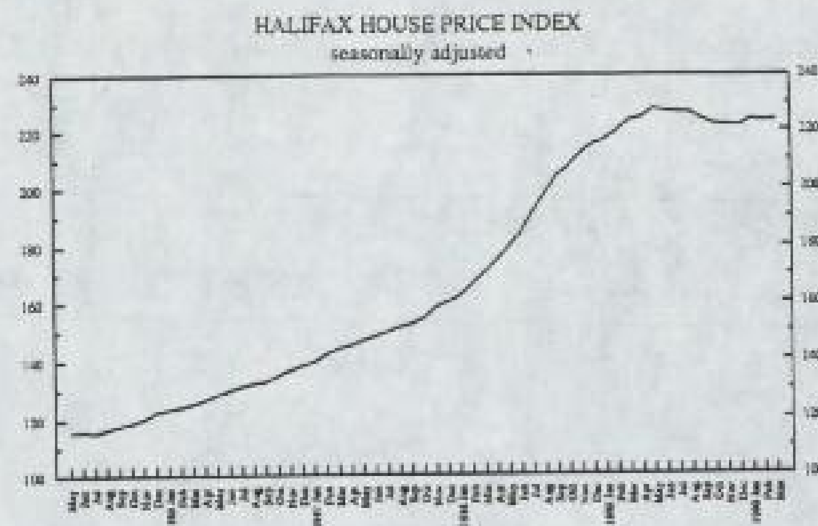
Chart: Measures of Inflation



22. **Whole economy underlying earnings growth** remained at 9¼ per cent in January (private sector 9 per cent - up from 8¾ per cent in December). Lower overtime and increased short-time working continue to reduce manufacturing earnings growth by about ½ per cent; the downward effect on whole economy earnings growth is now between ¼ and ½ per cent. DE's own confidential data show **private sector settlements** averaging 8.4 per cent in January, but the provisional outturn for February is lower at 7.6 per cent. DE expect whole economy underlying earnings growth to rise to 9½ per cent in February and to be between 9½ and 9¾ per cent in March. Some pick up in private sector wage demands seems likely in the next few months, given the expected rise in inflation. The outlook for settlements therefore depends largely on companies' response to slower domestic demand.

Housing Market

Chart: House Prices

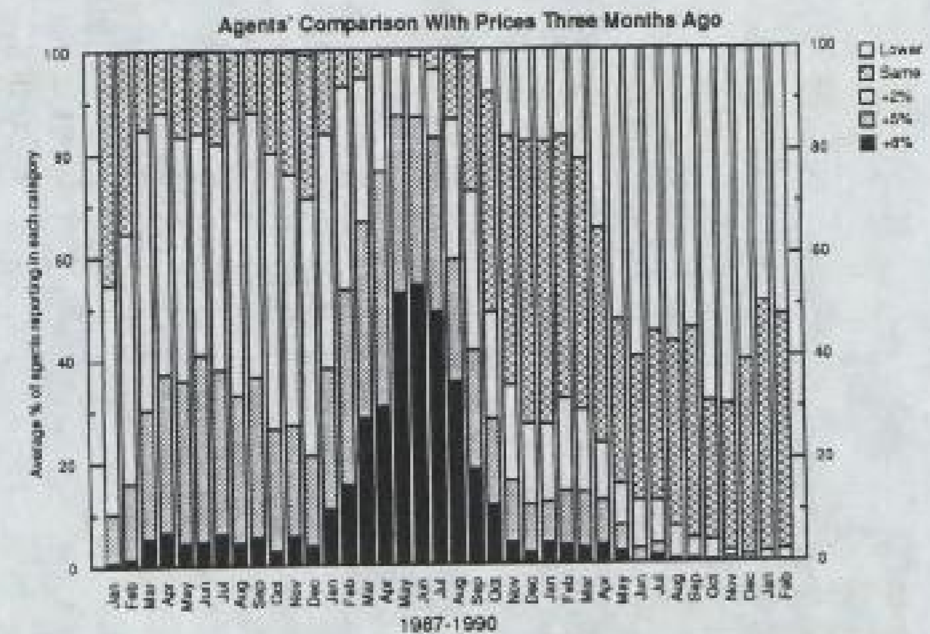


23. The Halifax house price index, after seasonal adjustment, was the same in March as in February (it rose ½ per cent before seasonal adjustment). The twelve month growth rate fell to zero from 1.6 per cent in February, and the trend in house prices is now more or less flat. The latest quarterly regional breakdown shows that prices rose in only three regions (North, North West, and Wales) in the first quarter. In East Anglia they fell 5 per cent and were nearly 20 per cent lower than a year earlier. Prices also fell significantly in the fourth quarter in the South West and the South East.

24. The February **RICS survey** reported that the rise in mortgage rates had put a stop to the increase in activity over the last two months. Unexpectedly high community charges have also dampened market confidence. Nevertheless the market was still active in East Anglia, particularly for first time buyers and for large houses, reflecting lower prices and special mortgage inducements. The North and North West were still fairly active, but recent increases in activity in Yorkshire, Humberside, the East Midlands and the

South West have come to an end. Overall, the market was slightly more depressed, with a few more agents reporting lower prices at the expense of those reporting stable prices. In the South East, 61 per cent of agents reported lower prices, and activity was half the national average.

Chart: The RICS Survey



C. PUBLIC SECTOR FINANCES AND THE FISCAL STANCE

25. The latest evidence does not alter our view of the fiscal stance in 1989-90, which looks to have turned out rather looser than projected at the time of the 1989 Budget. The 1990 Budget does not modify the fiscal stance significantly.

26. Table 9 gives the main indicators of fiscal stance. The PSDR in February was £1.0 billion, £0.3 billion below last month's forecast. The shortfall reflects £0.6 billion higher borrowing than forecast by local authorities partly offset by higher than expected repayments by public corporations and on central government own account. The public corporations' net repayment was slightly higher than forecast despite the fact that the proceeds from Giroleasing (£0.3 billion) did not come through in February as assumed, but in March.

27. In the first eleven months of 1989-90 the PSDR was £9.6 billion. The latest PSDR forecast of £7.1 billion in 1989-90 whole is consistent with slightly lower borrowing in March 1990 than in March 1989, adjusting for privatisation proceeds. Excluding special factors, local authorities are expected to borrow more than in March than last year, but this is more than offset by a slightly higher repayment by public corporations (Giroleasing) and slightly lower borrowing by central government.

Table: The PSBR

	outturns		forecasts				
			1989-90		1990-91		
	APRIL-FEB	**FEB**	**MARCH**	**TOTAL**	**APRIL**	**MAY**	**TOTAL**
CGBR	- 7.6	-1.6	2.7	-4.9	1.5	1.5	-4.8
CGBR(O)	-10.0	-0.9	5.2	-4.8	0.5	1.4	-7.7
PSBR	- 9.6	-1.0	2.6	-7.1	0.8	0.9	-6.9

Funding

28. There was a small underfund of £0.2 billion in January (see table below). Net repayments of gilts totalled £1.3 billion, mainly accounted for by maturities of £1.2 billion. Banks and building societies disposed of £0.4 billion net, leaving £0.9 billion of net disposals to score towards (un)funding (of which the overseas sector accounted for £0.6 billion). There were also withdrawals of £0.2 billion of National Savings.

Table: Funding in February

TOTAL FOR FUNDING	**£ bn**	**FUNDING**	**£ bn**
PSBR	-1.0	Net gilt sales to private sector & overseas	-0.9
Reserves	+0.1	National Savings, etc	-0.2
Total (ex maturities)	-0.9	**Total** (inc maturities)	-1.1

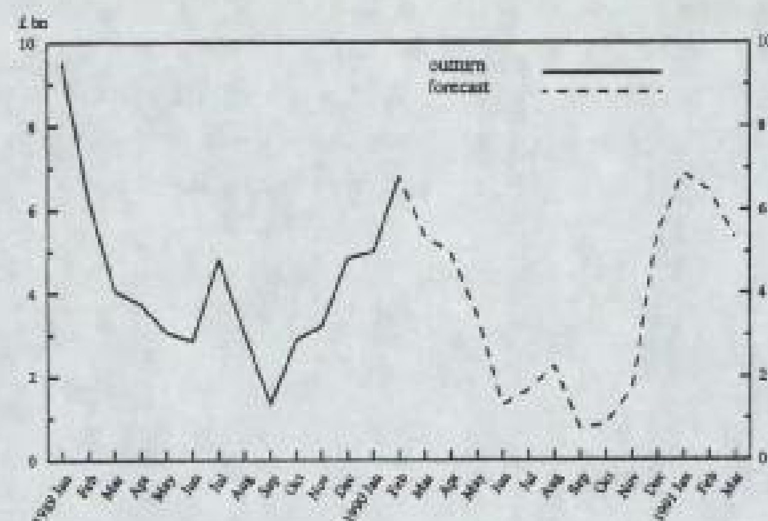
29. Assuming no buying-in from now on, a cumulative overfund (ie including carry overs from past years of £2.2 billion) of £0.3 billion is expected for 1989-90. On current assumptions buying-in of £1.1 billion will be required for a full fund in 1990-91 (table 20). This is predicated on net sales of gilts by banks and building societies falling back from over £4 billion in each of the last two years to £1 billion (higher net sales by banks and building societies would increase the amount of buying-in required).

Money Market Assistance

30. Money market assistance increased from £5 billion at the end of January to £6.8 billion at the end of February, £1¼ billion more than expected. The prospect, consistent with the funding assumptions above, is for the stock of assistance to fall back to £5¾ billion in March. With the Treasury Bill tender remaining at £700 million, the stock of Treasury Bills in the market is expected to rise by £3 billion during 1990-91 to £13 billion. This is enough to offset the expected expansion of bankers' deposits from other factors, and money market assistance is expected to end 1990-91 at £5¼ billion, the same as at the end of 1989-90. The main expansionary influences are sales of gilts by banks and building societies (£1 billion), higher net deposits of local authorities (£1-1½ billion) and in-year underfunding (£½ billion).

31. On the conventional assumption that buying-in is evenly spread throughout the year, the stock of assistance is expected to be at fairly low levels during the summer - £1½ billion in June and below £1 billion in September and October, reflecting the usual seasonal pattern of the CGBR. These figures are more than £¼ billion higher than in last month's forecast.

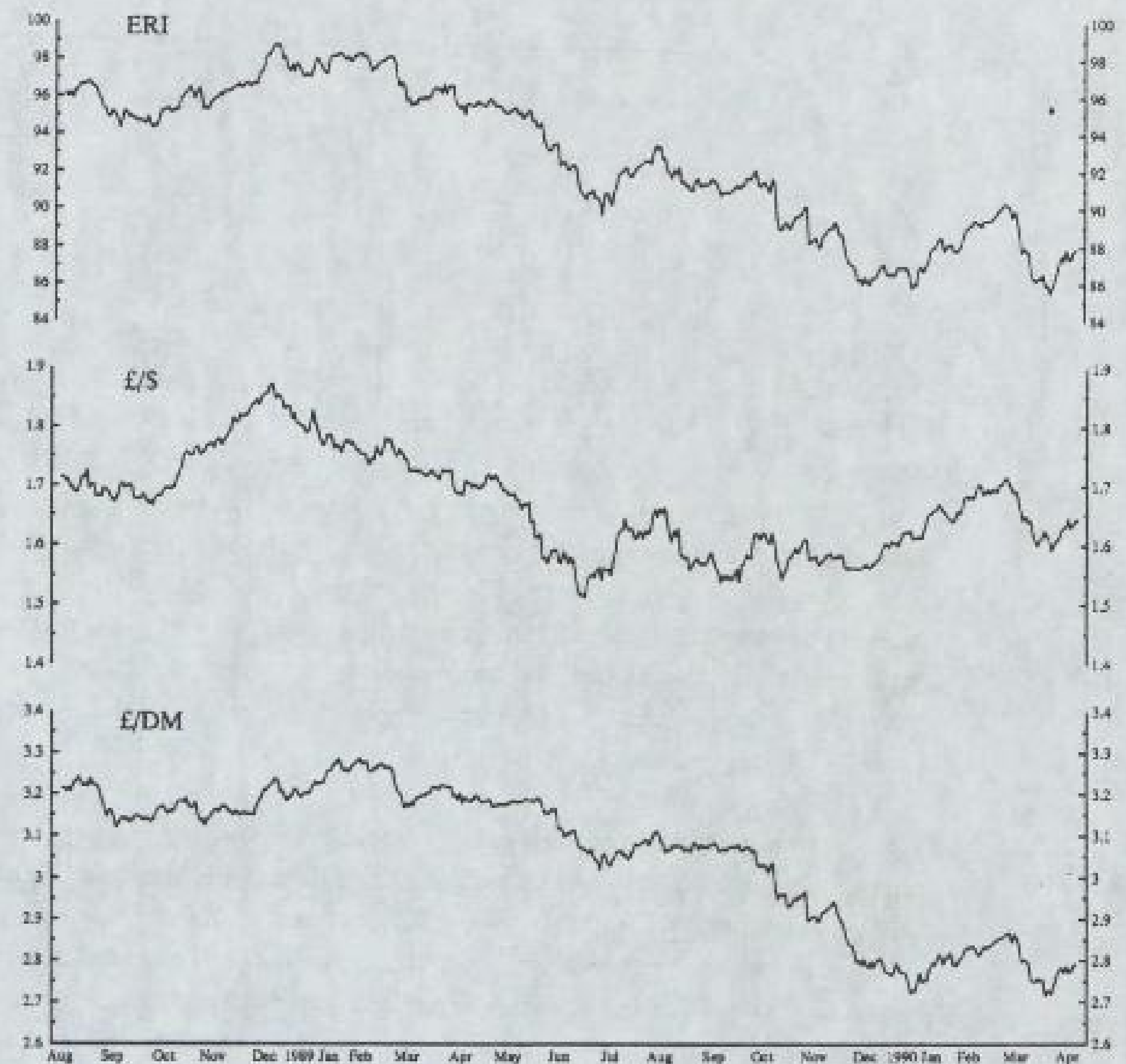
Chart: Money Market Assistance



D. EXCHANGE RATES

32. Sterling rose ¼ per cent to ERI 87.9 but was unchanged at DM2.79 and $1.64 since the last Assessment. It weakened at first to ERI 85.3 on political worries but after the Budget it recovered on reports of large Middle Eastern demand and short-covering. Sterling soon recovered from its sharp losses following the riot in London, helped by increased focus on high interest rates. The Bank's net market intervention was nil, after providing support for the pound early in the period.

Chart: Exchange Rates

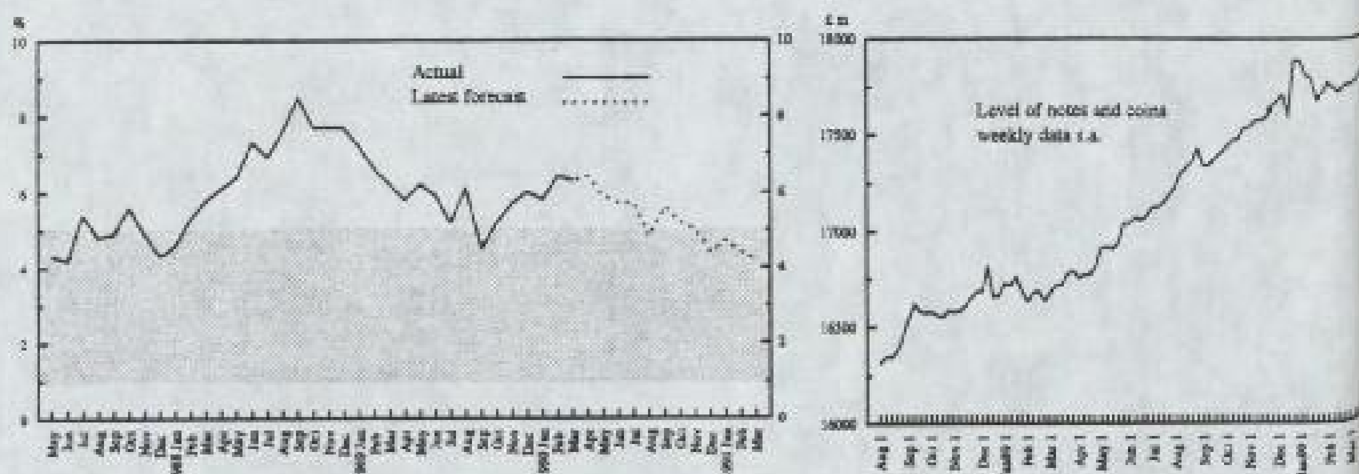


33. UK market interest rates are now the same as at the last Assessment (15.2 per cent), having been higher in the interim. With US rates also unchanged, sterling's interest advantage against the dollar remains at 6.8 per cent. German interest rates have fallen, so the pound's interest advantage against the deutschemark now stands at 7.0 per cent, up from 6.8 per cent at the last Assessment.

E. DOMESTIC MONETARY AND FINANCIAL MARKET DEVELOPMENTS

Narrow Money

Chart: MO Growth

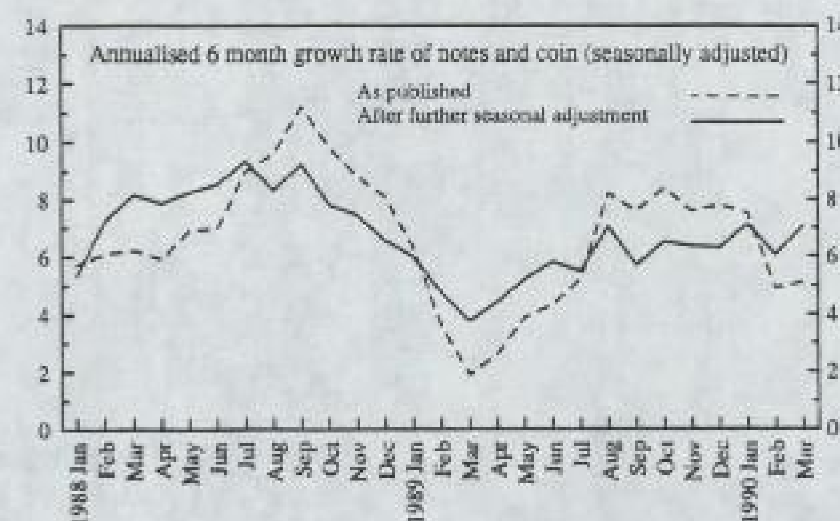


34. MO increased by 0.2 per cent, seasonally adjusted, in March; its twelve month growth rate fell slightly to 6.3 per cent from 6.4 per cent in February. Underlying growth, given by the twelve month growth rate of notes and coin, was 6.4 per cent, just below February's 6.5 per cent. The six month growth rate of notes and coin rose to 5.1 per cent from 4.9 per cent.

35. That the six month rate is well below the twelve month rate should not be taken as a sign of an imminent fall in the twelve month rate. The right hand chart above shows clearly how notes and coin's slow growth this winter matches equally slow growth last year, and this plateau in the early months of the year is characteristic even though the series

is seasonally adjusted. The chart below shows the six month growth rate of notes and coin growth with crude estimated corrections for residual seasonality. On this basis the six month growth rate looks to have been 6-7 per cent since last August.

Chart: Residual Seasonality in Notes and Coin Growth



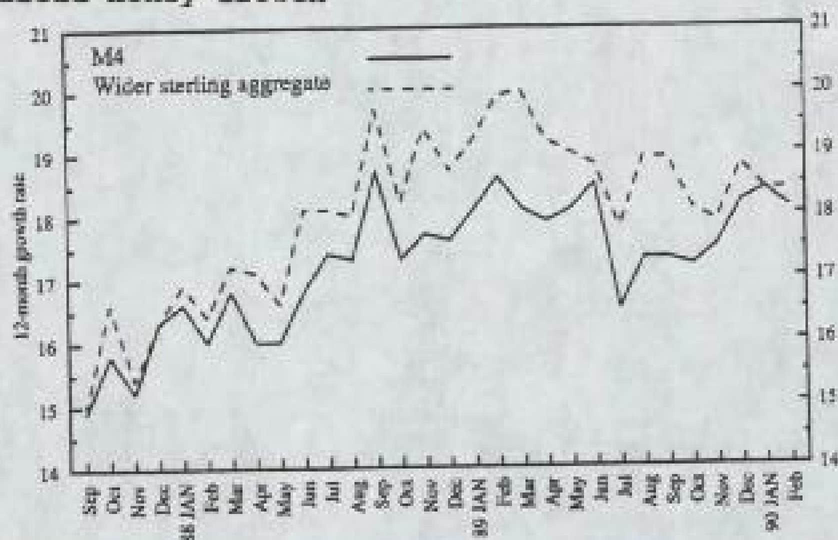
36. MO's average twelve month growth rate in 1989-90 was 5.8 per cent, lower than the 7.1 per cent of the previous year, but it was always above the upper limit of the 1 to 5 per cent target range (apart from in September, with the help of the postal strike of the previous year). The forecast (table 23 and chart above) shows MO growth slowing from now on, getting properly into the target range in the fourth quarter of the calendar year. But the starting position is worse than it was a year ago: in March 1989, notes and coin growth rate was 6.5 per cent and had been falling steadily over the previous few months; while notes and coin growth rate is now a little lower than a year ago at 6.4 per cent, it has been rising for several months.

Broad Money

37. Broad money growth as measured by the wider sterling aggregate M4W (which includes the sterling deposits of residents and non-residents) was unchanged in February at

18.4 per cent. As shown by the chart below, M4W's twelve month growth rate has come more into line with M4's growth rate as non-residents ran down their deposits at the end of last year, presumably because they found the exchange risk more than sufficient to outweigh sterling's interest advantage.

Chart: Broad Money Growth



38. M4 itself increased by 0.9 per cent (seasonally adjusted) in February, just below the average increase of the previous six non end-quarter months (1.0) per cent. The twelve month growth rate fell to 18.1 per cent from 18.4 per cent in January. It still remains in the 16½-18½ per cent corridor of the last 18 months or so, but February's figure brings to an end the upward drift since July of last year. The three month and six month growth rates also fell in February. They remain close to the twelve month rate.

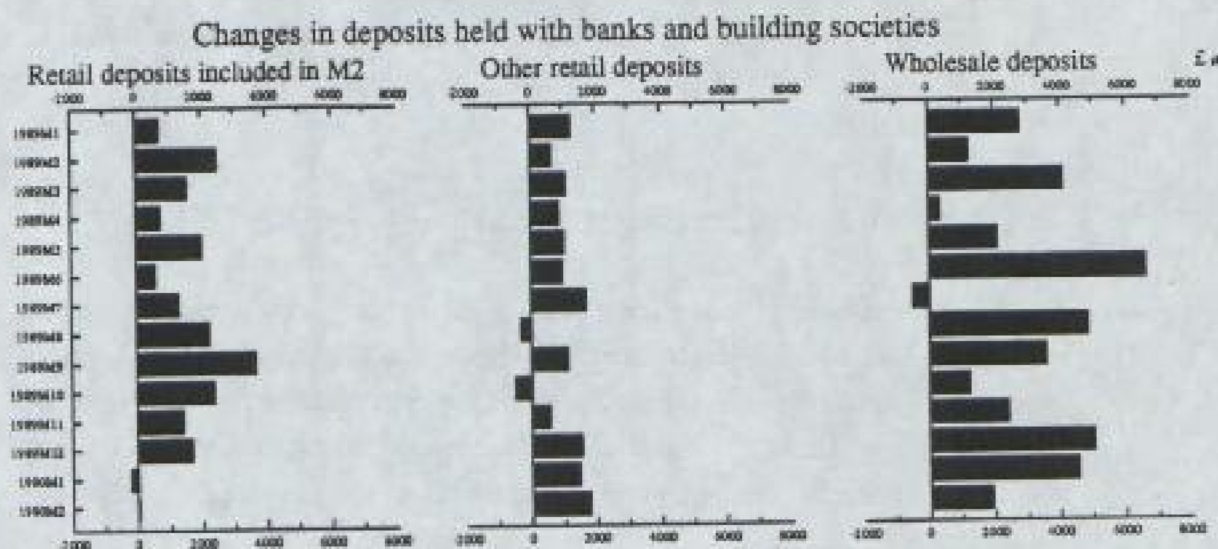
39. Retail deposits in M4 rose by 0.7 per cent in February, in line with the most recent non-end quarter months but below the average increase of the last six (0.9 per cent). Their twelve month growth rate fell to 11.6 per cent (from 12.2 per cent in January), the lowest figure since the first compilation of the series in January 1988. The alternative measure of retail deposits, M2, also slowed in February: its twelve month growth rate fell to 8.3 per cent, the lowest figure since the summer of 1985.

40. The available evidence continues to support the view that the stock of M4 is being switched into less accessible forms and is thus likely to be more firmly held:

- The faster growth of M4 itself than of retail M4 indicates a switch towards larger or more difficult to access deposits. These wholesale deposits' twelve month growth rate rose to 35.4 per cent in February from 34.7 per cent in January. But the wholesale deposit inflow was relatively modest, by recent standards, in February itself: less than £2 billion for only the second time in seven months.

- Retail M4 includes building society retail deposits of over £100,000 or for which more than one month notice of withdrawal is required, which are excluded from M2. Thus the faster growth of retail M4 compared to M2 means that there is a switch within building society retail deposits in favour of larger or less accessible deposits. In February, building societies' M2 deposits fell by £0.9 billion (seasonally adjusted) while their less accessible retail deposits (those included in M4 but not in M2) increased by £1.8 billion).

Chart: Sterling Deposits of UK Residents



The Building Societies' Position

41. Building society net retail inflows in February remained weak, even allowing for inflows of £5-6 million a day to the offshore subsidiaries established recently in anticipation of independent taxation. The announcement of the abolition of CRT in 1991 is likely to slow down or halt the establishment of these subsidiaries. But further switching of building society funds into other investments or offshore into bank subsidiaries may occur.

42. The trend in the composition of building societies retail deposits towards the 'less accessible' end of the spectrum must be putting further pressure on societies' margins (see also para 44): the retail money in the top slice of the market now costs the same as wholesale funding. But the recent rise in retail deposit rates gives the societies a competitive advantage of around ¼ per cent over the banks (the largest differential since December 1987) over a broader band of accounts and it may be that building societies retail inflows will show a marked improvement from now on - especially as societies are likely to offer special inducements in the run up to the 1991 abolition of CRT.

43. Building society total wholesale inflows (only some of which are scored in M4) increased in February by £0.8 billion, the lowest figure since August. Even so the inflow was still large by the standards of 1987 and 1988. It consisted of CDs (£0.6 billion) and Eurobond issues (£0.4 billion) - time deposits fell by just over £0.1 billion.

Building Society Interest Rates

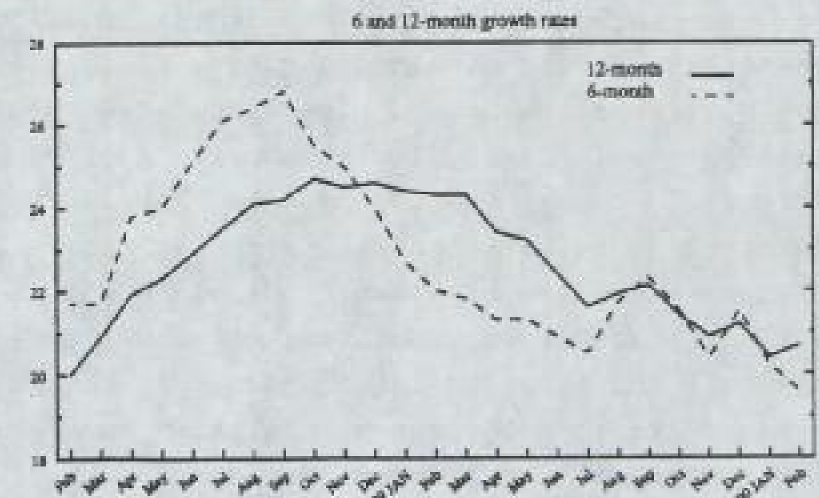
44. The recent rise in mortgage rates and deposit rates has raised building societies' margins slightly, but they still remain under pressure. The gap between base rates and building society (and bank) mortgage rates is still very low compared with the period before mid 1988. The societies are

still hedged in by strong competition. At this stage a further rise in mortgage rates seems unlikely in the absence of a further rise in base rates. But higher base rates would almost certainly prompt higher mortgage rates.

M4 Lending

45. M4 lending rose by 1.4 per cent (seasonally adjusted) in February, a little more than the average increase of the last three non-end quarter months (1.1 per cent) but a little less than in the previous three (1.6 per cent). The twelve month growth rate rose to 20.7 per cent from 20.4 per cent in January. As the chart below shows, its downward trend has flattened off in the last few months, remaining at a high level. The six month growth rate fell to 19.6 per cent in February, while the three month rate rose to 20.7 per cent.

Chart: M4 Lending Growth

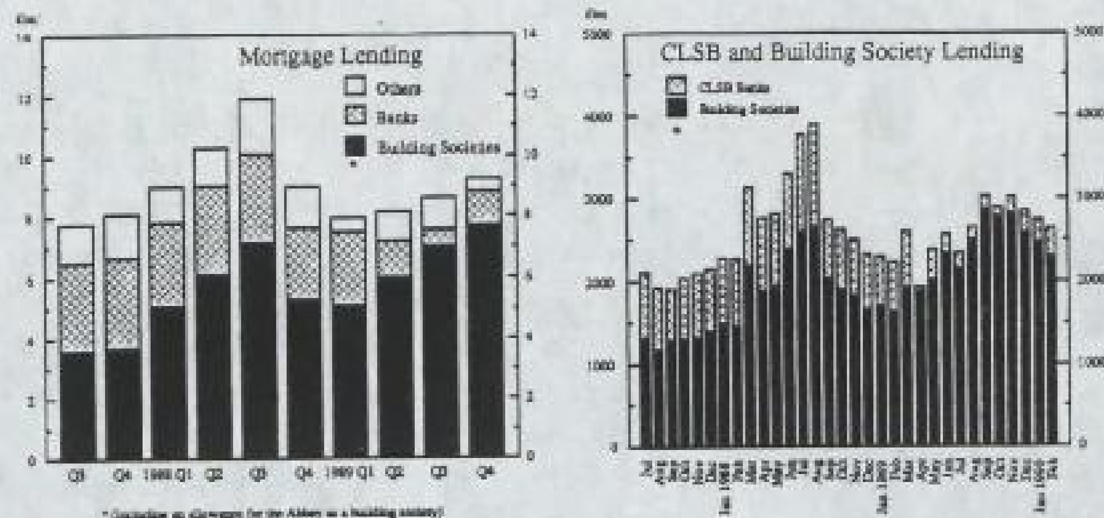


Mortgage Lending

46. Mortgage lending by building societies was £2.0 billion, seasonally adjusted, in February, compared to £2.1 billion in January. This continues the slow fall from the peak reached in September. Lending for house purchase by CLSB banks was over £0.3 billion, continuing the mild increase of the last few months. But this rise did not

offset the fall in building societies' lending, and the total continued to decline.

Chart: The Mortgage Market



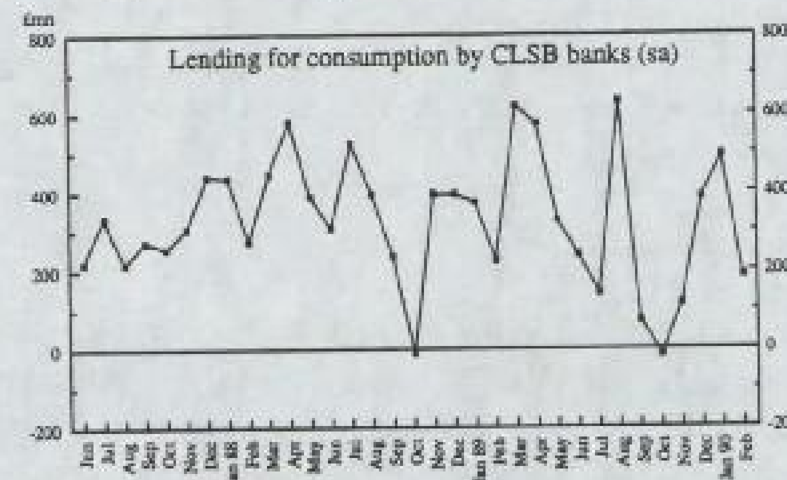
47. New building society commitments rose to £4.1 billion (seasonally adjusted) in February compared to January's £3.6 billion - the first rise since August last year. Such a sharp rise is particularly surprising given the rise in mortgage rates. It probably reflects substantial remortgaging rather than a pick up in the housing market. Perhaps as much as a third of all recent commitments have been for remortgages, compared with about one-fifth in 1989. Some of the remortgaging is "distress borrowing", intended to reduce total outgoings by clearing bank overdrafts and credit card bills and consolidating all debt into mortgages.

Other Lending to Persons

48. Lending for consumption by CLSB banks was £0.2 billion, seasonally adjusted, in February. This was around £¼ billion lower than in December and January, but still higher than in the August to October period of last year. It is still difficult to assess the trend in the series. But it is important to interpret them in the light of the

apparent extensive remortgaging which will artificially depress them. The consumer credit figures show a pick up, with an increase of £¾ billion (seasonally adjusted) in the three months to February, compared with an increase of £½ billion in the previous three months. But latest data on the volume of consumer credit searches shows a decline in the first part of the year over the corresponding period last year.

Chart: Lending for Consumption



Lending to Companies

49. Lending to companies by banks and building societies was probably £4½-£5 billion (seasonally adjusted) much higher than in January (perhaps up to £3 billion). No special factors have been identified which explain this rise. CLSB banks accounted for about half of lending in February: their detailed figures show that lending was once again well spread amongst sectors. Monthly figures are erratic. Nevertheless this development is disturbing, given that a slowdown in company spending is critical to the overall adjustment of the economy. Given the wide sectoral spread of the lending, and the still healthy level of profit margins (albeit lower than early last year), it could reflect some bouyancy in companies spending, rather than distress borrowing.

50. The amount of **sterling commercial paper** outstanding rose £0.3 billion to stand at £4.6 billion at the end of February.

51. UK borrowers announced **total sterling issues** of £1¾ billion in February, the same as in January. The February total consisted of £½ billion equities (mostly by ICCs), nearly £¾ billion floating rate issues and about £½ billion in fixed rate issues (overseas borrowers announced another £½ billion of fixed rate sterling issues). The March figures to date are much lower, with only £0.1 billion of equities announced (all ICCs), £0.2 billion floating rate issues and £0.3 billion of fixed rate sterling issues.

Broad Money Forecast

52. **M4 is** expected to rise by 2 per cent (seasonally adjusted) in March, faster than in February because of the crediting of historically high interest to accounts as the end of the quarter. The twelve month growth rate is expected to be close to 18 per cent. **M4 lending** will also be higher than in February, this time because of interest charged on loans. It is expected to rise by 1¾ per cent (£9 billion) after seasonal adjustment, with its twelve month rate around 20¼-20½ per cent.

Interest Rates and Capital Markets

53. At the time of the last Assessment the one month interest rate was 15.0 per cent, the three month rate 15.2 per cent and the twelve month rate 15.6 per cent. The one month interest rate now stands at 14.9 per cent, the three month rate remains at 15.2 per cent and the twelve month rate is 15.4 per cent.

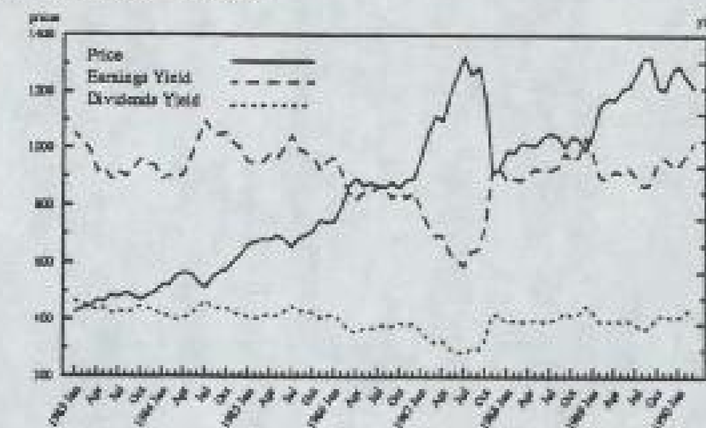
54. **The** yield curve of longer term rates is little changed. **Conventional gilts** began the period with the index at 77.79 and yields on shorts, mediums and longs at

12.7, 12.2, and 11.3 per cent respectively. At the end of the period, the index stood at 77.64 with par yields at 12.7, 12.2, and 11.4 per cent. The index has tracked sterling's movements for most of the period, and moved in sympathy with international bond markets. The market lost ground on the Budget, improved on the inflation figure, weakened on the disturbances in London. The announcements of the fourth conversion offer and the reserve figures had little effect.

55. Real yields on **index linked stock** which began the period at 4.2 per cent for mediums and 4.1 per cent for longs now stand at 4.3 per cent for mediums and 4.2 per cent for longs. **Break even yields** for index-linked Treasury 1992 and 2006 - the average rates of inflation at which indexed and equivalent conventional stocks would yield the same over their lives - have risen a little: they are currently 9.7 per cent and 7.7 per cent compared to 9.7 per cent and 7.6 per cent at the beginning of the period.

56. **UK equity prices** have hardly changed since the last Assessment, falling ½ per cent overall. The dividend yield has risen from 4.7 per cent to 4.9 per cent. Share prices are now 4½ per cent higher than a year ago.

Chart: The FT-500 Index



57. **Unit trusts'** net inflow was £0.3 billion in February, more than twice as high as in January and just below the average monthly increase in 1989.

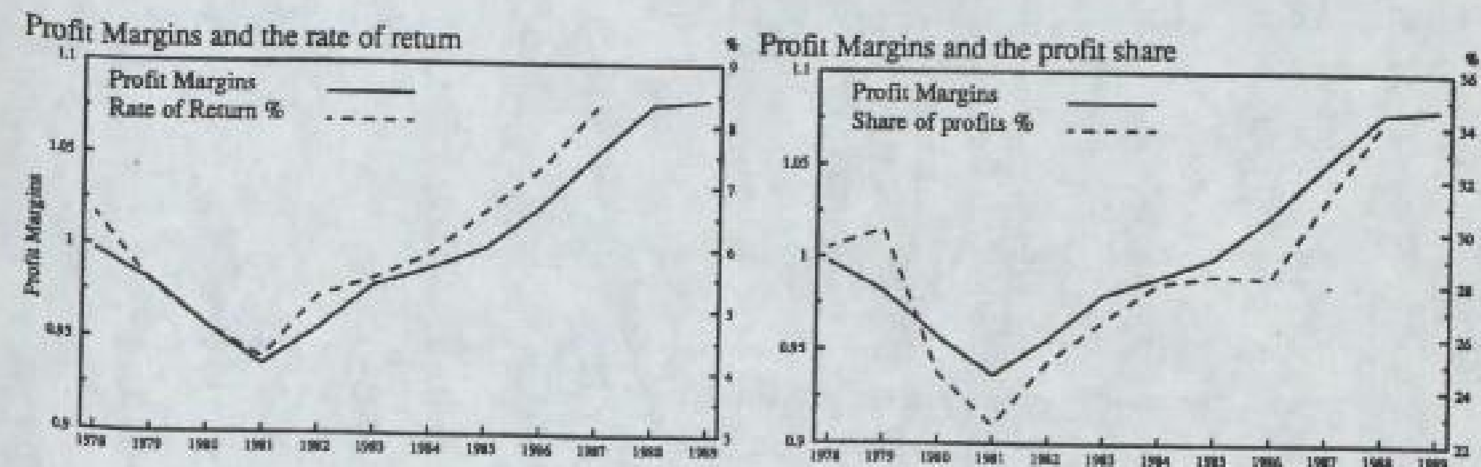
ANNEX: PROFITABILITY IN MANUFACTURING

1. Assessing the current state of profitability is an important part of the assessment of economic conditions. Both the Treasury and the Bank of England have measures of profit margins. A squeeze on margins can be one of the ways in which counter-inflationary policy measures have their effect. This annex describes the Treasury and Bank measures and appraises where the economy now stands.

2. Assessing profitability is difficult. Figures for the rate of return are published on an annual basis about nine months after the end of the year to which they relate. The share of profits in manufacturing output is similarly only available on an annual basis after a considerable interval. While it is possible to construct estimated quarterly versions of these measures, they rely on early estimates of profits which are notoriously subject to revision. The profits of manufacturing firms are not available at all on a quarterly basis.

3. We have to rely instead on constructed measures of profit margins calculated from input and output prices and unit labour costs. Our constructed measure of margins is a good predictor of other measures of profitability, particularly of the rate of return, as the charts below show.

Chart: Measures of Profitability in Manufacturing



4. Profit margins are measured as the ratio of output prices to unit costs. Data are not compiled by the CSO for unit costs and have to be estimated. In the Treasury's measure, which has been used in published forecasts, unit costs are defined as a weighted sum of a wide range input prices as shown in the table below. The weights are derived from a survey of firms' purchases of goods and services of other UK firms and of imports. Although the weights are now a little out of date (they relate to 1984), this is not likely to be a significant source of error: purchasing practices as revealed in the series of surveys are surprisingly stable.

Table: Definition of Unit Costs in Manufacturing

	WEIGHT	PERCENTAGE INCREASE IN 1989Q4 COMPARED WITH 1989Q3	1988Q4
Unit Labour Costs	45	2.2	4.8
Bought-in Services	19	2.0	10.3
Nat. Industry Prices*	6	7.9	4.3
Domestic Oil Prices	2	7.8	57.8
Imported Manufactures	22	0.6	5.3
Imported Basic Materials	1	0.5	9.0
Imported Services	1	2.7	13.1
Imported Foods, etc	1	3.6	8.0
Imported Fuels	1	7.1	43.8
Taxes	3	1.4	7.8
Total Costs	100	2.1	6.5

* includes also industrial gas prices.

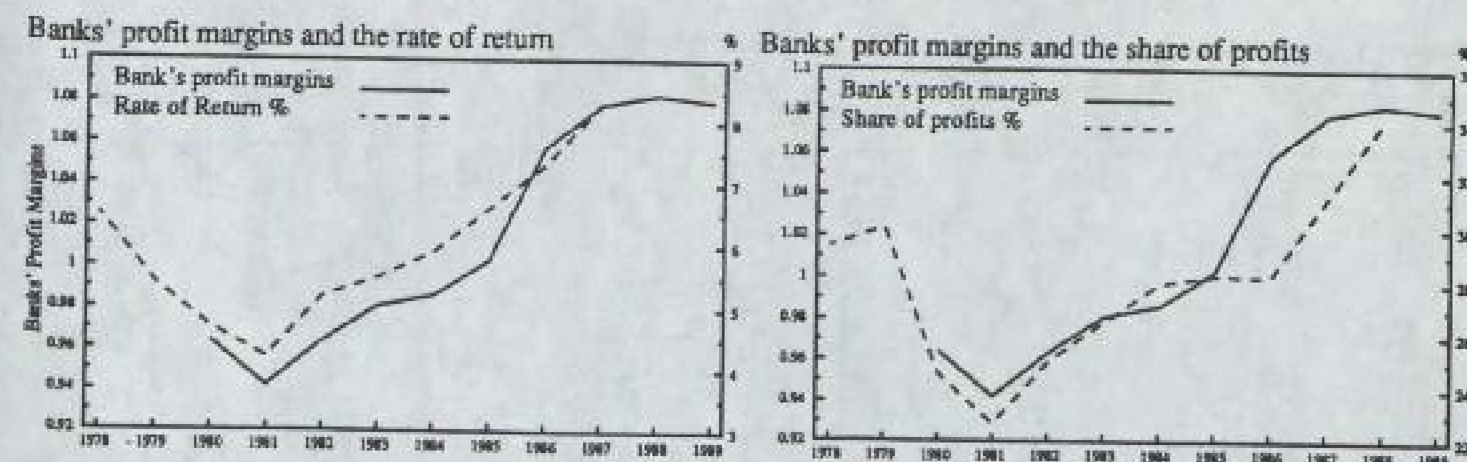
5. The direct unit labour costs of manufacturers themselves account for nearly half of total unit costs. As the costs of bought-in services (construction, catering, cleaning, design and advertising, legal advice etc) are proxied by the unit labour

costs in the non-manufacturing sector, labour costs as a whole, both direct and indirect, account for nearly two thirds of total costs.

6. The other major item is the cost of imported manufactures, which includes both semi-manufacturers (like bulk chemicals) and finished manufacturers (like car batteries and tyres, computer chips and other manufactured components of manufactured goods). The remaining items, accounting for around 15 per cent of total costs, are mainly fuels and unprocessed basic materials.

7. The Bank of England measure of costs, while broadly similar to the Treasury's differs significantly in that it uses the CSO's measure of the prices of materials and fuels (ie producer input prices) instead of the various individual input prices. Because producer input prices exclude the prices of all manufactured inputs, the Bank measure neglects any influence on UK manufacturers costs from changes in the prices of any manufactured components they may import.

Chart: Bank Measure of Profit Margins and the Rate of Return



8. Both the Treasury and the Bank measures use the producer price of manufacturers as the measure of the selling price of manufacturers. Producer prices have risen by 5.8 per cent over the last year by 2.0 per cent over the last three months - the

recent high rise reflects to some extent the annual revision of many firms' price lists in January.

9. The charts below show the quarterly path of the Treasury's measure of margins. The raw series is rather erratic and subject to seasonal influences. The latter arise because:

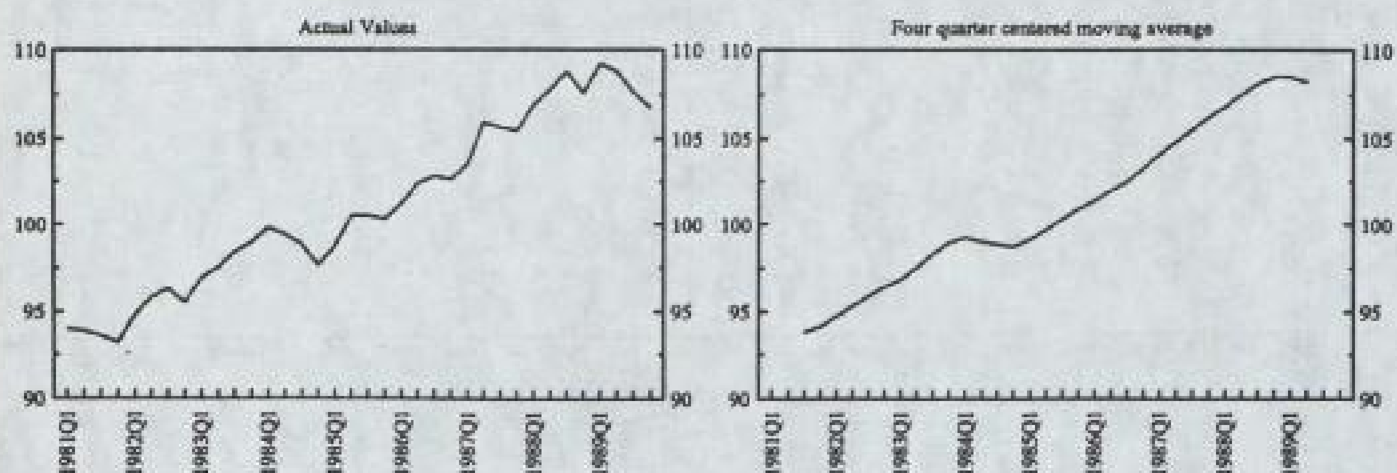
- output (selling) prices rise sharply in January of each year as firms adjust price lists;

- the prices of electricity and coal vary over the year, being much higher in the winter than in the summer [(this would affect the Bank measure much more than the Treasury measure given the greater implicit weight of electricity prices in total costs)];

- unit labour costs vary seasonally reflecting the wage round and variations in productivity.

A centred four quarter moving average is shown on the right hand panel. This both smooths away some of the erratic fluctuations in the series and, crudely, corrects for the seasonality.

Chart: Quarterly Path of Profit Margins



10. For several years calculated profit margins have shown a strong upward trend. The only interruptions to this have occurred

in 1985 and over the last few quarters. Both are periods in which output growth has slowed in response to tighter policy. Weak demand has meant that firms have not been able to pass on higher costs. It looks likely that margins peaked at the beginning of last year and have been declining since then. The measure's good track record suggests the observed slowdown in margins will in due course be reflected in the rate of return when it is eventually calculated.

Future Prospects

11. The FSBR forecast shows profit margins in manufacturing falling by 2 per cent in 1990, having risen slowly, by only ¼ per cent, in 1989. Margins are thought to have peaked in the first quarter of last year and are expected to fall steadily until the fourth quarter of this year to a level around 3½ per cent below the peak. Given the likely trends in costs, it is important that margins continue to fall this year if producer price inflation is to meet the 5¼ per cent FSBR forecast for the fourth quarter: if margins fail to fall, then, other things equal, producer price inflation will turn out at about 6½ per cent.

Chart: Prices, Costs and Margins

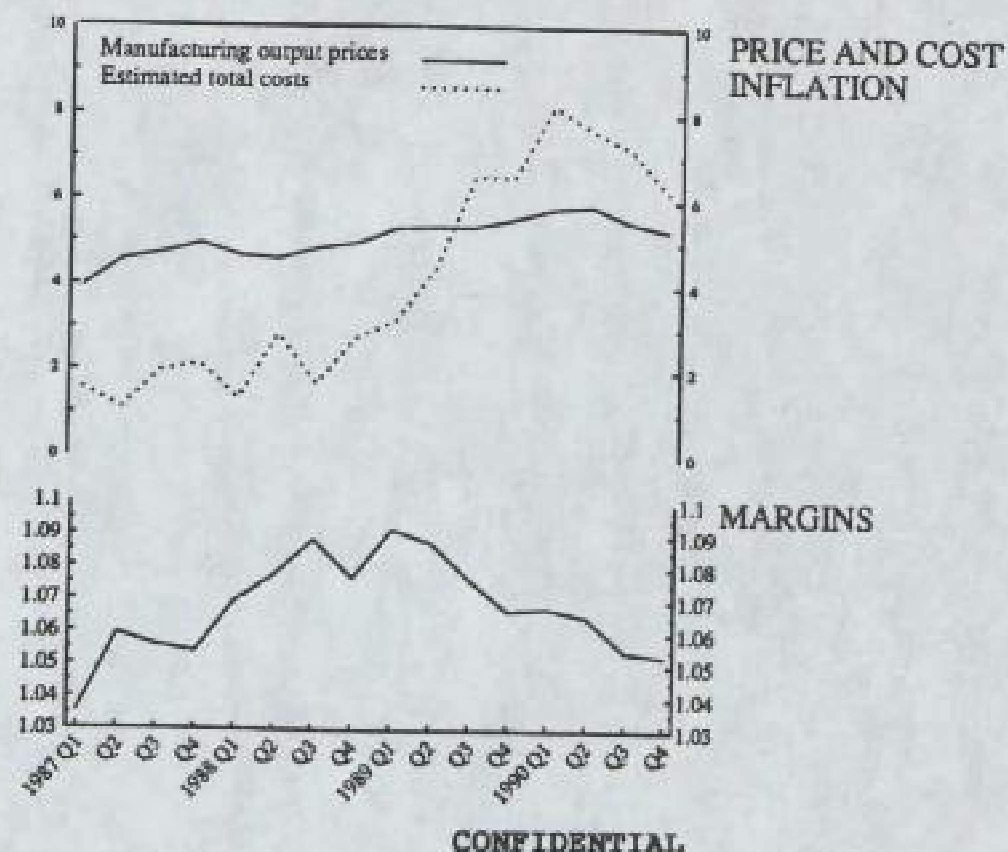


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Table 1

GERMANY KEY FIGURES

		Industrial Production index (1)	Consumer Prices	Trade Surplus (2) $bn	Money Supply M3	Money Supply Broad Money (3)
1984		3.0	2.4	1.6		
1985		5.0	2.2	2.1		
1986		1.7	-0.1	4.3		
1987		0.3	0.2	5.5	7.3	6.9
1988		3.7	1.3	6.1	7.2	6.7
1989		4.8	2.8	6.0	7.1	6.6
1987	Q1	-1.1	-0.6	5.3	7.5	
	Q2	0.6	0.1	5.4	8.0	
	Q3	-0.2	0.5	5.2	7.2	
	Q4	1.8	0.9	6.2	6.6	
1988	Q1	3.2	1.0	5.1	6.0	
	Q2	2.3	1.2	6.7	6.4	
	Q3	4.7	1.3	6.0	6.4	
	Q4	4.4	1.7	6.6	6.8	
1989	Q1	4.8	2.4	6.6	6.9	8.7
	Q2	4.6	2.9	5.8	5.9	8.3
	Q3	5.1	2.8	6.2	5.5	8.2
	Q4	4.7	3.0	5.3	4.6	8.3
1988	Jul	3.2	1.2	6.3 (5.9)	6.3	
	Aug	5.4	1.2	6.6 (6.2)	6.2	
	Sep	5.5	1.5	5.3 (6.3)	6.7	
	Oct	3.9	1.5	6.2 (6.3)	6.5	
	Nov	4.0	1.7	7.1 (6.6)	6.7	
	Dec	5.6	1.8	6.4 (6.3)	7.0	
1989	Jan	5.4	2.3	6.8 (6.4)	7.2	8.5
	Feb	4.1	2.5	6.5 (6.4)	6.8	8.7
	Mar	4.7	2.6	6.4 (6.6)	6.7	8.9
	Apr	7.5	2.9	5.8 (6.5)	6.4	8.6
	May	2.3	2.9	5.1 (6.2)	6.0	8.2
	June	4.4	2.9	6.4 (6.2)	5.4	8.2
	July	8.1	2.8	6.0 (6.0)	5.6	8.6
	Aug	3.2	2.8	6.9 (6.1)	5.8	8.0
	Sep	4.4	2.9	5.8 (6.0)	5.1	8.0
	Oct	4.6	3.1	5.3 (5.9)	5.0	8.6
	Nov	4.5	2.9	5.4 (6.0)	4.4	8.1
	Dec	4.6	3.0	5.2 (5.8)	4.5	8.3
1990	Jan	4.6	2.7	8.0 (6.1)	4.5	
	Feb		2.5			
Forecast (4)					Target	
1990		5	2	6½	4-6 (5.9)	
1991		4	2	6½		

1 Percentage change on a year earlier.
2 Yearly and quarterly figures are monthly averages. Monthly figures in brackets are 6 month moving averages.
3 Aggregate comprised of M3 plus marks held on deposit at foreign branches and subsidiaries of German banks.
4 FSBR.

* provisional.
** Bracketed figure is growth over target period; Q4 1989 to latest month at an annual rate compared with target for 1990 of 4-6 per cent.

Table 2: Developments and prospects in the G7 countries*

	Activity			Money supply		Costs and prices		
	Nominal GNP	Real GNP	Industrial production	M1	M3**	Unit labour costs	Consumer*** prices	GNP deflator
1984	9.2	4.8	8.2	7.0	9.0	-0.3	4.4	4.2
1985	7.1	3.3	2.8	8.5	8.7	1.8	3.8	3.7
1986	6.1	2.6	1.0	11.0	8.3	2.3	2.0	3.4
1987	6.6	3.5	3.3	11.3	8.5	-0.5	2.8	3.0
1988	7.8	4.5	6.0	6.7	8.3	-0.1	3.2	3.2
1989			3.8				4.3	
1987 Q1	5.6	2.4	1.1	13.6	8.7	-1.4	1.7	3.1
Q2	6.0	2.8	2.4	12.9	8.8	0.2	2.8	3.1
Q3	6.8	3.8	4.1	10.6	8.4	-0.2	3.1	2.9
Q4	7.9	4.8	5.6	8.5	8.2	+0.9	3.4	2.9
1988 Q1	8.1	5.3	6.4	7.1	8.1	-1.4	3.0	2.7
Q2	7.7	4.6	6.3	6.6	8.2	-0.2	2.9	3.0
Q3	7.9	4.4	6.2	6.9	8.5	-0.3	3.2	3.4
Q4	7.4	3.6	5.3	6.6	8.4	+0.8	3.5	3.7
1989 Q1	7.9	3.7	4.8	7.1	8.2	0.6	4.0	4.0
Q2	7.8	3.5	4.5	4.5	7.5	0.6	4.7	4.1
Q3	7.2	3.3	3.3	3.5	7.2	1.9	4.4	3.8
Q4			2.6				4.3	
1988 Jan			6.9	7.1	7.9		3.1	
Feb			6.2	7.1	8.1		2.9	
Mar			5.9	7.0	8.3		2.9	
Apr			6.4	6.7	8.2		2.9	
May			6.0	6.4	8.1		2.9	
Jun			6.2	6.8	8.3		3.0	
Jul			5.8	7.6	8.7		3.2	
Aug			6.4	6.7	8.4		3.2	
Sep			6.4	6.6	8.4		3.3	
Oct			4.8	6.2	8.3		3.4	
Nov			5.6	6.1	8.3		3.5	
Dec			5.6	7.3	8.6		3.6	
1989 Jan			5.0	7.0	8.2		3.9	
Feb			4.3	7.1	8.2		4.0	
Mar			5.0	7.1	8.2		4.1	
Apr			5.0	5.6	7.8		4.5	
May			4.1	4.4+	7.3		4.8	
Jun			4.3	3.4+	7.4		4.7	
Jul			3.7	5.1	7.3		4.6	
Aug			3.4	5.4	7.2		4.3	
Sep			2.9	3.5	7.2		4.2	
Oct			2.9	3.3	6.9		4.4	
Nov			2.4		6.8+		4.3	
Dec			2.4				4.3	
1990 Jan							4.7	
Feb							4.9	
Forecast++								
1990	6¼	2¾	2¼				4½	3½
1991	6¼	2¾	3				3¾	3½

* Percentage changes on a year before.
** M2 + CDs for Japan, M4 for UK.
*** 1988 consumption weights.
\+ Partly estimated
\++ FSBR

TABLE 3

THREE MONTH INTEREST RATES

	United States	Japan	Germany	France	UK	G7
1983	9.1	6.7	5.8	12.5	10.1	9.3
1984	10.4	6.5	6.0	12.2	9.9	9.7
1985	8.1	6.6	5.4	10.0	12.2	8.5
1986	6.5	5.1	4.6	7.7	10.9	7.1
1987	6.9	4.2	4.1	8.3	9.7	6.8
1988	7.7	4.5	4.3	7.9	10.3	7.3
1989	9.1	5.4	7.1	9.3	13.9	9.0
1987 Jan	5.9	4.3	4.5	8.6	11.1	6.6
Feb	6.1	4.2	4.0	8.5	10.9	6.6
Mar	6.2	4.2	4.0	8.0	10.0	6.4
Apr	6.5	4.1	3.9	7.8	9.8	6.5
May	7.0	3.8	3.8	8.2	8.8	6.6
June	7.0	3.9	3.7	8.3	8.9	6.6
July	6.7	4.0	3.8	7.8	9.2	6.6
Aug	6.8	4.0	4.0	7.8	10.0	6.7
Sept	7.4	4.2	4.0	7.8	10.2	7.1
Oct	8.0	4.8	4.7	8.3	9.9	7.5
Nov	7.2	4.3	3.9	8.8	9.0	6.9
Dec	7.7	4.5	3.7	8.6	8.8	7.0
1988 Jan	6.9	4.3	3.4	8.3	8.9	6.6
Feb	6.6	4.3	3.3	7.7	9.2	6.5
Mar	6.6	4.4	3.4	8.0	8.9	6.5
Apr	6.9	4.2	3.4	8.1	8.3	6.6
May	7.2	4.2	3.5	7.9	8.0	6.7
June	7.5	4.4	3.9	7.4	8.9	6.9
July	7.9	4.7	4.9	7.4	10.5	7.4
Aug	8.4	4.3	5.3	7.7	11.4	7.8
Sep	8.2	5.0	5.0	8.0	12.1	7.8
Oct	8.4	4.7	5.1	8.0	12.1	7.8
Nov	8.8	4.4	4.9	8.1	12.3	8.0
Dec	9.3	4.5	5.3	8.5	13.2	8.4
1989 Jan	9.3	4.6	5.7	8.5	13.1	8.5
Feb	9.6	4.7	6.5	9.2	13.0	8.9
Mar	10.1	4.8	6.6	9.1	13.0	9.2
Apr	10.0	4.7	6.4	8.8	13.2	9.0
May	9.6	5.0	7.0	8.9	13.1	9.0
June	9.2	5.4	7.0	9.0	14.1	9.0
July	8.8	5.5	7.1	9.2	13.9	8.9
Aug	8.7	5.4	7.0	9.0	13.8	8.8
Sept	8.8	5.6	7.4	9.2	14.0	9.0
Oct	8.7	6.1	8.1	9.9	15.0	9.2
Nov	8.4	6.8	8.3	10.5	15.1	9.3
Dec	8.3	6.7	8.1	10.7	15.1	9.3
Jan	8.2	7.0	8.3	11.3	15.2	9.4
Feb	8.2	7.2	8.3	11.0	15.1	9.4
Mar	8.4	7.5	8.5	10.6	15.4	9.6
Apr 5	8.4	7.3	8.2	10.2	15.2	9.4

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

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TABLE 4

EFFECTIVE EXCHANGE RATE INDICES (1985 = 100)*

	United States	Japan	Germany	France	UK	YEN/$	DM/$
1980	68.4	76.3	97.1	129.9	117.7	225.8	1.82
1981	76.6	87.5	92.4	120.5	119.1	219.5	2.25
1982	85.5	83.0	97.4	111.1	113.7	248.8	2.43
1983	89.7	91.8	101.1	103.3	105.3	237.4	2.55
1984	96.8	97.9	100.0	99.0	100.6	237.5	2.85
1985	100.0	100.0	100.0	100.0	100.0	238.3	2.94
1986	85.2	124.4	108.8	102.8	91.6	168.3	2.17
1987	70.3	133.2	115.4	103.0	90.1	144.7	1.80
1988	66.0	147.4	114.6	100.8	95.5	130.4	1.74
1987 Q1	72.6	127.5	115.7	103.6	86.7	153.2	1.84
Q2	70.1	135.0	114.9	102.9	90.5	142.6	1.81
Q3	71.3	132.3	114.6	102.7	90.4	147.0	1.84
Q4	67.0	137.9	116.4	102.7	92.8	134.0	1.71
1988 Q1	64.9	144.6	116.2	102.4	93.4	128.1	1.68
Q2	64.5	148.0	114.9	101.4	96.8	125.7	1.71
Q3	68.7	145.5	113.2	100.0	95.2	133.6	1.86
Q4	65.7	151.4	114.0	99.4	96.6	134.0	1.71
1989 Q1	67.2	150.2	112.6	98.8	97.1	128.5	1.85
Q2	70.4	143.5	112.4	99.2	93.7	138.0	1.93
Q3	70.8	138.8	112.8	99.6	91.7	142.2	1.92
Q4	69.2	135.1	116.3	101.5	88.0	143.1	1.81
1987 Oct	69.8	133.8	114.9	102.7	91.4	143.3	1.80
Nov	66.5	137.4	117.0	102.5	93.2	135.3	1.68
Dec	64.5	142.5	117.2	102.9	93.6	123.4	1.65
1988 Jan	64.5	144.2	116.7	103.0	92.9	127.9	1.65
Feb	65.6	144.4	116.0	102.4	92.2	129.2	1.70
Mar	64.5	145.2	115.9	101.8	95.3	127.1	1.68
Apr	63.8	147.4	115.5	101.5	97.2	124.9	1.67
May	64.1	148.3	115.0	101.4	97.7	124.8	1.69
Jun	65.9	148.3	114.2	101.3	95.4	127.4	1.76
Jul	68.1	145.3	113.3	100.6	94.8	133.1	1.85
Aug	69.1	146.3	112.7	99.5	96.0	133.7	1.89
Sept	69.0	145.1	113.6	99.7	94.8	134.5	1.87
Oct	67.1	149.1	113.7	99.8	95.7	128.9	1.82
Nov	65.2	152.7	114.3	98.9	96.4	123.1	1.75
Dec	64.8	152.3	113.9	99.5	97.7	123.5	1.76
1989 Jan	66.7	150.9	112.6	98.7	97.9	127.4	1.84
Feb	67.0	151.1	112.4	98.1	97.5	127.6	1.85
Mar	67.9	148.8	112.6	99.3	95.9	130.4	1.87
Apr	68.2	147.1	112.8	99.6	95.4	132.0	1.87
May	70.6	143.9	112.1	99.0	94.3	138.0	1.95
June	72.4	139.3	112.4	98.9	91.3	144.1	1.98
July	70.0	139.5	113.3	99.6	92.3	140.4	1.89
Aug	70.6	139.8	112.6	99.5	91.6	141.2	1.93
Sep	71.7	137.1	112.6	99.6	91.3	145.1	1.95
Oct	69.9	137.5	114.7	100.6	89.7	142.2	1.87
Nov	69.6	135.2	115.9	101.3	87.0	143.5	1.83
Dec	68.1	132.4	118.3	102.6	86.5	143.7	1.74
1990 Jan	67.2	129.2	119.0	103.6	87.9	145.0	1.69
Feb	67.1	127.8	118.9	103.7	89.6	145.6	1.68
Mar	68.5	122.6	118.9	104.4	87.0	153.2	1.71
Apr 5	68.7	118.9	118.9	104.8	87.9	157.6	1.70
% Change since dollar peak (Feb 85)	- 39.3	19.7	22.7	8.4	- 3.3	-39.6	-50.5
% Change since Plaza (Sept 85)	- 30.5	7.7	17.0	3.9	-15.8	-34.9	-41.4
% Change since Louvre Accord (Feb 87)	- 5.4	- 6.3	2.4	0.8	2.7	2.6	- 7.0

* Effective exchange rate indices calculated on basis of IMF index (1985=100)

TABLE 5

ECONOMIST COMMODITY PRICE INDICES 1985=100

	All items indices				SDR indices			BRENT OIL
Annual	SDR	Dollar	Sterling	Real*	Food	Nfa**	Metals	
1981	99.3	115.2	73.5	105.3	93.7	104.7	106.2	
1982	91.8	99.9	73.4	94.3	89.3	96.0	93.8	
1983	107.2	112.7	95.7	110.4	102.0	116.6	110.1	
1984	110.3	111.5	107.2	113.1	112.3	111.6	106.2	
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	
1986	89.8	103.7	90.6	86.4	92.4	89.9	85.4	
1987	87.4	111.5	87.1	82.2	73.0	103.3	100.6	
1988	111.4	147.4	106.3	103.3	85.7	109.6	156.2	
Quarterly								
1988 Q1	99.8	134.6	95.9	93.9	77.6	105.5	133.4	15.85
Q2	115.5	155.7	108.8	109.1	84.0	115.1	169.1	16.35
Q3	116.4	148.8	112.4	111.7	92.9	114.0	157.9	14.47
Q4	113.7	150.3	107.9	107.7	88.3	103.6	164.4	13.50
1989 Q1	118.0	153.0	112.1	112.5	90.4	107.1	172.4	16.70
Q2	114.8	143.6	113.2	107.1	91.3	108.8	158.9	17.98
Q3	107.8	133.5	107.2		83.1	111.7	147.1	17.27
Q4	100.9	127.5	103.1		77.7	107.9	135.3	18.89
1990 Q1	95.7	124.1	96.1		76.9	106.3	120.1	19.52
Monthly								
December	117.3	156.4	110.1		89.5	101.7	175.5	14.92
January	119.9	156.8	113.2		90.4	107.1	179.0	16.25
February	116.3	150.6	110.2		89.3	106.2	169.2	16.03
March	117.7	151.6	112.9		91.6	108.0	169.0	17.82
April	115.6	148.1	111.4		90.8	107.0	163.8	19.03
May	116.3	145.3	114.5		92.1	108.5	163.0	17.75
June	112.4	137.3	113.6		91.0	110.8	150.0	17.17
July	100.4	134.7	106.8		86.2	112.0	132.0	17.33
August	107.8	134.2	107.2		81.6	111.0	150.5	16.81
September	107.4	131.7	107.6		81.4	112.1	148.2	17.68
October	104.3	130.9	105.8		78.3	109.1	145.2	18.56
November	101.8	128.0	104.4		79.3	108.7	135.0	18.65
December	96.5	123.5	99.0		75.5	105.8	125.6	19.45
January	93.1	121.0	94.0		75.2	104.8	115.2	20.27
February	93.1	121.7	91.9		75.5	106.0	113.8	19.66
March	100.9	129.5	102.4		80.1	108.0	131.4	18.63
Weekly								
Mar 6	99.1	128.0	99.5		79.1	107.6	127.1	19.38
Mar 13	101.1	129.2	103.5		80.4	107.2	131.9	18.65
Mar 20	102.0	131.3	104.5		80.3	107.6	134.8	18.10
Mar 27	101.5	129.4	102.0		80.5	109.5	131.7	18.38
Apr 3(prov)	102.2	130.6	102.3		80.4	110.0	133.6	18.60
% ch. on one yr	-10.5	-11.0	-7.1		-11.2	1.2	-15.6	-6.50

* In relation to prices of manufactured exports. Recent figures are estimated.

30/03/90

TABLE 6

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

	OUTPUT AND ACTIVITY					PRICES AND UNIT LABOUR COSTS					
								PRODUCER PRICES **		UNIT WAGE COSTS	
	MONEY GDP		GDP(O)	MANUFACTURING OUTPUT	RETAIL SALES *	RPI	RPI EXCL. MORTGAGE PAYMENTS	OUTPUT	INPUT	MANUFACTURING	WHOLE ECONOMY
1985-86	9.3	1986	3.0	0.9	5.3	3.4	3.6	4.1	-10.5	4.5	5.5
1986-87	7.2	1987	4.9	5.6	5.9	4.2	3.7	4.4	5.0	1.3	4.1
1987-88	10.8	1988	4.6	7.0	6.9	4.9	4.6	4.8	4.8	2.9	6.8
1988-89	10.9	1989	2.7	4.8	2.2	7.8	5.9	5.4	5.3	4.5	N/A
1986 Q1	7.6		2.6	-1.5	4.7	4.9	4.6	4.8	-11.3	8.1	6.1
1986 Q2	6.3		1.9	-1.2	4.9	2.8	3.3	4.0	-13.5	6.5	6.9
1986 Q3	7.0		3.4	1.0	5.3	2.6	3.3	3.8	-11.8	3.6	4.6
1986 Q4	7.8		4.1	5.1	6.2	3.4	3.4	3.7	-5.0	-0.4	4.5
1987 Q1	7.9		4.0	4.0	5.0	3.9	3.7	3.8	-0.7	1.0	3.7
1987 Q2	9.3		4.7	6.2	5.8	4.2	3.7	4.4	5.4	-0.1	3.5
1987 Q3	10.9		5.3	7.1	6.5	4.3	3.6	4.5	10.8	1.2	4.0
1987 Q4	11.4		5.3	5.5	6.3	4.1	4.0	4.8	5.1	3.4	5.1
1988 Q1	11.7		5.8	7.9	8.3	3.5	3.7	4.7	3.6	2.0	6.1
1988 Q2	11.1		4.8	6.1	7.0	4.3	4.4	4.7	6.2	4.4	6.5
1988 Q3	11.1		4.3	7.5	6.5	5.5	5.1	4.8	4.2	2.4	6.9
1988 Q4	11.1		3.6	6.7	5.8	6.5	5.2	5.0	5.1	3.3	7.7
1989 Q1	10.9		3.4	7.1	3.7	7.7	5.6	5.3	7.0	3.0	8.6
1989 Q2	10.3		2.7	5.9	2.9	8.2	6.0	5.4	6.2	3.7	9.0
1989 Q3	8.2		2.1	3.3	1.2	7.7	5.8	5.4	3.6	6.1	10.2
1989 Q4	7.7		2.4	3.1	1.1	7.6	6.1	5.6	4.5	5.1	N/A
		1988 JUNE		7.0	7.0	4.6	4.7	4.7	7.4	2.7	
		JULY		7.5	7.6	4.8	5.0	4.8	4.7	2.4	
		AUGUST		6.0	6.9	5.7	5.0	4.8	3.9	3.4	
		SEPTEMBER		8.9	6.4	5.9	5.2	4.9	3.9	0.9	
		OCTOBER		6.2	6.1	6.4	5.1	5.0	3.5	2.7	
		NOVEMBER		7.3	5.7	6.4	5.1	5.0	5.6	2.5	
		DECEMBER		6.7	5.7	6.8	5.1	4.9	6.3	2.7	
		1989 JANUARY		7.1	4.4	7.5	5.5	5.3	7.2	3.1	
		FEBRUARY		8.2	4.0	7.8	5.7	5.3	6.2	2.8	
		MARCH		6.1	3.7	7.9	5.7	5.4	7.5	3.0	
		APRIL		7.1	3.8	8.0	5.9	5.3	7.7	3.0	
		MAY		6.1	3.9	8.3	6.0	5.4	7.1	3.3	
		JUNE		4.6	2.9	8.3	5.9	5.4	4.0	4.5	
		JULY		3.8	2.2	8.2	5.8	5.3	2.8	5.7	
		AUGUST		4.1	1.1	7.3	5.7	5.4	3.2	5.2	
		SEPTEMBER		1.9	1.1	7.6	5.8	5.5	4.8	7.6	
		OCTOBER		3.8	1.2	7.3	6.1	5.5	4.5	4.9	
		NOVEMBER		3.1	1.1	7.7	6.1	5.6	4.8	5.2	
		DECEMBER		2.4	1.0	7.7	6.1	5.7	4.2	5.4	
		1990 JANUARY		0.2	1.5	7.7	6.1	5.6	2.2	7.3	
		FEBRUARY			2.1	7.5	6.2	5.8	0.9		

* Monthly figures show three months on a year earlier
** Excluding food, drink and tobacco

Table 7

BUSINESS CONFIDENCE SURVEYS

NOT FOR USE - SEASONALLY ADJUSTED

		CBI INDUSTRIAL TRENDS SURVEYS (percent balances)					EUROSTAT EC GALLUP CONSUMER CONFIDENCE
		TOTAL ORDER BOOK	EXPORT ORDER BOOK	EXPECTED OUTPUT	EXPECTED PRICES	STOCKS	
1987	A	3	-4	24	23	5	4
	M	5	-2	28	30	0	6
	J	4	8	35	26	-1	10
	J	9	7	28	24	1	9
	A	11	9	38	26	-1	8
	S	11	6	31	26	3	5
	O	15	6	28	24	-7	8
	N	13	9	39	27	-5	55
	D	15	4	30	25	2	3
1988	J	22	8	31	29	-1	7
	F	16	8	30	27	-2	3
	M	16	6	31	24	1	5
	A	16	5	30	28	2	5
	M	16	3	31	20	-3	8
	J	16	1	28	28	-1	9
	J	17	3	33	28	1	7
	A	17	1	32	27	0	2
	S	17	4	32	32	0	-2
	O	15	2	28	33	1	-5
	N	15	-6	28	32	6	-4
	D	11	-5	26	31	1	-12
1989	J	8	-7	22	26	7	-12
	F	-1	-11	20	27	6	-11
	M	2	-13	16	27	9	-15
	A	3	-4	14	27	12	-16
	M	-9	-10	15	27	8	-11
	J	-3	-14	11	28	9	-16
	J	-2	-12	20	31	9	-17
	A	-4	-1	11	30	11	-14
	S	-6	-8	0	27	9	-14
	O	-9	-8	7	30	13	-27
	N	-16	-16	3	20	14	-25
	D	-14	-7	3	24	15	-24
1990	J	-15	2	5	26	14	-18
	F	-21	-3	-5	22	10	-23
	M	-25	0	-5	24	16	-33

TABLE 8: Forecasts for real GDP and RPI growth

Percentage increases on a year earlier

	HMT		OUTSIDE FORECASTS	
	latest internal forecast	latest published forecast	Non-City average (2)	City average
GDP: 1990 (f) (1)		1.0	1.6	1.2
RPI: 1990 Q4 (f)		7 1/4	5.8	5.4
1989 Jan	7.5			
Feb	7.8			
Mar	7.9			
Apr	8.0			
May	8.3			
Jun	8.3			
Jul	8.2			
Aug	7.3			
Sep	7.6			
Oct	7.3			
Nov	7.7			
Dec	7.7			
1990 Jan	7.7			
Feb	7.5			
Mar (f)	8.1			

(f) forecast
(1) 1985 prices, at factor cost
(2) Average of NIESR, LBS, DRI, IMF, Henley, Cambridge Econometrics, Liverpool, CBI, OECD, Oxford, EC

TABLE [illegible]: INDICATORS OF FISCAL STANCE

	PSBR		PSBR EXCLUDING PRIVATISATION PROCEEDS		PSFD	
	Cash £ billion	Ratio to GDP (per cent)	Cash £ billion	Ratio to GDP (per cent)	Cash £ billion	Ratio to GDP (per cent)
1970-71	0.8	1.5	0.8	1.5	-0.2	-0.4
1971-72	1.0	1.6	1.0	1.6	0.7	1.2
1972-73	2.4	3.6	2.4	3.6	2.0	3.0
1973-74	4.3	5.8	4.3	5.8	3.5	4.6
1974-75	8.0	9.0	8.0	9.0	6.0	6.7
1975-76	10.3	9.2	10.3	9.2	8.1	7.3
1976-77	8.3	6.4	8.3	6.4	7.4	5.7
1977-78	5.4	3.6	5.9	3.9	6.6	4.4
1978-79	9.2	5.3	9.2	5.3	8.3	4.8
1979-80	9.9	4.8	10.3	4.9	8.1	3.9
1980-81	12.5	5.3	12.7	5.4	11.6	4.9
1981-82	8.6	3.3	9.1	3.5	5.5	2.1
1982-83	8.9	3.1	9.4	3.3	8.5	3.0
1983-84	9.7	3.1	10.8	3.5	11.7	3.8
1984-85	10.1	3.1	12.2	3.7	13.4	4.0
1985-86	5.6	1.6	8.4	2.3	7.7	2.1
1986-87	3.6	0.9	8.0	2.1	8.0	2.1
1987-88	-3.4	-0.8	1.7	0.4	0.6	0.1
1988-89	-14.5	-3.0	-7.4	-1.6	-8.7	-1.8
1989-90						
FSBR forecast	-13.8	-2.75	-8.8	-1.75	-7.3	-1.5
AS forecast	-12.6	-2.5	-8.3	-1.5	-6.8	-1.25

(b) Quarterly Data

£ billion		PSBR		PSBR excluding privatisation		PSFD	
		sa*	ua	sa*	ua	sa+	ua
1986	Q2	2.1	2.5	3.2	3.6	1.7	3.3
	Q3	1.8	3.6	1.8	3.6	3.0	3.8
	Q4	-0.6	-1.7	1.6	0.5	1.3	-0.9
1987	Q1	0.2	-0.8	1.4	0.3	2.0	1.8
	Q2	0.0	1.4	2.4	3.8	1.3	2.9
	Q3	-0.2	0.5	1.4	2.1	0.2	1.0
	Q4	-1.7	-2.5	-0.5	-1.3	0.1	-2.2
1988	Q1	-1.5	-2.8	-1.5	-2.8	-0.7	-1.2
	Q2	-2.7	-1.7	0.0	1.0	-1.2	0.7
	Q3	-3.4	-2.1	-1.2	0.1	-2.7	-1.7
	Q4	-4.2	-5.0	-3.0	-3.9	-1.9	-4.3
1989	Q1	-4.3	-5.7	-3.3	-4.7	-2.9	-3.3
	Q2	-1.1	0.0	0.7	1.7	-0.8	0.8
	Q3	-1.7	-0.6	-0.5	0.6	-1.4	0.0
	Q4	-2.2	-2.8	-1.5	-2.1	-2.6	-5.0

*financial year - constrained
+calendar year - constrained

Table 10: CGBR(O): Differences from Budget profile

	April-February (outturn)	
	£ billion	Percentage
Receipts		
Inland Revenue	0.4	½
Customs and Excise	-0.4	- ½
NICs	-1.2	-4
Interest and dividends	0.2	2½
Other receipts	-0.1	-2½
Total receipts	-1.0	- ½
Expenditure		
Privatisation proceeds	1.1	24
Interest payments	0.6	4½
Departmental expenditure[1]	-0.9	- ½
Total expenditure	0.9	½
CGBR(O)	1.8	
CGBR(O) excluding privatisation proceeds	0.7	

(1) on a cash basis, net of certain receipts and on-lending

TABLE 11

HALIFAX STANDARDISED INDEX OF ALL HOUSE PRICES

	Index nsa	Index sa	Percentage Change On Previous Period nsa	Percentage Change On Previous Period sa	% Growth Annualised 3 Mth sa	% Growth Annualised 6 Mth sa	Percentage Change On Previous Year nsa
Annual Data							
1984	107.2						7.2
1985	117.0						9.1
1986	129.9						11.0
1987	149.9						15.4
1988	184.8						23.3
1989	223.1						20.7
Quarterly Data							
1988 Q2	180.2	179.8	9.3	7.5			17.3
Q3	198.9	197.2	10.4	9.7			22.3
Q4	212.0	211.3	6.6	7.2			30.3
1989 Q1	217.8	220.8	2.7	4.5			34.0
Q2	226.8	226.4	4.1	2.5			25.9
Q3	227.3	225.4	0.2	-0.4			14.3
Q4	222.8	221.9	-2.0	-1.6			5.1
1990 Q1	220.6	223.6	-1.0	0.8			1.3
Monthly Data							
1989 Jan	213.4	217.2	-0.8	0.8	19.6	28.4	33.6
Feb	216.9	219.9	1.6	1.2	14.9	23.5	32.0
Mar	221.6	223.7	2.1	1.7	16.3	19.8	31.1
Apr	224.3	224.5	1.2	0.4	14.1	16.8	28.5
May	228.0	227.8	1.7	1.5	15.2	15.0	26.9
Jun	228.3	226.8	0.1	-0.4	5.7	10.9	23.1
Jul	228.5	226.5	0.1	-0.1	3.6	8.7	18.1
Aug	227.7	226.1	-0.3	-0.2	-3.0	5.7	14.2
Sep	226.0	223.8	-0.7	-1.0	-5.2	0.1	9.5
Oct	224.0	222.2	-0.9	-0.7	-7.4	-2.0	7.0
Nov	222.5	222.0	-0.7	-0.1	-7.1	-5.0	4.5
Dec	221.2	221.5	-0.6	-0.2	-4.0	-4.6	2.8
1990 Jan	219.8	223.8	-0.6	1.0	2.9	-2.4	3.0
Feb	220.4	223.4	0.3	-0.2	2.5	-2.4	1.6
Mar	221.5	223.6	0.5	0.1	3.8	-0.2	-0.0

REGIONAL STANDARDISED INDICES

Region 1990 Q1	Percentage change on :- previous quarter	previous year
UK	-0.9	1.3
Greater London	-0.7	-8.1
South East	-3.2	-13.3
North	2.4	25.2
Yorkshire & Humberside	-0.4	14.9
North West	1.9	23.4
East Midlands	-1.7	-1.2
West Midlands	-0.9	-2.0
East Anglia	-5.0	-19.5
South West	-2.8	-12.1
Wales	1.6	8.0
Scotland	-0.3	16.7
Northern Ireland	-2.2	-1.1

TABLE 12

EXCHANGE RATES

DATE	Exchange Rate Index*	Real Exchange Rate @	Oil Adjusted ERI +	Dollar : sterling exchange rate	D-Mark sterling exchang rate	Interest rate differentials UK-USA	Interest rate differentials UK-Germany	Brent spot price ($/bl)
1986 q2	96.0	97.1	109.3	1.51	3.39	+3.2	+5.6	12.8
q3	90.2	91.3	103.1	1.5	3.10	+3.8	+5.4	12.4
q4	85.1	86.4	94.9	1.43	2.87	+5.1	+6.5	14.8
1987 q1	86.8	87.5	94.0	1.54	2.83	+4.3	+6.5	17.9
q2	90.4	92.0	97.2	1.64	2.96	+2.1	+5.4	18.6
q3	90.5	91.9	96.9	1.62	2.97	+2.8	+5.8	19.0
q4	92.9	94.1	100.4	1.76	2.99	+1.2	+4.6	18.1
1988 q1	93.3	95.0	103.2	1.78	3.01	+2.2	+5.6	15.7
q2	96.7	99.7	106.4	1.84	4.14	+1.0	+4.7	16.2
q3	95.1	98.9	101.9	1.62	2.97	+2.8	+6.2	19.0
q4	96.7	100.4	104.8	1.80	3.17	+3.6	+7.3	13.6
1989 q1	97.3	101.1	105.7	1.75	3.24	+3.2	+6.9	17.8
q2	93.7	99.0	100.7	1.65	3.15	+3.7	+6.8	18.7
q3	91.7	97.2	99.6	1.60	3.08	+5.1	+6.7	17.6
q4	88.0	93.5	94.0	1.58	2.87	+6.6	+7.1	19.4
1988 Aug	96.0	99.7	107.1	1.70	3.20	+2.8	+5.9	14.8
Sep	94.7	98.6	107.2	1.68	3.14	+3.9	+7.2	13.3
Oct	95.9	99.6	109.4	1.75	3.16	+3.5	+6.9	12.6
Nov	96.6	100.3	109.7	1.81	3.16	+3.6	+7.2	13.0
Dec	97.6	101.4	108.5	1.83	3.20	+3.8	+7.8	15.2
1989 Jan	97.8	101.7	106.6	1.77	3.25	+3.7	+7.8	17.2
Feb	97.5	101.4	107.0	1.76	3.25	+3.3	+6.5	16.8
Mar	96.5	100.0	103.4	1.73	3.21	+2.7	+6.3	19.5
Apr	95.4	100.4	101.5	1.70	3.18	+3.2	+6.7	19.8
May	94.5	99.7	101.7	1.64	3.18	+3.4	+6.9	18.6
Jun	91.2	96.8	99.1	1.60	3.10	+4.4	+6.8	17.7
Jul	92.5	97.5	100.0	1.63	3.08	+5.1	+6.8	17.8
Aug	91.4	97.1	100.0	1.60	3.10	+5.0	+6.8	17.1
Sep	91.3	97.1	98.9	1.57	3.07	+5.2	+6.6	17.8
Oct	89.6	95.5	96.1	1.58	2.96	+6.5	+7.2	19.1
Nov	88.0	93.6	93.9	1.57	2.89	+6.6	+7.0	19.4
Dec	86.5	91.7	92.0	1.60	2.77	+6.7	+7.0	19.7
1990 Jan	87.9	92.8	92.4	1.65	2.79	+6.8	+7.1	21.2
Feb	89.6		94.2	1.69	2.85	+6.8	+6.8	20.0
Mar	87.1		93.0	1.63	2.77	+6.9	+7.0	18.6
Apr 5	87.9			1.64	2.79	+6.8	+7.0	18.1

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

* 1985 = 100

TABLE 13

NOMINAL AND REAL INTEREST RATES

	Three month interbank	Three month Eurodollar	Base rate	Long Rate (20 year Gilts)	Expected inflation over 12 months *	Real 3-month interbank rate	Yield on index-linked Gilts** 1990 ------- 1992	Yield on index-linked Gilts** 2001	Yield on index-linked Gilts** 2011
1986 q1	12.4	7.9	12.3	10.2	3.9	8.2	4.3	4.2	3.8
q2	10.2	7.0	10.4	9.0	3.6	6.5	3.6	3.6	3.4
q3	10.0	6.2	10.0	9.7	3.4	6.5	3.7	3.9	3.5
q4	11.2	6.1	11.0	10.7	4.1	6.8	3.7	4.1	3.8
1987 q1	10.6	6.3	10.8	9.6	4.3	6.0	3.0	3.7	3.5
q2	9.2	7.1	9.4	9.0	3.8	5.2	2.4	3.8	3.6
q3	9.9	7.1	9.7	9.8	3.7	6.0	2.6	4.2	3.9
q4	9.2	7.8	9.0	9.5	4.0	4.7	2.4	4.1	3.8
1988 q1	9.0	6.9	8.7	9.4	4.1	4.8	2.2	4.0	4.0
q2	8.4	7.4	8.0	9.2	4.0	4.5	2.0	3.8	3.8
q3	9.9	7.1	9.7	9.8	3.8	5.9	2.6	4.2	3.9
q4	12.5	8.9	12.7	9.3	6.7	5.5	3.4	3.7	3.7
1989 q1	13.0	9.7	13.0	9.2	6.6	6.1	3.1	3.6	3.6
q2	13.4	9.7	13.7	9.7	6.6	6.5	3.3	3.7	3.7
q3	13.9	8.8	14.0	9.5	6.7	6.7	3.2	3.5	3.6
q4	15.1	8.5	15.0	9.9	6.8	7.8	4.1	3.7	3.7
1988 Oct	12.0	8.6	12.0	9.2	6.4	5.3	2.6	3.7	3.8
Nov	12.3	8.8	13.0	9.3	7.1	4.9	2.8	3.6	3.7
Dec	13.2	9.4	13.0	9.5	6.5	6.3	3.7	3.8	3.8
1989 Jan	13.1	9.4	13.0	9.3	7.5	5.2	3.5	3.8	3.8
Feb	13.0	9.7	13.0	9.1	6.7	5.9	3.0	3.6	3.6
Mar	13.0	10.1	13.0	9.2	5.5	7.1	2.7	3.5	3.5
Apr	13.3	10.1	13.0	9.6	5.9	7.0	3.0	3.6	3.6
May	13.1	9.7	14.0	9.5	6.8	5.9	2.8	3.6	3.6
Jun	14.1	9.3	14.0	9.9	7.1	6.5	4.0	3.9	3.8
Jul	13.9	8.8	14.0	9.5	7.0	6.4	3.4	3.6	3.6
Aug	13.8	8.8	14.0	9.4	6.5	6.9	2.9	3.5	3.5
Sep	14.1	8.9	14.0	9.6	6.7	6.9	3.2	3.5	3.6
Oct	15.2	8.7	15.0	9.8	6.4	8.3	4.1	3.7	3.7
Nov	15.1	8.5	15.0	10.0	6.9	7.7	3.9	3.7	3.7
Dec	15.1	8.4	15.0	9.9	7.0	7.6	4.2	3.7	3.7
1990 Jan	15.1	8.3	15.0	10.2	6.5	8.1	4.5	3.8	3.8
Feb	15.1	8.3	15.0	10.7	6.9	7.7	4.9	4.0	3.9
Mar	15.3	8.4	15.0	11.5	7.8	7.0	5.2	4.3	4.1
Apr 5	15.2	8.4	15.0	11.4	7.8	6.9	5.2	4.3	4.1

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

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

All figures except base rate are averages over the month/quarter; base rates are end month.

TABLE 14: CURRENT ACCOUNT

percentage change on previous year

	1985=100 EXPORT VOLUMES less oil and erratics	1985=100 IMPORT VOLUMES less oil and erratics	1985=100 TERMS OF TRADE AVIs	CURRENT BALANCE £mns
1982	0.8	8.7	-0.4	4606
1983	-0.6	10.3	-0.7	3793
1984	8.6	10.8	-1.2	1954
1985	6.8	4.0	1.4	3161
1986	2.1	6.8	0.6	-41
1987	7.1	8.5	0.7	-4395
1988	4.0	14.2	2.2	-15019
1989	10.2	8.2	-0.5	-20851
1988 Q4	4.4	14.5	2.0	-5467
1989 Q1	12.7	15.5	1.2	-4559
Q2	7.0	10.6	0.6	-4890
Q3	6.8	6.3	-1.5	-6308
Q4	14.3	1.6	-2.1	-5094
1988 Jan	6.9	14.7	3.6	-855
Feb	-8.0	13.0	3.9	-1225
Mar	2.8	15.6	3.1	-1185
Apr	7.9	15.2	2.0	-680
May	5.4	11.2	1.7	-1073
Jun	3.6	16.3	0.9	-1180
Jul	5.9	16.8	1.9	-1462
Aug	5.1	11.0	2.8	-942
Sep	5.8	13.9	1.3	-949
Oct	4.0	19.1	1.6	-2061
Nov	2.5	13.0	1.5	-1840
Dec	6.5	11.3	2.7	-1566
1989 Jan	13.2	20.6	1.9	-1393
Feb	13.5	13.8	0.7	-1753
Mar	11.4	12.2	0.9	-1413
Apr	2.8	11.3	0.9	-1671
May	9.4	11.0	1.0	-1489
Jun	8.9	9.5	0.1	-1730
Jul	6.8	2.1	-1.0	-1991
Aug	3.8	9.1	-1.6	-2361
Sep	9.8	7.7	-1.9	-1956
Oct	15.2	1.4	-1.4	-1920
Nov	10.8	4.1	-1.7	-2019
Dec	16.9	-0.5	-3.3	-1155
1990 Jan	5.7	1.6	-0.4	-2020
Feb	10.8	0.4	-0.0	-1395

SECRET

TABLE 15 (Until publication - except for the wider sterling aggregate which is not published and remains secret)

GROWTH RATES OF MONETARY AGGREGATES AND BANK & BUILDING SOCIETY LENDING

£ million

			1989Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	1990Jan	Feb
M0	Monthly change	sa	-69	44	119	137	89	71	254	-25	132	113	157	-49	34
	Monthly % change	nsa	-2.2	1.9	0.1	1.6	0.3	1.9	1.7	-1.1	0.1	0.8	7.6	-6.5	-1.4
	Monthly % change	sa	-0.4	0.3	0.7	0.8	0.5	0.4	1.5	-0.1	0.8	0.6	0.9	-0.3	0.2
	3-month annualised % change	sa	0.5	-0.6	2.2	7.3	8.4	7.2	10.0	7.2	8.7	5.1	9.5	5.1	3.2
	6-month annualised % change	sa	3.5	1.3	2.6	3.9	3.8	4.7	8.7	7.8	7.9	7.5	8.4	6.9	4.2
	Annual % change	sa	6.6	6.1	5.8	6.2	5.9	5.2	6.1	4.5	5.2	5.7	6.0	5.8	6.4
M4	Monthly change	nsa	3095	10064	1696	5406	9479	2691	5668	8979	2701	4474	8690	3241	2558
	Monthly % change	nsa	0.9	2.8	0.5	1.4	2.5	0.7	1.4	2.3	0.7	1.1	2.1	0.8	0.6
	Monthly % change	sa	1.2	2.0	0.6	1.2	2.3	0.5	1.7	2.2	0.6	1.1	2.2	1.1	0.9
	3-month annualised % change	sa	16.6	18.5	16.4	16.4	18.0	17.5	19.8	19.5	19.9	17.1	16.8	19.2	18.2
	6-month annualised % change	sa	16.4	16.0	15.8	16.5	18.2	17.0	18.1	18.7	18.7	18.5	18.2	19.6	17.6
	Annual % change	nsa	18.6	18.1	17.9	18.1	18.5	16.5	17.3	17.3	17.2	17.5	18.2	18.4	18.1
M5	Monthly change	nsa	2998	10166	2377	5444	9807	2847	5562	9331	2415	4482	9105	2675	2587
	Monthly % change	nsa	0.8	2.7	0.6	1.4	2.5	0.7	1.4	2.3	0.6	1.1	2.1	0.6	0.6
	Monthly % change	sa	1.2	1.9	0.7	1.2	2.3	0.6	1.6	2.2	0.5	1.1	2.1	1.0	0.9
	3-month annualised % change	sa	15.3	18.0	16.2	16.4	18.4	17.5	19.5	19.0	18.8	16.5	16.3	18.6	17.5
	6-month annualised % change	sa	15.5	15.0	15.2	15.8	18.2	16.9	17.9	18.7	18.2	18.0	17.6	18.7	17.0
	Annual % change	nsa	17.8	17.1	17.3	17.5	18.0	16.0	16.8	16.8	16.7	17.0	17.9	17.9	17.7
NIBM1	Monthly change	nsa	103	900	-1723	322	274	-605	-141	283	-842	198	2266	-4367	487
	Monthly % change	nsa	0.2	1.9	-3.6	0.7	0.6	-1.3	-0.3	0.6	-1.8	0.4	5.0	-9.1	1.1
	Monthly % change	sa	-0.5	-0.4	-3.6	-0.7	0.1	-1.4	0.2	0.9	-0.6	-1.2	6.0	-5.5	0.3
	3-month annualised % change	sa	-4.0	-18.4	-16.5	-17.3	-15.6	-7.8	-4.3	-1.3	2.0	-3.5	17.5	-4.1	1.8
	6-month annualised % change	sa	2.1	-4.2	-11.8	-10.9	-17.0	-12.3	-11.0	-8.7	-3.0	-3.9	7.7	-1.1	-0.9
	Annual % change	nsa	5.3	2.4	-1.3	-3.0	-3.5	-5.0	-4.7	-6.6	-7.6	-7.5	-5.5	-7.1	-6.3
M4C	Monthly change	nsa	5200	10747	2651	7940	12013	-6	7476	8879	6847	5886	8382	1896	3021
	Monthly % change	nsa	1.3	2.7	0.6	1.9	2.9	0.0	1.7	2.0	1.5	1.3	1.8	0.4	0.6
	Monthly % change	sa	1.7	2.0	0.8	1.7	2.7	-0.1	2.0	2.0	1.5	1.3	1.9	0.7	0.9
	3-month annualised % change	sa	19.1	19.2	19.3	19.6	23.0	18.4	19.6	16.5	24.2	21.0	20.4	16.9	15.0
	6-month annualised % change	sa	16.5	16.1	17.0	19.3	21.1	18.9	19.6	19.7	21.3	20.4	18.4	20.5	18.0
	Annual % change	nsa	18.0	18.0	18.3	19.2	19.6	17.2	18.1	17.9	19.2	19.9	19.8	19.9	19.1
Wider Sterling Aggregate	Monthly change	nsa	3649	11678	2525	4956	8516	4995	6809	10603	1798	4142	9209	4953	4227
	Monthly % change	nsa	0.9	2.9	0.6	1.2	2.0	1.2	1.6	2.4	0.4	0.9	2.0	1.1	0.9
	Monthly % change	sa	1.2	2.2	0.8	1.0	1.8	1.0	1.8	2.3	0.4	0.9	2.0	1.4	1.2
	3-month annualised % change	sa	18.7	22.9	17.9	16.8	15.3	16.4	20.3	22.7	19.6	15.6	14.2	19.0	20.0
	6-month annualised % change	sa	19.3	18.8	18.1	17.7	19.0	17.2	18.5	19.0	18.0	17.9	18.4	19.3	17.8
	Annual % change	nsa	19.9	20.0	19.2	19.0	18.8	17.8	18.9	18.9	18.1	17.9	18.8	18.4	18.4
M4 Lending	Monthly change	nsa	4490	9878	4961	6042	9093	7856	6786	11412	5069	4435	10963	5386	6715
	Monthly % change	nsa	1.1	2.3	1.1	1.4	2.0	1.7	1.5	2.4	1.0	0.9	2.2	1.1	1.3
	Monthly % change	sa	1.2	1.9	1.4	1.4	1.7	1.7	1.7	2.2	1.1	1.0	2.2	1.1	1.4
	3-month annualised % change	sa	21.6	22.0	19.9	21.1	19.8	21.1	22.3	24.9	21.9	18.5	18.3	18.7	20.7
	6-month annualised % change	sa	22.0	21.8	21.3	21.3	20.9	20.5	21.7	22.3	21.5	20.4	21.5	20.2	19.6
	Annual % change	nsa	24.3	24.3	23.4	23.2	22.4	21.6	21.9	22.1	21.4	20.9	21.2	20.4	20.7

TABLE 16

REAL PERCENTAGE GROWTH RATES OF MONETARY AGGREGATES

	RPI excluding MIPs	M0	M4	M5
FINANCIAL YEARS (12 month % changes to March)				
1981-82	9.8	-6.5	3.7	3.0
1982-83	5.9	-0.6	7.9	8.0
1983-84	4.6	1.0	6.8	6.1
1984-85	5.2	0.2	8.2	8.2
1985-86	4.0	-0.6	10.1	9.1
1986-87	3.8	0.6	9.9	9.3
1987-88	3.8	1.7	12.5	12.3
1988-89	5.7	0.4	11.7	10.8
1989 Jan	5.5	1.8	11.9	11.2
Feb	5.7	0.9	12.2	11.4
Mar	5.7	0.4	11.7	10.8
Apr	5.9	-0.1	11.3	10.8
May	6.0	0.2	11.4	10.8
Jun	5.9	0.0	11.9	11.4
Jul	5.8	-0.6	10.1	9.6
Aug	5.7	0.4	11.0	10.5
Sep	5.8	-1.2	10.9	10.4
Oct	6.1	-0.8	10.5	10.0
Nov	6.1	-0.4	10.7	10.3
Dec	6.1	-0.1	11.4	11.1
1990 Jan	6.1	-0.3	11.6	11.1
Feb	6.2	0.2	11.2	10.8

TABLE 17

CONFIDENTIAL (Until Publication)

M0 : THE WIDE MONETARY BASE

Monthly data	Level £ million (Change in brackets)							% change on previous month		3 month % growth annualised		6 month % growth annualised		Percentage change on previous year			
	Notes and Coin (nsa)	Notes and Coin (sa)		Bankers' Deposits	M0 (nsa)	M0 (sa)		Notes & Coin (sa)	M0 (sa)	Notes & Coin (sa)	M0 (sa)	Notes & Coin (sa)	M0 (sa)	Notes and Coin (nsa)	Notes and Coin (sa)	M0 (nsa)	M0 (sa)
1989 February	16351	16657	(-68)	152	16504	16810	(-70)	-0.4	-0.4	0.9	0.5	3.6	3.5	6.5	6.5	6.6	6.6
March	16695	16734	(77)	119	16815	16853	(43)	0.5	0.3	0.6	-0.6	1.9	1.3	7.1	6.5	6.8	6.1
April	16630	16778	(44)	194	16824	16972	(119)	0.3	0.7	1.3	2.2	2.6	2.6	5.3	6.1	5.0	5.8
May	16922	16944	(166)	166	17088	17110	(138)	1.0	0.8	7.0	7.3	3.9	3.9	6.6	6.3	6.5	6.2
June	17003	17062	(118)	136	17139	17198	(88)	0.7	0.5	8.1	8.4	4.3	3.8	5.8	6.2	5.5	5.9
July	17339	17149	(87)	120	17459	17269	(71)	0.5	0.4	9.1	7.2	5.2	4.7	5.7	5.7	5.2	5.2
August	17558	17329	(180)	196	17754	17525	(256)	1.1	1.5	9.4	10.0	8.2	8.7	5.9	5.9	6.1	6.1
September	17416	17361	(32)	139	17555	17500	(-25)	0.2	-0.1	7.2	7.2	7.6	7.8	4.7	4.7	4.5	4.5
October	17412	17473	(112)	160	17572	17633	(133)	0.6	0.8	7.8	8.7	8.4	7.9	5.5	5.5	5.3	5.2
November	17552	17581	(108)	167	17719	17748	(115)	0.6	0.6	5.9	5.2	7.6	7.5	5.7	5.8	5.6	5.7
December	18871	17714	(133)	186	19057	17900	(152)	0.8	0.9	8.5	9.5	7.8	8.4	5.6	6.0	5.6	6.0
1990 January	17739	17777	(63)	76	17815	17853	(-47)	0.3	-0.3	7.2	5.1	7.5	6.9	6.1	6.3	5.6	5.8
February	17429	17749	(-28)	141	17570	17890	(37)	-0.2	0.2	3.9	3.2	4.9	4.2	6.6	6.5	6.4	6.4
March (4/4) @	17526	17800	(51)	125	17650	17925	(35)	0.3	0.2	1.9	0.5	5.1	4.9	5.0	6.4	5.0	6.3

Weekly data	Level £ million (Change in brackets)						Percentage change on previous week	Percentage change on previous year			
	Notes and Coin (u/a)	Notes and Coin (s/a)	(s/a)	Bankers' Deposits	M0 (sa)		M0 (sa)	Notes and Coin (nsa)	Notes and Coin (sa)	M0 (nsa)	M0 (sa)
1990 January											
3rd	18592	17886	(0)	57	17943	(-96)	-0.5	7.2	6.9	6.4	6.2
10th	17822	17816	(-70)	88	17904	(-39)	-0.2	6.9	6.6	6.3	6.0
17th	17513	17794	(-22)	54	17848	(-56)	-0.3	6.3	6.1	5.8	5.7
24th	17355	17676	(-118)	144	17820	(-28)	-0.2	5.9	5.9	5.8	5.8
31st	17412	17714	(38)	38	17752	(-68)	-0.4	6.4	6.5	6.1	6.1
February											
7th	17434	17775	(61)	26	17801	(49)	0.3	6.6	6.6	5.7	5.6
14th	17395	17740	(-35)	116	17856	(55)	0.3	6.4	6.3	5.9	5.9
21st	17409	17723	(-17)	245	17968	(112)	0.6	6.5	6.6	7.0	7.0
28th	17478	17758	(35)	178	17936	(-32)	-0.2	6.4	6.5	7.0	7.1
March											
7th	17474	17762	(4)	166	17928	(-8)	0.0	6.3	6.3	6.3	6.3
14th	17489	17774	(12)	114	17888	(-40)	-0.2	5.9	6.3	5.5	5.9
21st	17534	17811	(37)	191	18002	(114)	0.6	3.1	6.2	4.1	7.2
28th	17605	17853	(42)	28	17881	(-121)	-0.7	2.9	6.3	2.1	5.4

@@ The figures have been corrected for the write-off of £51 million of notes on 1 June 1989 under the terms of the 1983 Currency Act.

TABLE 18

CONFIDENTIAL

BUILDING SOCIETY BALANCE SHEET FLOWS

Unadjusted £ million

	Total Flow	ASSETS: Net Mortgage Advances & Unsecured Lending	ASSETS: Liquid Assets	ASSETS: Fixed Assets	LIABILITIES: Retail principal	LIABILITIES: Interest credited	LIABILITIES: Wholesale funds	LIABILITIES: Other (eg reserves)
1987 *	1650	1268	339 (16.9)	43	630	570	194	256
1988 *	2565	2062	435 (16.8)	69	1101	621	451	391
1989 *	2568	2210	233 (16.0)	125	641	815	696	418
1987 Q3*	1547	1288	215 (16.1)	44	409	516	337	285
Q4*	2063	1390	692 (16.9)	-19	1038	785	222	18
1988 Q1*	1870	1686	10 (16.5)	174	1027	626	113	104
Q2*	3176	2205	925 (17.0)	46	1349	407	697	716
Q3*	2636	2506	116 (16.4)	14	986	554	641	456
Q4*	2578	1849	688 (16.8)	41	1043	896	353	286
1989 Q1*	2088	1782	70 (16.4)	236	912	773	161	241
Q2*	2407	2232	123 (16.4)	52	568	615	318	916
Q3*	2736	2294	391 (15.6)	51	721	728	888	399
Q4*	3039	2530	349 (15.4)	160	363	1142	1416	117
1989 Dec	3249	2471	302 (15.4)	476	187	2725	2145	-1808
1990 Jan	2281	2143	281 (15.3)	-143	335	2250	959	-1263
Feb	2392	2077	186 (15.2)	129	314	178	857	1043
Forecast								
1990 March	2453	1823	560 (15.3)	70	600	273	500	1080

* Monthly averages
Figures in ( ) are end period liquidity ratio, unadjusted
Figures for July onwards exclude the Abbey National.

TABLE 19

THE [illegible]ONENTS OF M4 AND M5

	NOTES & COIN	RETAIL DEPOSITS[1]	WHOLESALE DEPOSITS	M4	NATIONAL SAVINGS	MONEY MARKET INSTRUMENTS[2]	M5
% CHANGES							
Financial years[3] (nsa)							
1984-85	4.5	13.0	19.6	13.8	4.5	31.8	13.8
1985-86	3.0	13.9	19.6	14.5	5.4	-12.4	13.5
1986-87	-2.1	12.9	21.4	14.1	9.7	-4.9	13.5
1987-88	14.3	13.0	28.2	16.8	11.3	16.0	16.6
1988-89	3.0	15.8	26.2	18.1	4.5	-20.8	17.1
1989 Feb	4.7	16.5	26.2	18.6	5.9	-7.3	17.8
Mar	3.0	15.8	26.2	18.1	4.5	-20.8	17.1
Apr	5.4	15.4	26.5	17.9	3.9	5.5	17.3
May	5.3	14.9	28.2	18.1	3.3	7.9	17.5
Jun	6.4	13.8	32.5	18.5	2.6	19.6	18.0
Jul	1.0	13.7	25.8	16.5	2.0	18.6	16.0
Aug	5.8	13.0	29.5	17.3	1.7	15.9	16.8
Sep	3.4	12.9	30.1	17.3	1.7	16.9	16.8
Oct	3.8	12.3	31.1	17.2	1.8	11.8	16.7
Nov	6.4	12.8	30.6	17.5	1.6	11.4	17.0
Dec	5.7	12.5	33.9	18.2	1.1	43.5	17.9
1990 Jan	5.9	12.2	34.7	18.4	1.4	23.3	17.9
Feb	6.1	11.6	35.4	18.1	1.4	27.9	17.7
Over 6 months (sa)							
1989 Sep	9.6	13.0	33.7	18.7	2.7	68.4	18.7
Oct	-3.8	13.2	35.4	18.7	3.2	14.6	18.2
Nov	7.6	12.1	35.3	18.5	2.4	18.8	18.0
Dec	8.8	13.8	28.3	18.2	1.4	16.5	17.6
1990 Jan	0.6	12.2	37.5	19.6	2.1	-8.0	18.7
Feb	3.1	12.0	30.7	17.6	1.2	2.8	17.0
CHANGES £ MILLION							
(sa)							
1989 Sep	315	4756	3564	8835	36	166	9037
Oct	-501	1879	1206	2584	38	-314	2308
Nov	286	1940	2407	4633	-17	159	4775
Dec	697	3206	5023	8926	-33	341	9234
1990 Jan	-932	1257	4538	4863	56	-395	4524
Feb	150	1815	1901	3866	-8	110	3968

[1] Net inflow including Term shares and SAYE.
[2] Treasury bills, bank bills, LA temporary debt, and CTDs.
[3] March on March.

TABLE 20 SECRET

30/03/90

FUNDING : FINANCIAL YEARS 1989-90 AND 1990-91

£ million

	1989-90			1990-91
	Forecast	Outturn	Residual	Forecast
	1989-90	April-Feb 90	Mar 90	
Within Year Contribution to Funding Requirement:				
1 PSBR (+)/PSDR (-)	-7058	-9641	2583	-6900
2 Intervention (increase in reserves +)	-5860	-5600	-260	0
3 Maturities	9889	9108	781	5781
4 TOTAL FOR FUNDING	**-3029**	**-6133**	**3104**	**-1119**
FUNDED BY:				
Non-gilts				
5 National Savings	-1800	-1624	-176	-1000
6 CTDs sales to M4PS	218	218	0	0
7 Other public debt sales to M4PS and overseas	-1875	-1775	-100	-400
8 Total non-gilt funding	**-3457**	**-3181**	**-276**	**-1400**
Gilts				
9 Gilt sales to M4PS and overseas needed for full fund within year	428	-2952	3380	281
10 Net gilt sales to banks, building socs and other public sector	-4369	-4169	-200	-1000
11 Required gross official gilt sales	**-3941**	**-7121**	**3180**	**-719**
12 Actual gross gilt sales to date		-5800 (-527)		
13 Over(+)/Under(-)funding	-2199	1321	-3520	-340
14 Remaining gross gilt sales required			**-340 (-340)**	
15 Gross gilt sales required over whole year	-6140			-1059

(Figures in brackets in lines (13) and (15) are monthly averages)

Relationship between lines:
(4)= (1)+(2)+(3)
(8)= (5)+(6)+(7)
(9)= (4)-(8)
(11)= (9)+(10)
(13): Col(1) Underfunding required in 1989-90 to offset previous cumulative overfunding
Col(2) Line (12) - line (11)
Col(3) By residual from cols(1) and (2)
(14)= (11)+(13)
(15)= (12 col 2)+(14 col 3)

Table 21:- BORROWING BY PRIVATE SECTOR EXCLUDING BUILDING SOCIETIES (£ million)

		BANK/BUILDING SOC. STERLING BORROWING			OTHER STERLING BORROWING				ALL BORROWING		
		Banks	B Soc	TOTAL	Sterling Commercial Paper(*)	Ordinary Shares (*)	Preference & Euro-Sterling (**)	TOTAL	Sterling	Foreign Currency	TOTAL
Change in Quarter											
1986											
	Q1	7157	3967	11124	0	471	959	1430	12554	2362	1491
	Q2	5189	5220	10409	0	1369	949	2318	12727	1575	1430
	Q3	4877	5738	10615	23	1431	738	2192	12807	3688	1649
	Q4	10138	4782	14920	68	2338	229	2635	17555	623	1817
1987											
	Q1	7147	3619	10766	416	1553	764	2733	13499	7142	2064
	Q2	8692	4240	12932	597	2259	1342	4198	17130	4733	2186
	Q3	10855	3889	14744	259	5950	1663	7872	16911	-1152	1575
	Q4	10908	3926	14834	-167	3746	764	4343	19177	-178	1899
1988											
	Q1	13154	4980	18134	909	370	1724	3003	21137	-376	2076
	Q2	13154	4980	18134	597	1028	1742	3367	21501	1022	2252
	Q3	15002	7414	22416	160	1560	1989	3709	26125	3034	2915
	Q4	14163	5416	19579	-344	2232	2488	4376	23955	3152	2710
1989											
	Q1	15353	6422	21775	821	-1536	2932	2217	23992	6505	3049
	Q2	12646	7450	20096	-198	2581	1999	4382	24478	2479	2695
	Q3	19367	6687	26054	-570	1870	2372	3672	29726	4565	3429
	Q4	12861	7606	20467	-761	1375	1177	1791	22258	2968	2522
Annual totals											
1985		19693	14733	34426	0	3414	1963	5377	39803	1185	4098
1986		27361	19707	47068	91	5609	2875	8575	13911	2062	1597
1987		37602	15674	53276	1105	13508	4533	19146	16679	2636	1931
1988		30455	12055	42510	1322	5190	7943	14455	17739	1134	1887
1989		60227	28165	88392	-708	4290	8480	12062	100434	16517	11697
Change in Month											
1989	JANUARY	5522	1885	7407	552	220	1263	2035	9442	3503	1294
	FEBRUARY	2406	2084	4490	-5	43	846	884	5374	701	607
	MARCH	7425	2453	9878	274	-1799	823	-702	9176	2301	1147
	APRIL	2696	2265	4961	373	826	188	1387	6348	-998	535
	MAY	3199	2843	6042	-317	322	908	913	6955	480	743
	JUNE	6751	2342	9093	-254	1433	903	2082	11175	2997	1417
	JULY	5972	1884	7856	1	874	970	1845	9701	1088	1078
	AUGUST	4577	2209	6786	7	148	607	762	7548	2769	1031
	SEPT	8818	2594	11412	132	848	795	1775	13187	436	1362
	OCTOBER	2435	2634	5069	-431	913	323	805	5874	1766	764
	NOVEMBER	1792	2643	4435	297	305	814	1416	5851	738	658
	DECEMBER	8634	2329	10963	-627	157	40	-430	10533	464	1099
1990	JANUARY	3325	2061	5386	668	284	426	1378	6764	531	729
	FEBRUARY	4727	1988	6715	280	776	521	1577	8292	-425	786

* UK ICCs only
** Announced issues by UK ICCs and OFIs
** Gross issues announced by UK ICCs and OFIs. From Jan 1990 net issues by ICCs & OOFIs.

Table 22:- FINANCE OF U.K. INDUSTRIAL AND COMMERCIAL COMPANIES (£ million)

				OTHER BORROWING				ALL BORROWING
	Sterling	Foreign Currency	TOTAL	Sterling Commercial Paper	Ordinary Shares	Preference & Euro-St ICC's	TOTAL	TOTAL
Change in Quarter								
1985								
Q1	3344	-352	2992		924	405	1329	4321
Q2	723	207	930		1092	557	1649	2579
Q3	197	1371	1568		873	404	1277	2845
Q4	847	1377	2224		525	289	814	3038
1986								
Q1	3722	108	3830	0	471	559	1030	4860
Q2	-314	108	-206	0	1369	669	2038	1832
Q3	-26	1128	1102	23	1431	521	1975	3077
Q4	5360	-15	5345	68	2338	229	2635	7980
1987								
Q1	1136	2028	3164	416	1553	449	2418	5582
Q2	602	687	1289	597	2259	1007	3863	5152
Q3	3524	-34	3490	259	5950	1302	7511	12382
Q4	4232	544	4776	-167	3746	278	3857	8633
1988								
Q1	7539	2099	9638	909	370	1039	2318	11956
Q2	4474	2080	6554	597	1028	794	2419	8973
Q3	4951	2302	7253	160	1603	1227	2990	10243
Q4	6061	1863	7924	-344	1916	1851	3423	11347
1989								
Q1	6449	2470	8919	821	-1506	2064	1379	10298
Q2	4973	1776	6749	-198	1498	1195	2495	9244
Q3	10002	3406	13408	140	1447	847	2434	15842
Q4	5027	956	5983	-761	1379	404	1022	7005
Annual totals								
1984	6995	271	7266	0	1129	586	1715	8981
1985	5111	2603	7714	0	3414	1655	5069	12783
1986	8742	1329	10071	91	5418	1978	7487	17558
1987	9494	3225	12719	1105	12236	3036	16377	29096
1988	23025	8344	31369	1322	4833	4911	11066	42435
1989	26451	8608	35059	2	2818	4510	7330	42389
Change in Month								
1989 JANUARY				552	227	662	1441	
FEBRUARY				-5	46	844	885	
MARCH				274	-1791	558	-959	
APRIL				373	800	89	1262	
MAY				-317	257	205	145	
JUNE				-254	443	901	1090	
JULY				1	761	405	1167	
AUGUST				7	154	47	208	
SEPTEMBER				132	539	395	1066	
OCTOBER				-431	831	100	500	
NOVEMBER				297	261	264	822	
DECEMBER				-627	157	40	-430	
1990 JANUARY				668	284	304	1256	
FEBRUARY				280	776	359	1415	

* Gross Issues announced by U.K. ICCs. Net issues from Jan 1990.

TA[illegible] 23: M0 Forecast (all series seasonally adjusted)

	Levels		percentage growth rates			
			6 months		12 months	
	Notes & coin	M0	Notes & coin	M0	Notes & coin	M0
1988-89 *	16417	16587			7.3	7.1
November	16621	16788	8.8	8.5	7.8	7.6
December	16707	16880	8.1	8.0	7.5	7.4
January	16724	16879	6.3	5.8	7.6	7.4
February	16658	16810	3.6	3.5	6.5	6.6
March	16734	16854	1.9	1.3	6.5	6.1
1989-90						
April	16779	16973	2.6	2.6	6.1	5.8
May	16944	17110	3.9	3.9	6.3	6.2
June	17063	17199	4.3	3.8	6.2	5.9
July	17150	17272	5.2	4.7	5.7	5.2
August	17330	17526	8.2	8.7	5.9	6.1
September	17362	17501	7.6	7.8	4.7	4.5
October	17473	17633	8.4	7.9	5.5	5.2
November	17579	17746	7.6	7.5	5.8	5.7
December	17717	17903	7.8	8.4	6.0	6.0
January	17778	17854	7.5	6.9	6.3	5.8
February	17749	17890	4.9	4.2	6.5	6.4
March(e)	17800	17925	5.1	4.9	6.4	6.3
Forecast 1990-91						
April	17883	18058	4.7	4.9	6.6	6.4
May	17943	18118	4.2	4.2	5.9	5.9
June	18009	18184	3.3	3.2	5.5	5.7
July	18086	18261	3.5	4.6	5.5	5.7
August	18197	18372	5.1	5.5	5.0	4.8
September	18304	18479	5.7	6.3	5.4	5.6
October	18382	18557	5.7	5.6	5.2	5.2
November	18450	18625	5.7	5.7	5.0	5.0
December	18522	18697	5.8	5.7	4.5	4.4
January	18517	18692	4.8	4.8	4.2	4.7
February	18495	18670	3.3	3.3	4.2	4.4
March	18498	18673	2.1	2.1	3.9	4.2
1989-90 *	17394	17544			6.0	5.8
1990-91 *	18274	18449			5.1	5.2

(e) - estimate
* average of monthly figures

TABLE 24 : M4 COUNTERPARTS AND FORECAST

£ million

OUTTURN: FEBRUARY 1990

PSBR	-1038
LA and PC debt sales to M4ps (-)	-2
CG debt sales to M4ps (-)	
o/w Gilts	338
Treasury bills, other	-223
National Savings	174
CTD's	33
Public sector external & fc finance	368
PUBLIC SECTOR CONTRIBUTION (-)	-350
(o/w over(-)/under(+) funding)	193
Sterling lending nsa	6715
(sa)	(7269)
Banks' and B Socs' externals	-1909
Banks' and B Socs' £NNDLs	-1898
TOTAL M4	2558
Monthly % growth nsa	0.6
sa	0.9
Annual % growth nsa	18.1
sa	17.9

FORECAST: MARCH 1990

PSBR	2505
LA and PC debt sales to M4ps (-)	0
CG debt sales to M4ps (-)	
o/w Gilts	602
Treasury bills, Other	-100
National Savings	229
CTD's	20
Public sector external & fc finance	-152
PUBLIC SECTOR CONTRIBUTION (-)	3104
(o/w over(-)/under(+) funding)	3304
Sterling lending nsa	10511
sa	(9000)
Banks' and B Socs' externals & £NNDLs	-2330
TOTAL M4	11285
Monthly % growth nsa	2.6
sa	2.0
Annual % growth nsa	18.0
sa	17.9

Table 25 MONEY MARKET ASSISTANCE

	OUT-TURN Jan	Feb	1990-91 FORECAST Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	TOTAL 89/90	TOTAL 90/91
INFLUENCES ON BANKERS' BALANCES																	
1 CGBR (+)	-5398	-1598	2735	1452	1524	2185	-1114	-414	1485	-2414	-1014	-2815	-4914	186	1089	-4910	-4764
2 CG bank deposits (+)	-211	-166	0	0	0	0	0	0	0	0	0	300	-300	0	0	18	0
3 Reserves etc (+)	17	113	-260	0	0	0	0	0	0	0	0	0	0	0	0	-5837	0
4 Notes & Coin (-)	2100	-78	-619	71	53	-350	166	-269	-183	588	-489	-1402	1801	50	-125	-687	-89
5 National Savings (-)	-26	109	299	83	83	83	83	83	83	83	83	83	83	83	87	1800	1000
6 CTDs (-)	38	23	0	0	0	0	0	0	0	0	0	0	0	0	0	-252	0
BGS (-)																	
Gross sales (-)	374	115	75	88	88	88	88	88	88	88	88	88	88	88	91	5800	1059
Maturities (+)	1409	1216	781	0	432	553	938	0	0	1573	490	0	1795	0	0	9889	5781
7 Net sales (-)	1783	1331	856	88	520	641	1026	88	88	1661	578	88	1883	88	91	15689	6840
o/w																	
M4ps & Overseas (-)	784	924	656	5	437	558	943	5	5	1578	495	5	1800	5	8	11320	5840
Banks/B Socs/OPS (-)	999	407	200	83	83	83	83	83	83	83	83	83	83	83	83	4369	1000
8 Other	276	92	0	0	0	0	0	0	0	0	0	0	0	0	0	-347	0
9 TOTAL INFLUENCES ON BANKERS' BALANCES	-1421	-174	3011	1694	2180	2559	161	-512	1473	-82	-842	-3746	-1447	407	1142	5474	2987
OPERATIONS																	
10 Issue Department Commercial Bills	1179	1127	-1480	-354	-1504	-2166	360	561	-1473	82	842	3746	1447	-407	-1142	1160	-8
11 Other	-1004	535	0	0	0	0	0	0	0	0	0	0	0	0	0	114	0
12 ASSISTANCE	175	1819	-1480	-354	-1504	-2166	360	561	-1473	82	842	3746	1447	-407	-1142	1274	-8
13 LEVEL OF ASSISTANCE	4995	6814	5334	4980	3476	1310	1670	2231	758	840	1682	5428	6875	6468	5326		
14 Treasury bills (exc repos)	1133	-1505	-1531	-1340	-676	-393	-521	-49	0	0	0	0	0	0	0		
15 TOTAL OPERATIONS	1308	314	-3011	-1694	-2180	-2559	-161	512	-1473	82	842	3746	1447	-407	-1142		
16 Treasury bills: amount outstanding	6998	8503	10034	11374	12050	12443	12964	13013	13013	13013	13013	13013	13013	13013	13013		
Memo items:																	
17 Bankers' balances	-112	160	0	0	0	0	0	0	0	0	0	0	0	0	0		
18 Level of ID commercial bills	3968	5095	3615	3261	1757	-409	-49	512	-961	-879	-37	3709	5156	4749	3607		

Relationship between lines:
9 = 1+2+3+4+5+6+7+8 = 15-17
12 = 10+11
13 = previous month's level + 12
15 = 12+14 = 9+17
Signs in lines 1-9 indicate increase + or - and therefore the effect on Bankers' Balances; the effect on assistance is in the opposite direction

TABLE 26

GILT REDEMPTIONS UP TO END FINANCIAL YEAR 1990/91

			amount outstanding (£ millions)
Financial year 1989/90			
1990	March	Exchequer 12 1/2	1250
Financial year 1990/91			
	May	Treasury 3	550
	June	Treasury 8 1/4	600
	July	Treasury 8	956
	October	Treasury 10 conv	1887
	November	Exchequer 2 1/2	500
1991	January	Treasury 11 3/4	2200

MONTHLY MONETARY REPORT : CHARTS

1 Exchange Rates

2 World interest rates

3 Broad Money Growth

4 Real M0 growth

5 M0 forecast

6 M4 forecast

7 Bank and Building Society Lending

8 Corporate bond issues

9 Money Market Assistance

10 Nominal Interest Rates

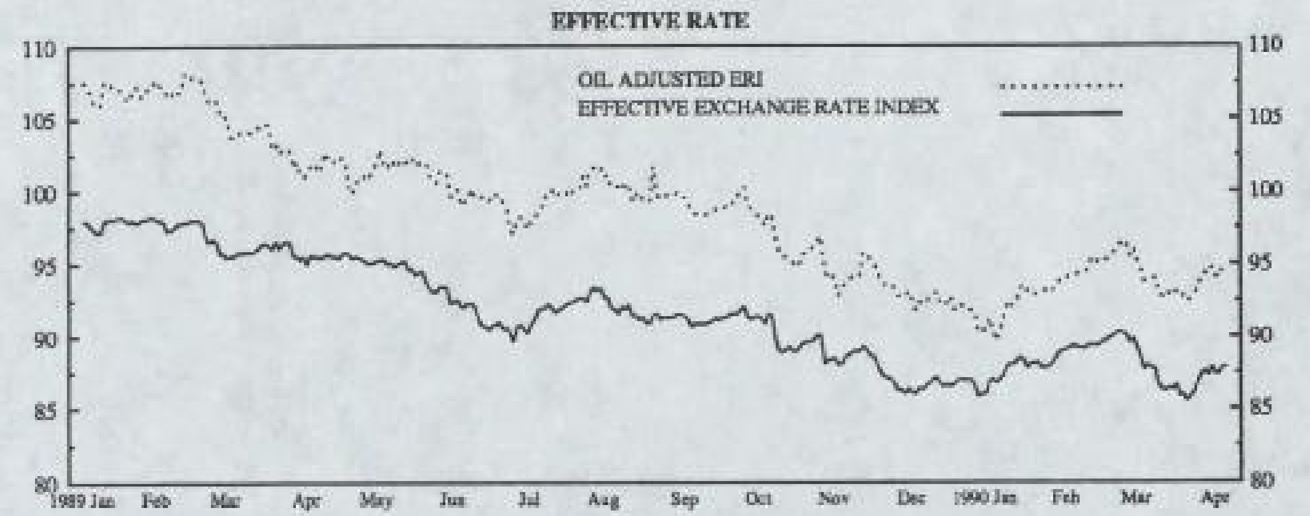
11 Yield Curve

12 Real Yields

13 House prices

14 Stock indices

CHART 1: EXCHANGE RATES



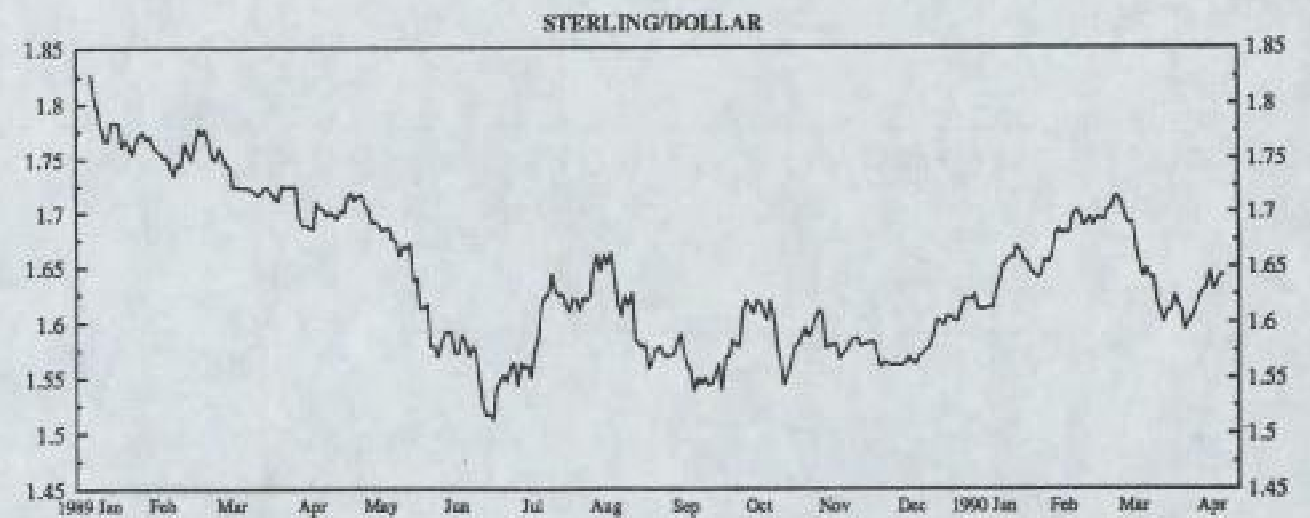
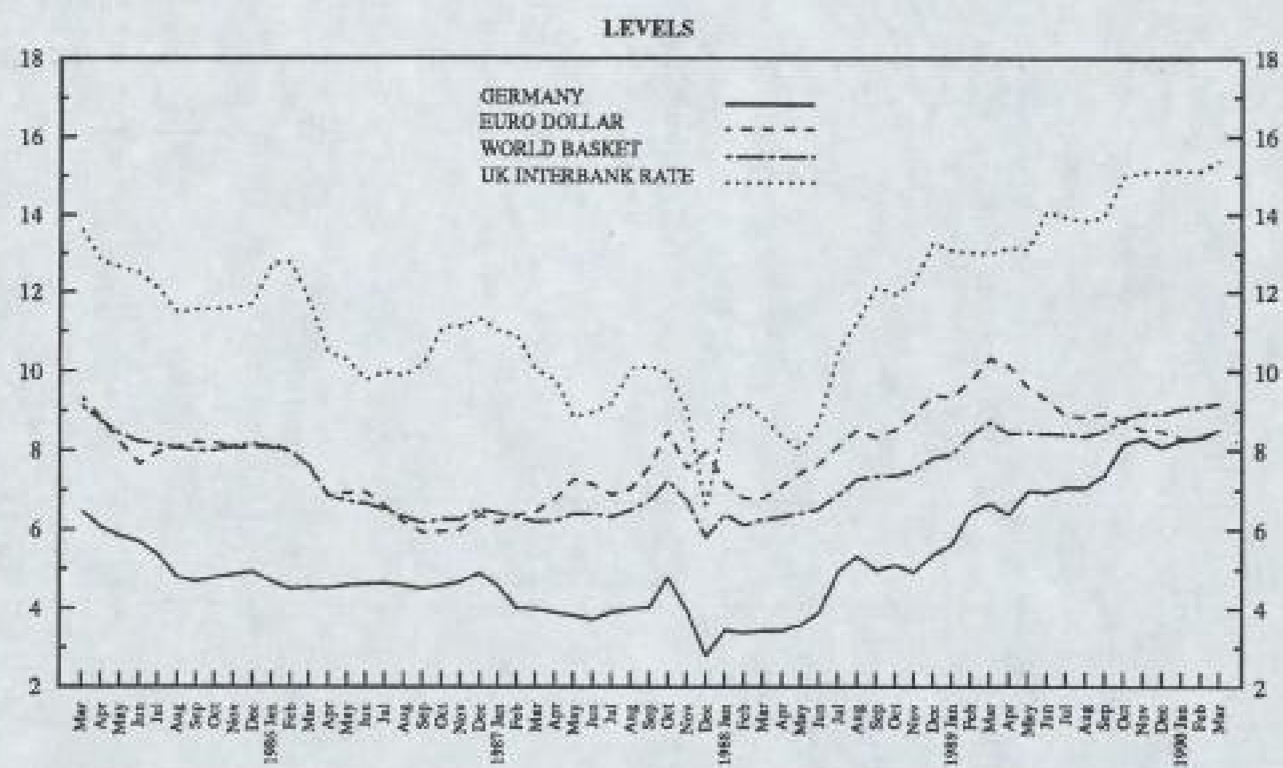


CHART 2: WORLD INTEREST RATES



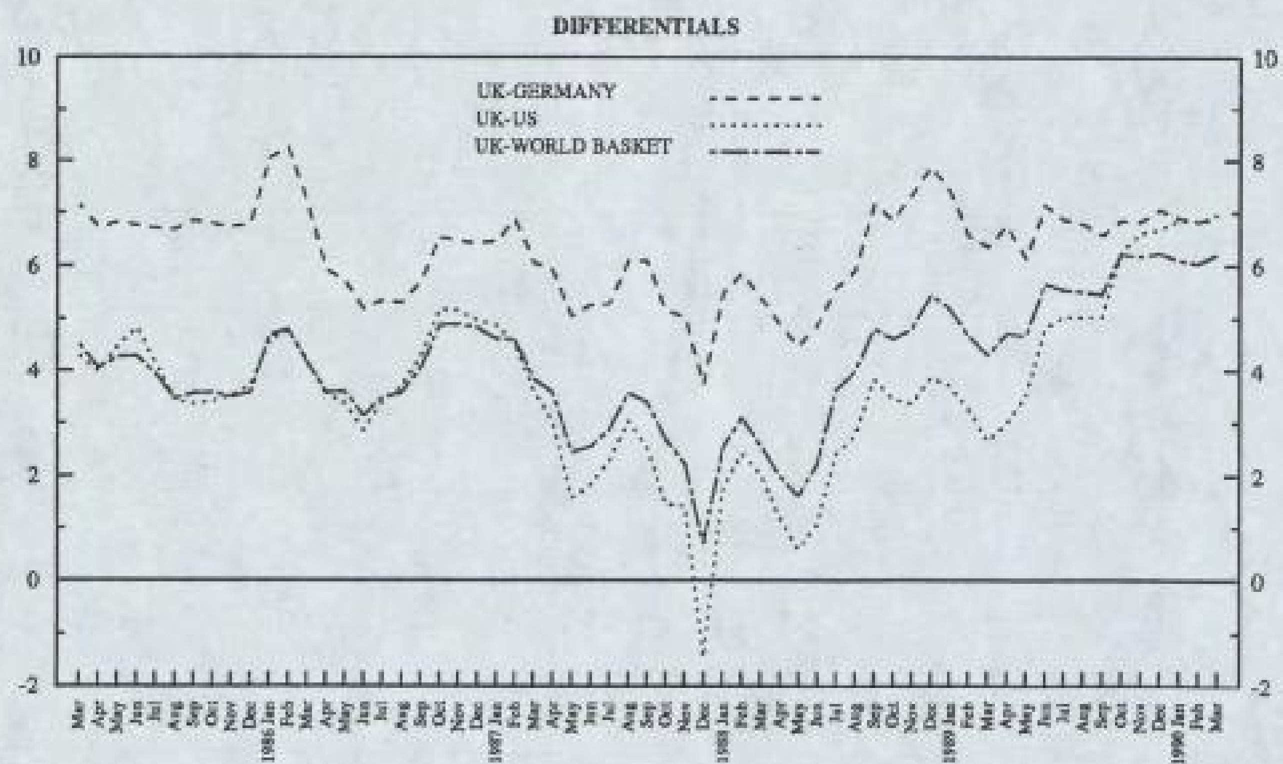


CHART 3: BROAD MONEY

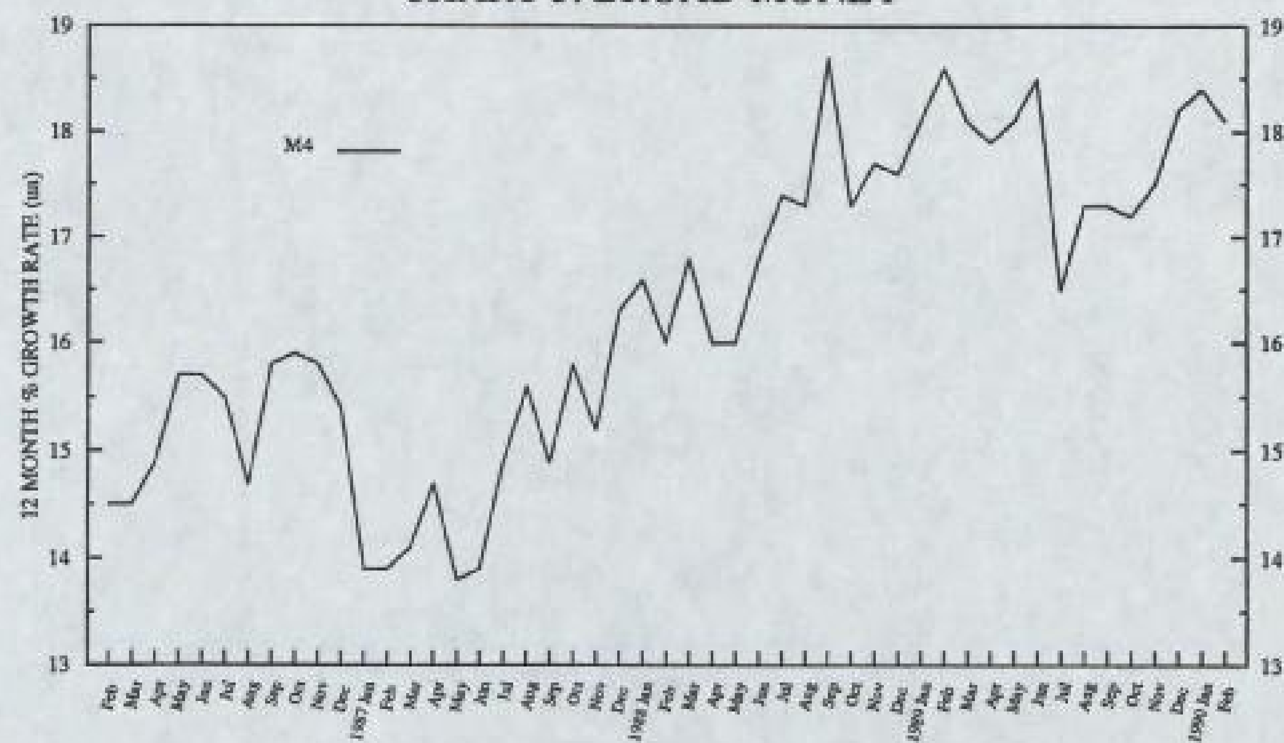


CHART 4: REAL M0

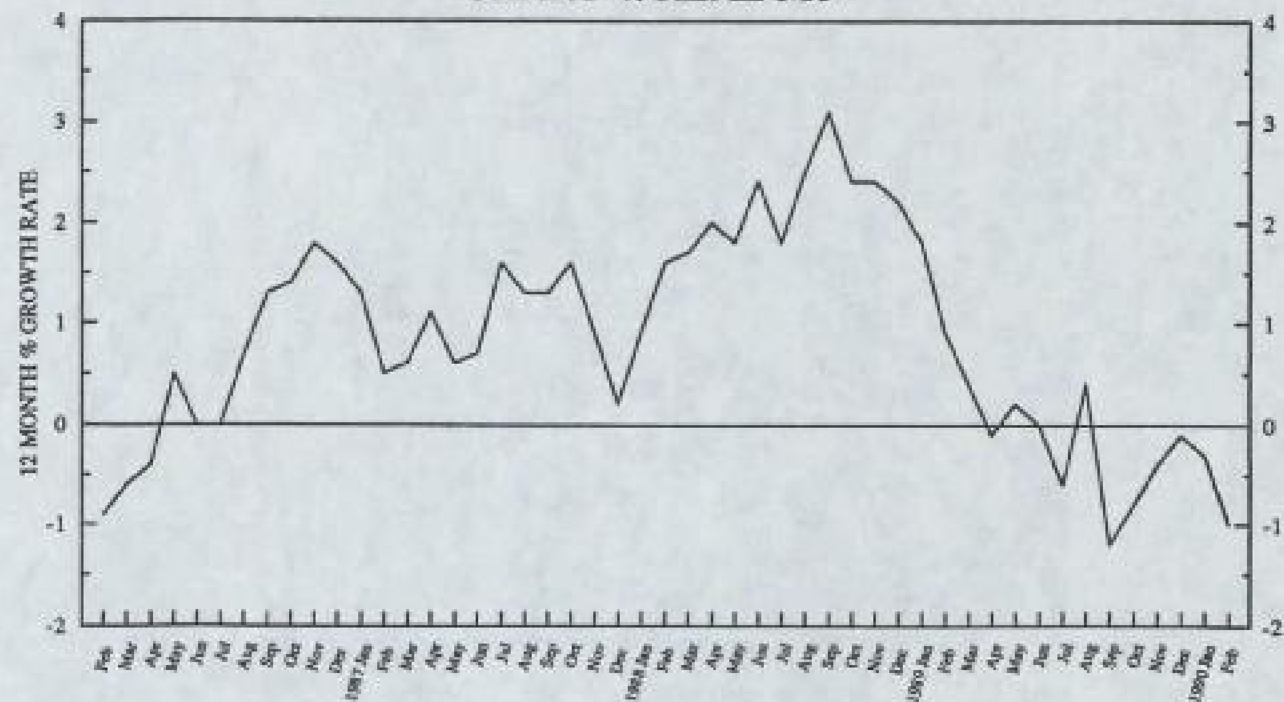


CHART 5: M0 FORECAST

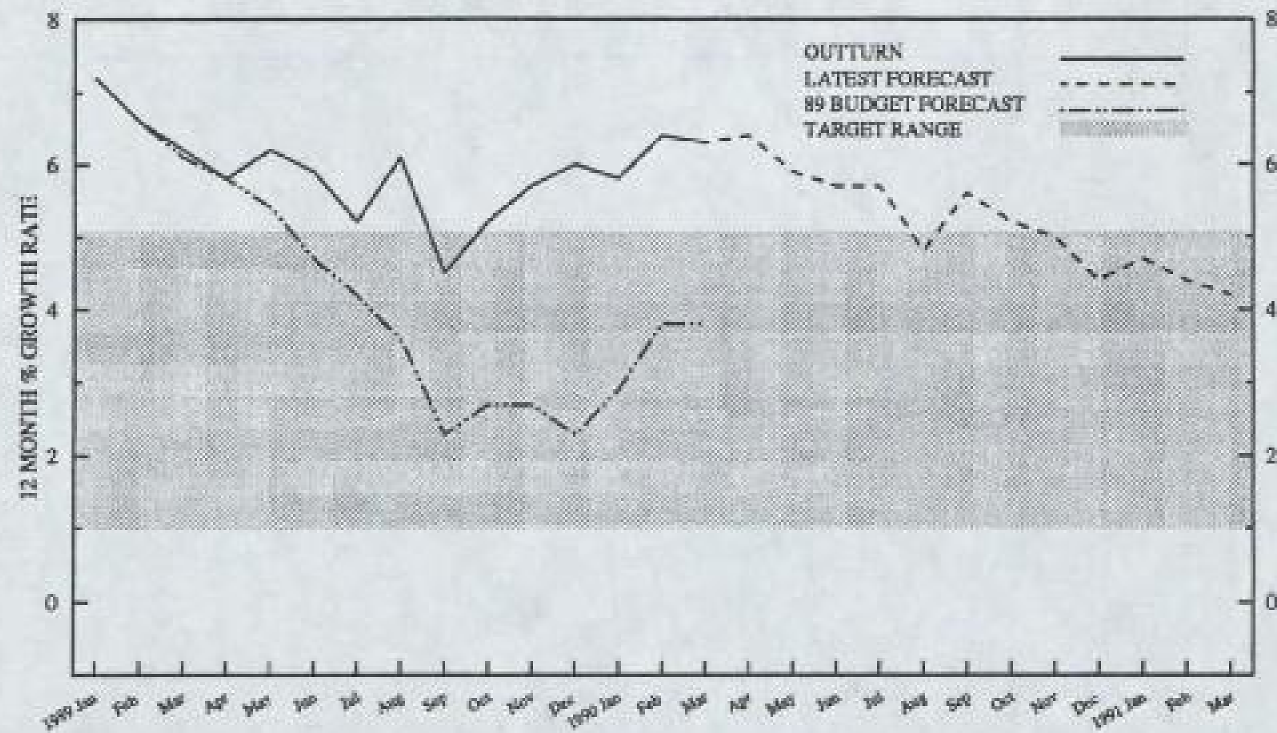


CHART 6: M4 FORECAST

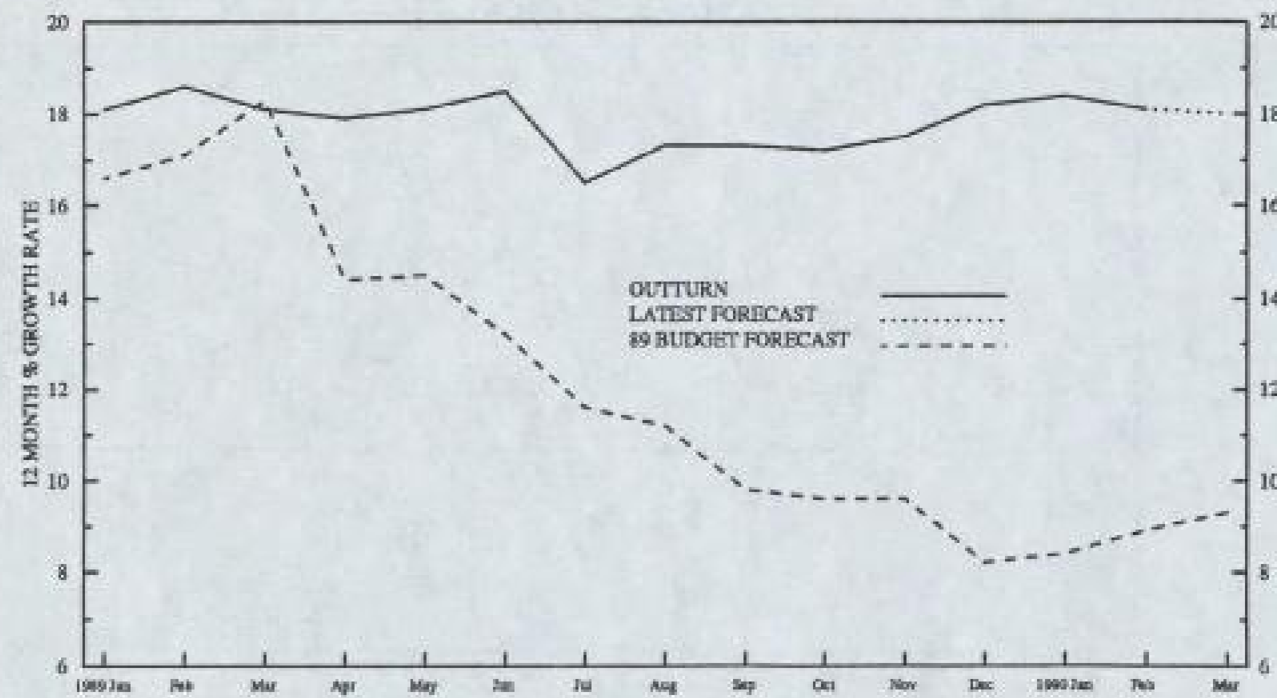


CHART 7: BANK & BUILDING SOCIETY LENDING

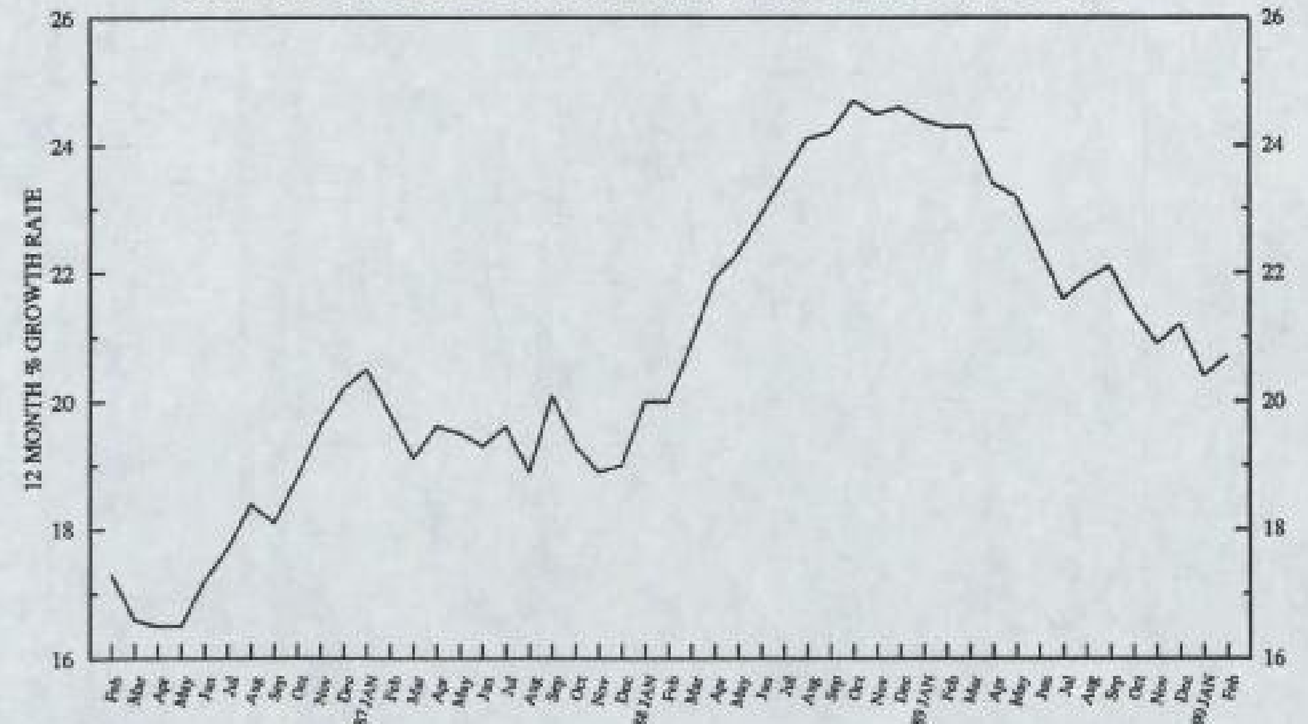


CHART 8: STERLING BOND ISSUES

(Domestic and Euro Markets)

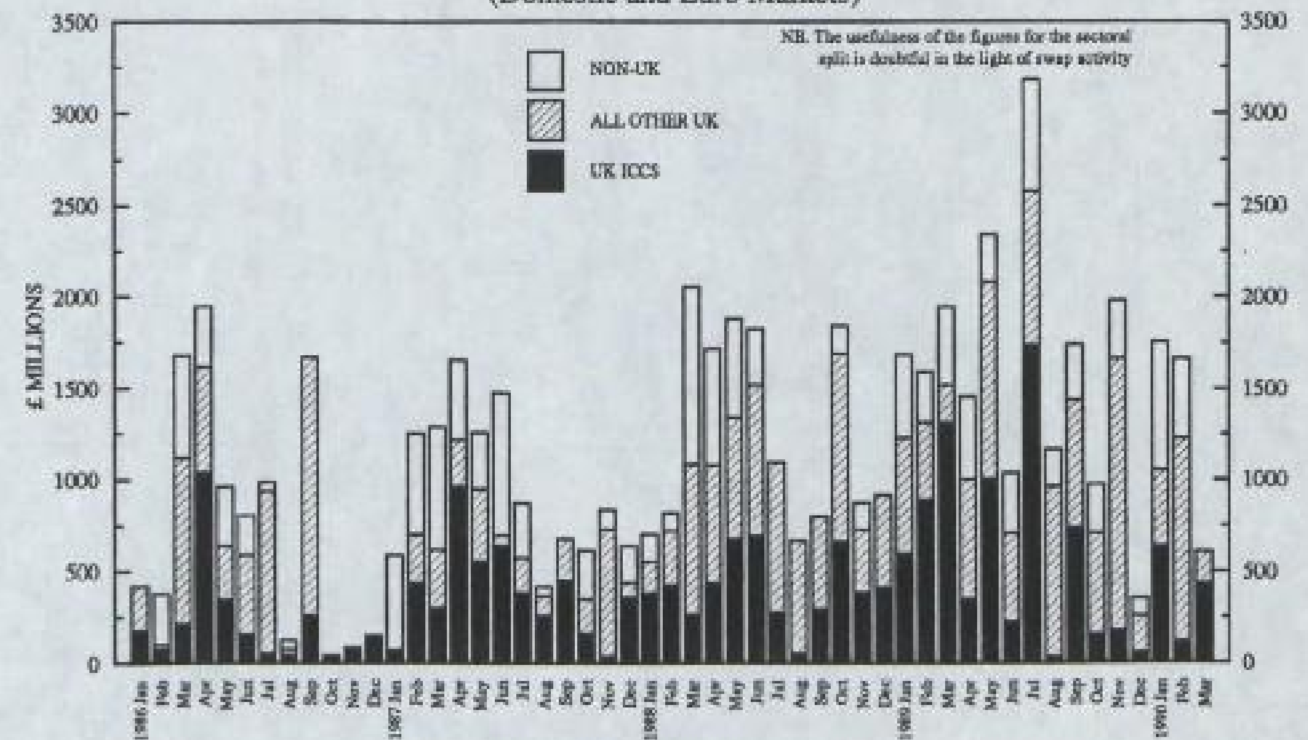


CHART 9: MONEY MARKET ASSISTANCE

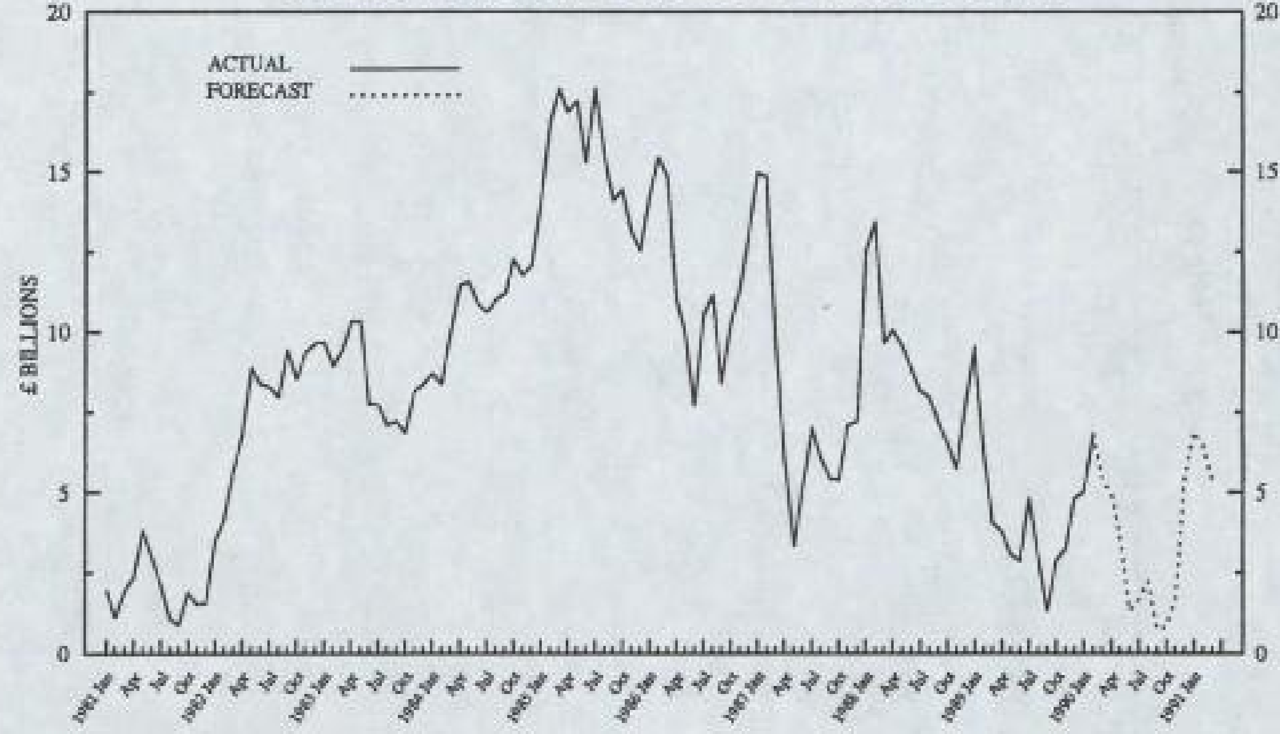


CHART 10: NOMINAL INTEREST RATES

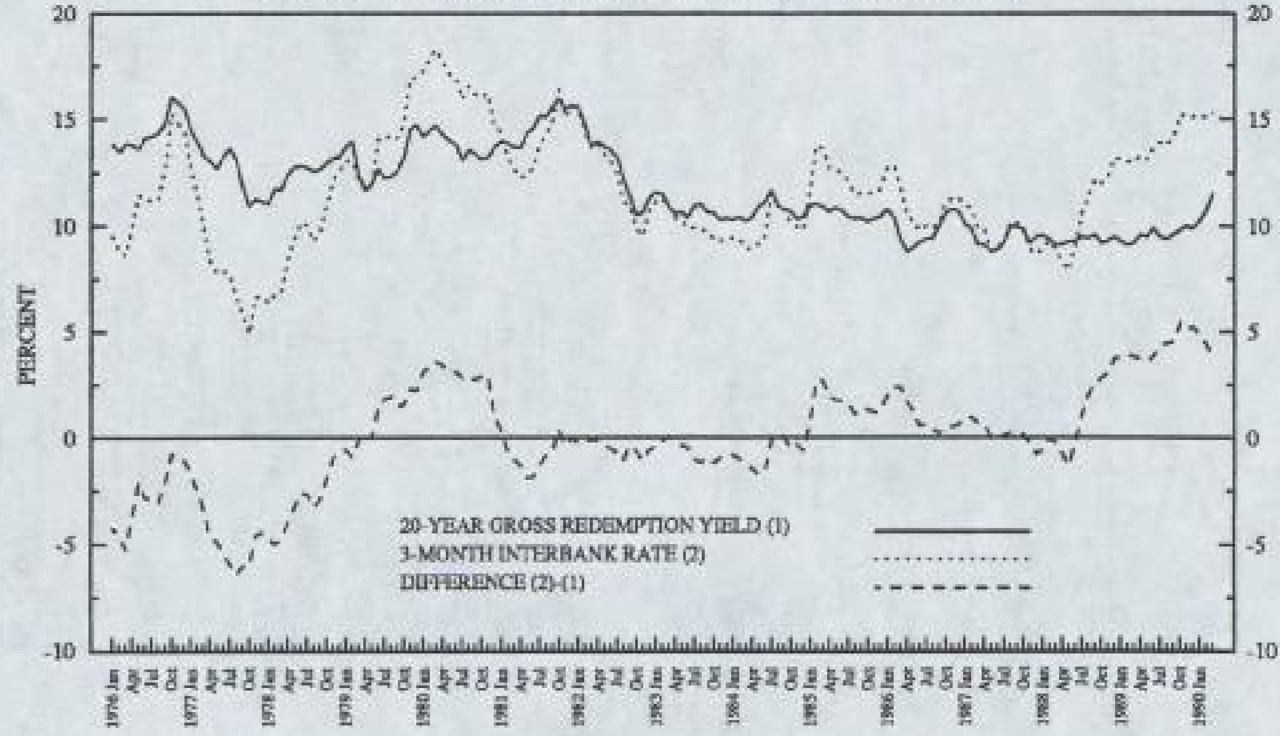


CHART 11

Time/Yield curves of British Government stocks

2nd April, 1990

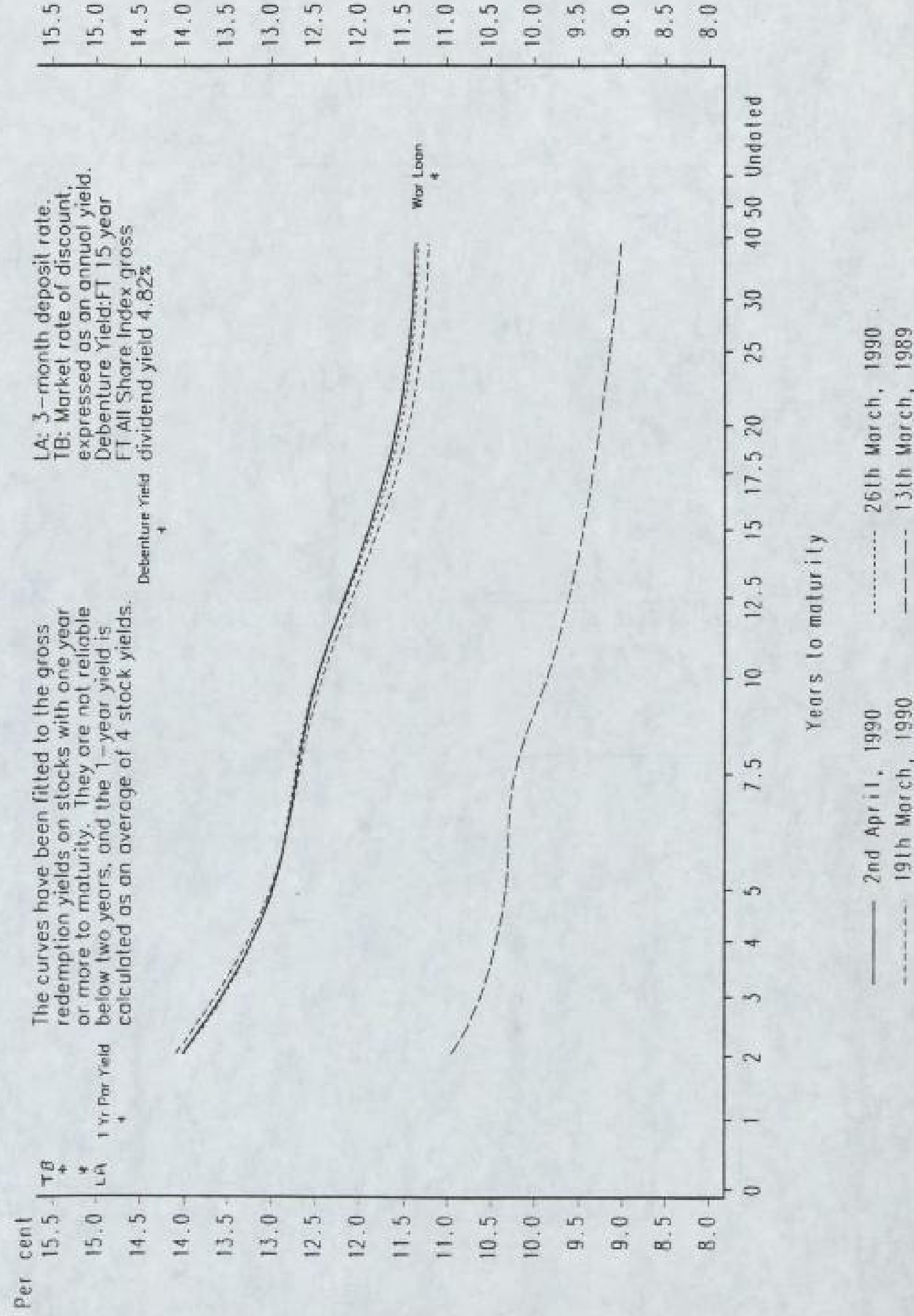
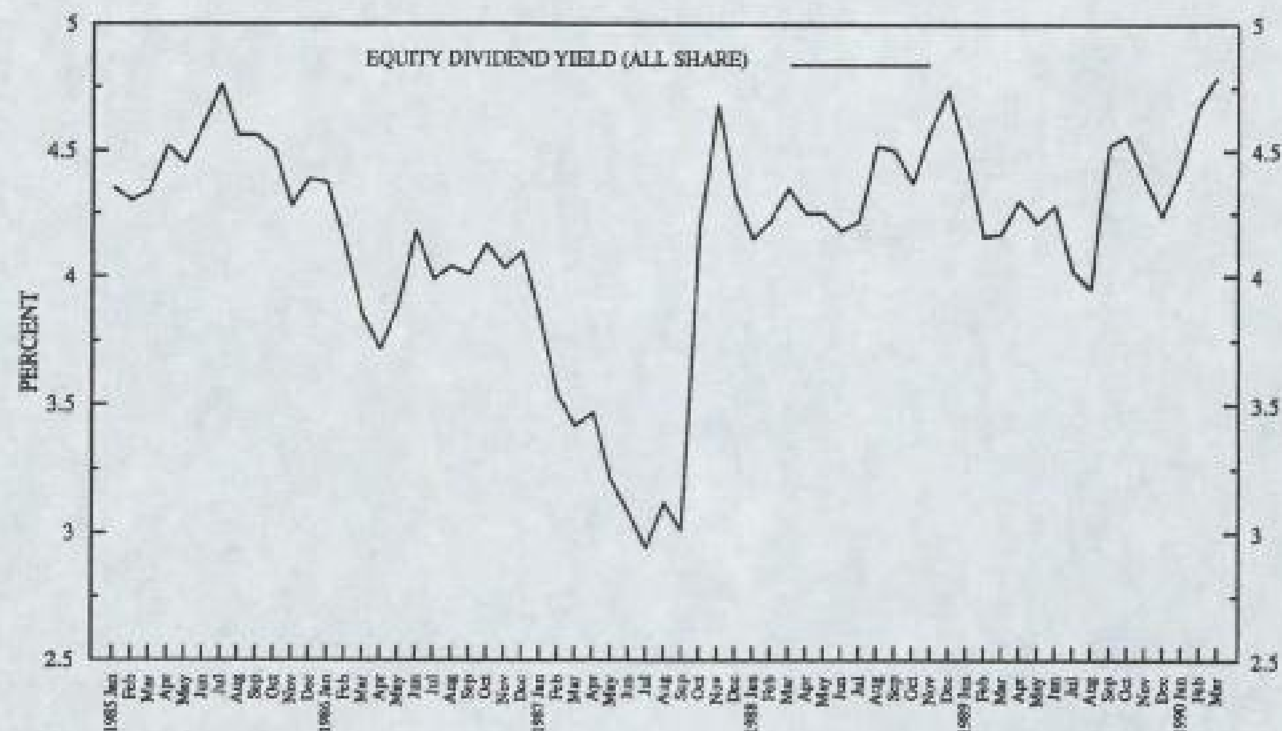


CHART 12: REAL YIELDS



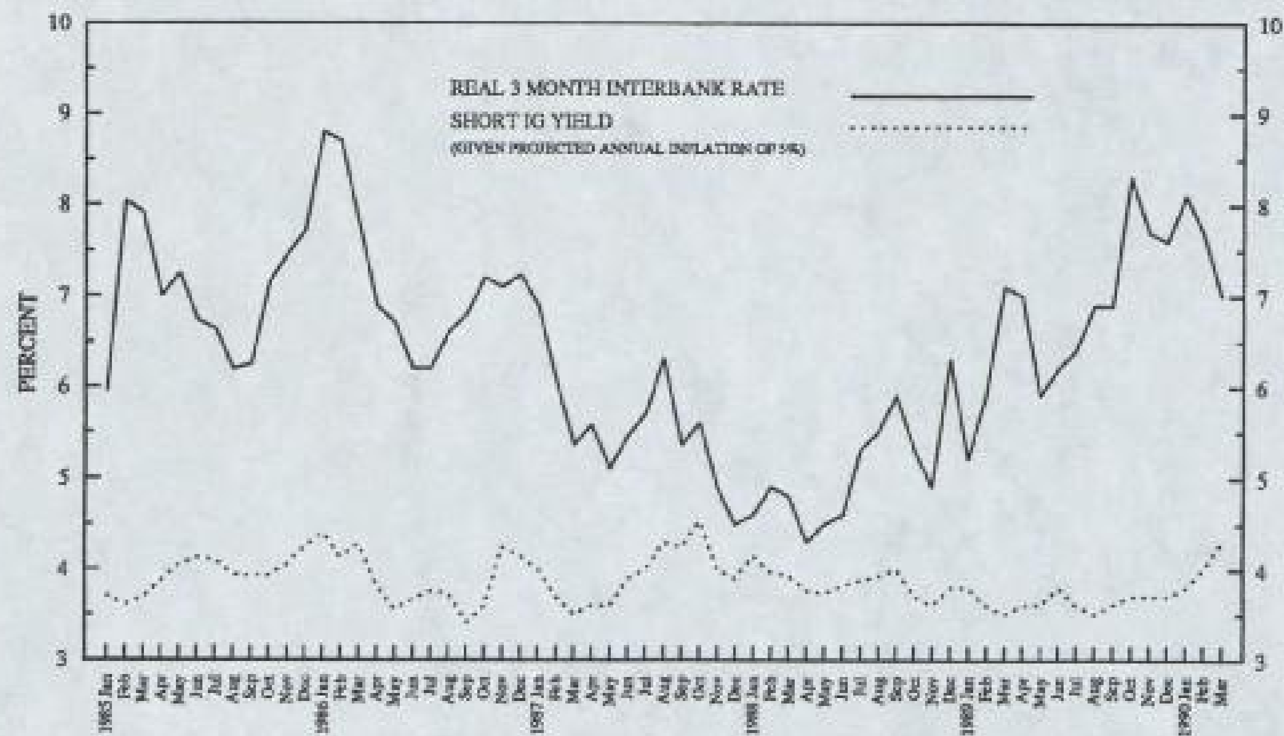
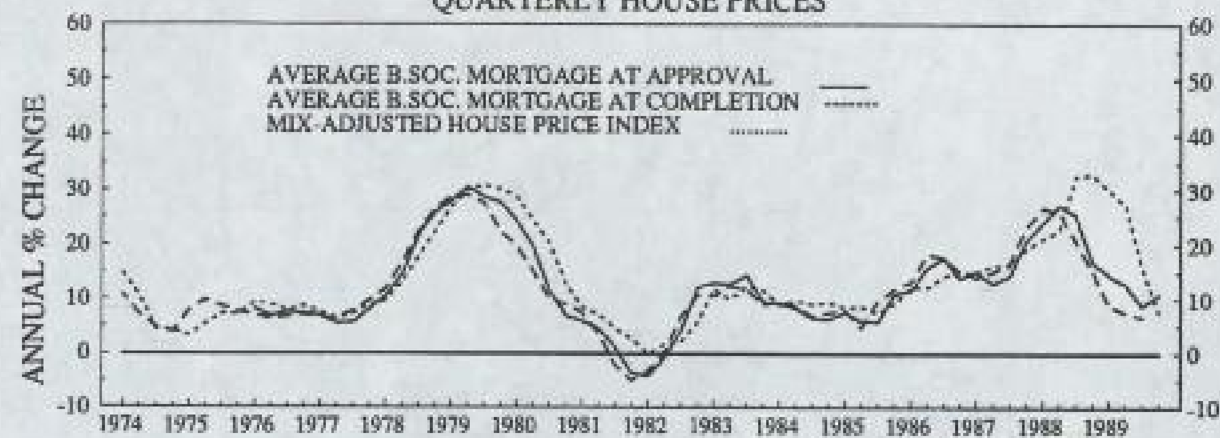
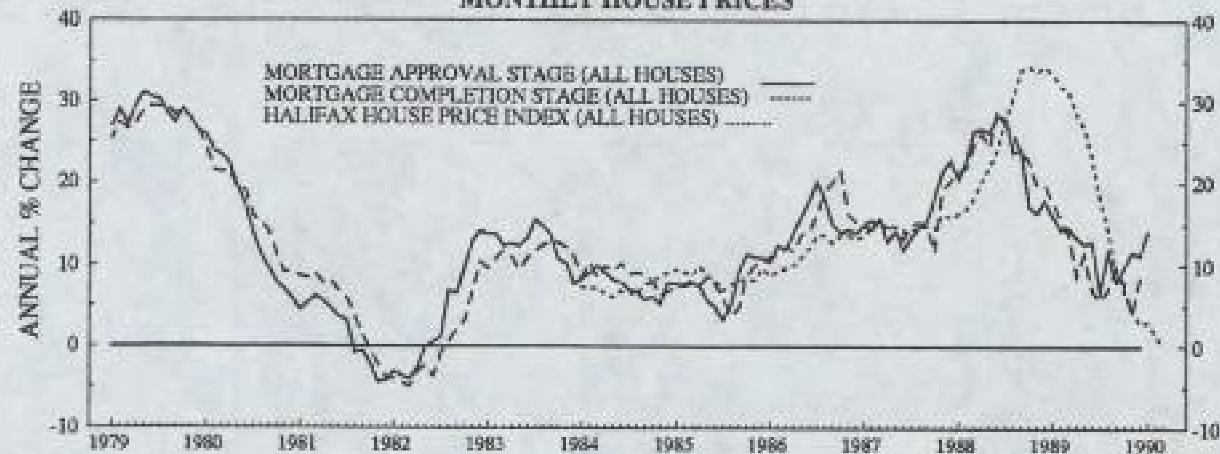


CHART 13 : HOUSE PRICES





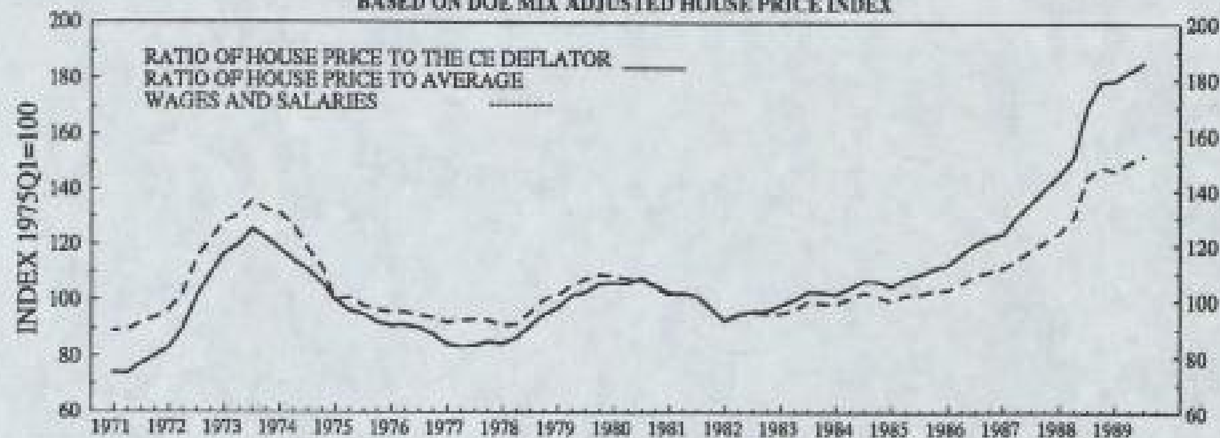
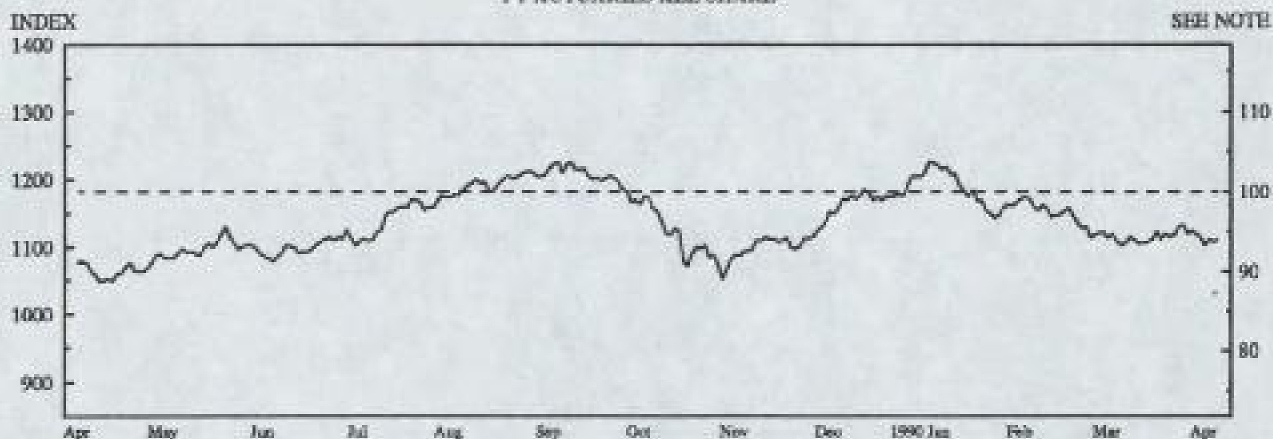
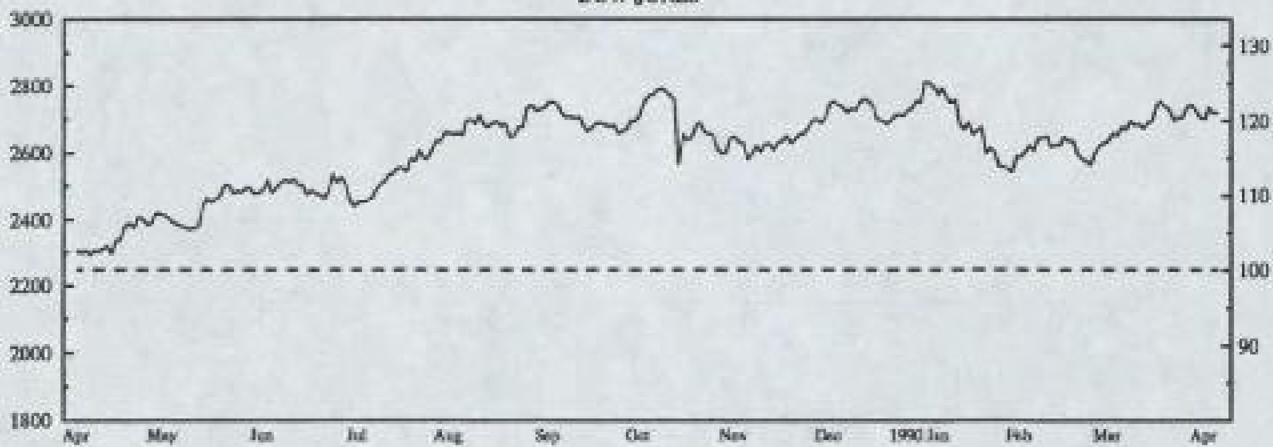
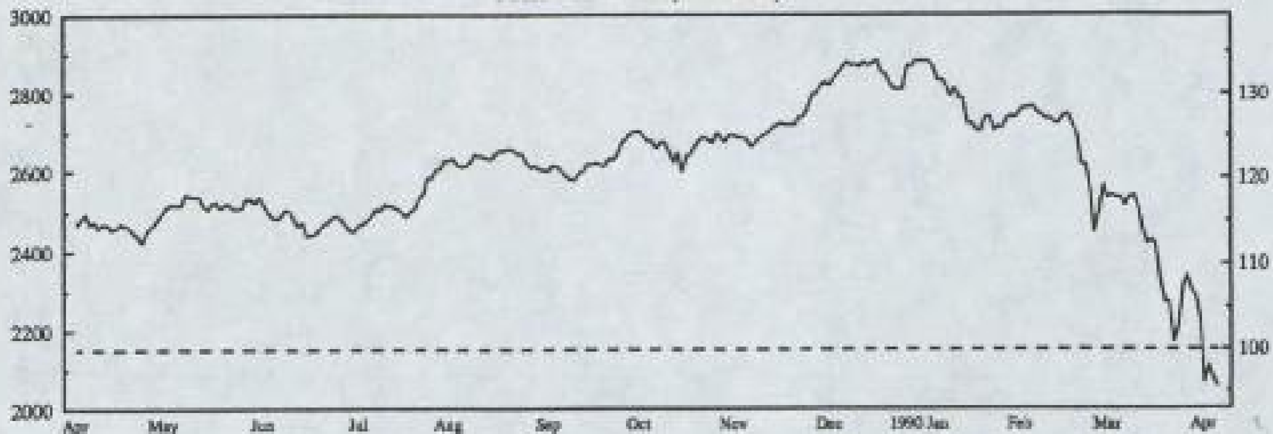


CHART 14: STOCK INDICES







NOTE: RIGHT HAND SCALE SHOWS LEVEL OF STOCK INDEX
RELATIVE TO PRE 1987 CRASH LEVEL (100)

8(a-e)

E

PRIME MINISTER

ECONOMIC POLICY OVER THE NEXT YEAR

Perhaps I could leave you some valedictory thoughts on economic management over the next year or so. Some of the points have a bearing on the issues you will be discussing with the Chancellor next week.

The note is in three parts:

A. what went wrong?
B. where are we now?
C. where do we go from here?

A. What Went Wrong?

We have discussed several times the errors over the last two to three years. But it may be helpful, with the benefit of hindsight, to summarise the key issues; because there are morals to be drawn for the future.

Ever since 1985 the Government - and most outside commentators - have under-estimated the impact of three inter-related factors:

a) the effect of financial deregulation on ordinary peoples' ability and willingness to borrow. In the early 1980s it was still quite hard work for people to borrow from banks and building societies; managers made people think they were doing them an enormous favour granting a mortgage or a loan. Financial deregulation has changed all that; potential lenders are now queuing up to lend to anyone with any kind of security to offer.

b) For most people that security is their house. Two-thirds of people now have that asset. And the housing boom

meant that most people now have an asset whose value is substantially higher than the existing debt secured on it. This meant lenders were very relaxed about increasing secured loans; and potential borrowers quickly cottoned on to how easy it was to raise extra money. For those with mortgages below £30,000 - still very much the majority in the mid 1980s - there was the added tax incentive.

c) The success of supply side policies and the turnaround in the economy meant that people felt much more confident about spending and borrowing; and less concerned about saving for a rainy day. Indeed by 1987-88 more and more people believed that the economic cycle was a thing of the past and that growth (including rising house prices) would carry on indefinitely.

These three factors combined to make private sector expenditure much more buoyant. And it was just when that effect was at its peak that the main policy errors were made. These arose both in:

(i) Fiscal Policy. Even though we moved into a large fiscal surplus it was probably not big enough. Indeed it was unplanned and arose only because of the cyclical position. The private sector was running such a large deficit that - temporarily - we should have run an even bigger fiscal surplus. That is not to say the supply side reforms in the 1988 Budget were wrong; far from it. But the overall stance of that Budget, eg on excise duties, was too loose. And there was no doubt that people did increase their spending plans in 1988 partly as a result of it. This added to the inflationary pressures and the leakage into imports and a trade deficit.

(ii) Monetary Policy. This was the big problem. The former Chancellor could not have picked a worse time to reduce interest rates. To my mind that was a far bigger mistake than the heavy intervention (although I would not want to defend that either). Interest rates are the touchstone of overall monetary policy. And given the very high "demand

for money" (excuse the economic jargon) resulting from the factors described above, interest rates (the price of money) should not have been allowed to drop below, say, 12 per cent at any point. But in fact they were lower than that all the way from early 1986 to mid 1988.

B. Where Are We Now?

The present state of the economy is still very hard to read. Demand is surprisingly resilient, but I think it is clearly slowing down. Indeed if it were slowing more than it is, the threat of a recession would be very great. I would guess that the higher community charges to finance greater than planned local authority spending could on balance restrain demand a bit further. And hopefully the stagnation in the housing market will provide a salutary lesson for personal borrowers.

The key problems are the monetary aggregates and retail prices. Broad money will stay difficult to interpret, particularly as some of the new savings measures will increase it. Narrow money needs to decelerate but, with inflation higher than expected, the 1 - 5 per cent target range is pretty tight.

I will not dwell on the RPI, which you are rightly concerned about because of the effect it could have upon wage bargaining etc. But however great the short-term problems, I continue to caution against trying to change the index now. It won't improve people's perceptions of inflation, and you will add to the problems by attracting charges of fiddling the figures. Better, I believe, to explain the oddities of the RPI and take the benefits as they unwind next year.

As to policy adjustments, a key point is that the economic indicators we are seeing now have been influenced by the policy actions in 1988, and possibly 1987. The lags are long. And if the present policy levers are held still until you are sure they are working, changes will have been left too late. If you are to get the timing of changes to interest rates right, at some point you will have to take a bit of a gamble.

C. Where Do We Go From Here?

My present guess is that interest rates ought to be reduced before the end of 1990. I do not think you should move before the summer. That would be too soon and would give very much the wrong signal - both to the markets and to private sector - against the background of a high RPI.

The choice may lie between bringing rates down in late summer/early autumn or leaving it until nearer the year end. But whenever you start the process it will be crucial not to allow rates to fall too fast or too far. In my view you should not be contemplating rates below, say, 12 per cent at any point in the next 12-18 months.

The handling of interest rates will be inextricably linked to the ERM. I share your instinctive worries about fixed exchange rate systems. But the fact is that, since the markets believe that sterling's membership of the ERM would give overall economic policies greater credibility, then it will, at any rate for a period. The Chancellor is right to say that the prospect for achieving some reduction in interest rates over the next year will be considerably enhanced by being in the system rather than outside it. There is a good case for linking the date of entry closely to the point at which you decide it is safe to reduce interest rates.

But the main danger of ERM membership later this year is that, because for a period this will give the markets greater confidence in sterling, there could be strong pressures to reduce interest rates more than is prudent on domestic grounds. You must resist that, and so avoid a repeat of the early 1988 mistake.

That means ensuring that the Chancellor will agree, once we are a member, to insist on a revaluation of sterling if there is strong market pressure to push it up.

To revert to timing. If you judge that it is appropriate before the end of this year both to start to bring interest rates down and to join the ERM there seem to be two main possibilities:

a) late September/early October. There may just be enough of a drop in the RPI by then, and you could seize the initiative in the Party Conference season and before Parliament reassembles.

b) around the time of the Autumn Statement in November. This would come before the IGC, and so strengthen the UK's hand there. And this could be a good time to give policy a greater credibility in market terms because you may be forced in the Autumn Statement to present some uncomfortably high public expenditure numbers.

I make this last point because I believe the Chief Secretary was right the other week to stress just how difficult the public spending round will be.

I know the Treasury always says this. But I judge this year will be by far the most difficult since the early 1980s, both because of the cyclical effects and the strength of the pressures for more spending on politically sensitive programmes. And this will be the more difficult to handle because I do not think that the public sector surplus this year will turn out to be as high as the £7b forecast. We have constantly under-estimated the extent of the swings in the PSBR, and my guess is that, net of the £5b allowed for privatisation proceeds this year, we could well be running a deficit before the end of 1990-91. So you must be cautious on fiscal as well as monetary policy.

PAUL GRAY
11 APRIL 1990

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PRIME MINISTER

SEMINAR WITH THE TREASURY

The Chancellor has suggested to you a couple of times having a further seminar with the senior Treasury team, along the lines of the one held in January. You have welcomed this.

We have, therefore, been looking at the diary possibilities. Last time, it was a late afternoon meeting, followed by supper. This is something you would only want to do if the following day is fairly quiet. Those possibilities are few and far between, and we cannot find a suitable time until mid-May.

The Chancellor is, I think, keen to have the meeting fairly soon. So the only other option Amanda and I can identify is to hold it on the Tuesday following Easter Monday, 17 April; and for it to take the form of a 1030 meeting followed by lunch. Both the Chancellor and Chief Secretary would be content with this. But the question is whether you would want to use up part of that particular day for this purpose.

On attendance, the Chancellor wanted the Chief Secretary to join him (it was the Economic Secretary last time). And the two key officials are Peter Middleton and Terry Burns. Last time, Michael Scholar came in place of Peter Middleton (who was on his honeymoon). But you may want to consider having Michael along again, given that he is the key Deputy Secretary on economic policy matters, as well as Peter and Terry.

(i) (a) content with a morning meeting and lunch on 17 April?

OR

(b) prefer to wait until we can find an evening in, say, mid-May?

(ii) do you want Michael Scholar to come as well as the others?

PAUL GRAY

26 March 1990

C:\wpdocs\economic\seminar (pmm)

Prime Minister[2]

Worrying.

PRCG 21/3

PAUL GRAY

21 March 1990

'EQUAL PAY' AWARDS BY J SAINSBURY AND MARKS & SPENCER

The decision by Sainsbury to grant pay rises ranging from 8.5% to 21% for retail staff is seen by other retailers as a precipitate response to an industrial tribunal case under the 1983 'Equal Value' amendment to the 1970 Equal Pay Act.

But Marks & Spencer has followed suit and many others will do so. The 'knock on' effect must be very significant; it had been assumed that we were about twelve months away from decisions of this sort.

Howell Harris Hughes

HOWELL HARRIS HUGHES

FINANCIAL TIMES WED

 21 3.90

M and S sales staff win 26% over three years

By Maggie Urry

MARKS and Spencer, the most profitable retailer in the UK, has given its 44,000 sales assistants a £31.50 a pay rise to bring their their wages in line with those of 3,000 warehouse workers who will not receive a pay increase.

There will be no further rises until July 1993 unless circumstances change significantly. The company said its workers will now be paid between 30 to 40 per cent more than people doing similar jobs in other companies.

M and S said the pay award follows changes in the work of sales and warehouse staff with the advent of new technology. Sales assistants' jobs had got more complex while those of warehouse workers had become simpler.

The change in job content meant that the differential between the types of work was no longer fair, said Mr Clive Nickolds, personnel group executive.

The company denied that the rise awarded had been prompted by an industrial tribunal ruling last year which said the work of a female check-out operator at a J Sainsbury food store could be compared to that of a male warehouse worker.

However, the news came only a day after Sainsbury announced rises of between 8.5 and 21 per cent for 60,000 retail staff following a job evaluation intended to comply with equal pay for work of equal value legislation.

Last year, M and S paid a flat rate increase to sales and warehouse staff in an attempt to bring the pay of the two groups more in line. As in other companies, most warehouse staff are men and most check-out operators women.

The M and S rise will take the basic pay for sales assistants in the provinces to £150.50 for a 39-hour week, a rise of 26.5 per cent, matching the rate for warehouse staff. The pay of staff in the south east of England will rise to £165.50 and in the west end of London to £184.00.

The increase works out at between 7 per cent and 8.5 per cent on an annualised basis, while warehouse workers will receive a one-off £500 payment to soften the blow of not being able to expect a rise for over three years.

Managerial and administrative staff were given an annual increase of 8.5 per cent yesterday. M and S said the deal would cost the group an extra £20m in the first year. However, it thought this would not affect the group's profitability.

The company expected improvements in productivity to continue at the 8 per cent a year rate of recent years, and a fall in staff turnover — which had risen to 20 per cent among sales staff — was expected.

The company, which does not recognise any trade unions, decided on the new pay structure after a year long internal review. The deal was not negotiated with staff but presented to them yesterday.

Over the next few months M and S will introduce a system of salary bands, to give scope for making merit awards to individual workers.

The high cost of checking-out jobs equality

John Gapper on the pressures facing stores like Sainsbury to raise women staff pay

FOR the past two years, Sainsbury has been trying to estimate the worth of its 60,000 retail staff in a project known as "Placing New Values on Our People." The new values of many of its female people have turned out rather high.

"You are Sainsbury's most valuable asset," starts the pamphlet explaining the evaluation which led to the company awarding check-out operators pay increases of 14.5 per cent while raising the pay of clerks only 8.5 per cent.

They could also have turned into a [illegible] liability. An industrial tribunal [illegible]

It remains an open question as to whether the defence is impregnable. The Hay system withstood a challenge in the United States courts by a woman employee of the Republic Bank of Dallas, but has not been full[illegible] teste[illegible] Europe. Usdaw, the distrib[illegible] union, has dropped its Sain[illegible] and said yesterday that the Mar[illegible] Spencer award was in line with its estimates.

A separate question facing Marks [illegible] Spencer is whether it will disillusi[illegible] warehouse staff by not atta[illegible] enough money to the pay restruct[illegible]

FILE KK

bc PU

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

7 March 1990

INSEAD

Thank you for your letter of 2 March, enclosing a note on the INSEAD competitiveness study. The Prime Minister was grateful for this material.

(PAUL GRAY)

Duncan Sparkes, Esq.,
HM Treasury.

chex.jp/ds/32

CC

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

2 March 1990

Paul Gray Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

Prime Minister
You may like to see this Treasury commentary on the study to which Trevor Holdsworth referred when he came to see you in January.

Dear Paul,

In your letter of 24 January, recording the Prime Minister's meeting with Sir Trevor Holdsworth, you suggested that we might look into a competitiveness study by the French business school INSEAD, which had been mentioned by Sir Trevor. This apparently showed the UK in a second position in Europe behind Spain. I apologise for the delay in replying - it has taken some time to track down the source of Sir Trevor's information.

... I attach a short note on the INSEAD study.

Yours,

Duncan.

DUNCAN SPARKES
Assistant Private Secretary

EEC Integration towards 1992

Damien J Neven, INSEAD and CEPR

The competitiveness study mentioned by Sir Trevor Holdsworth to the Prime Minister during their meeting on 23 January 1990 was conducted by Dr Damien Neven, as part of his work on the implications of 1992, and is not yet published. (He has promised to send us a copy on publication, probably in a few weeks.) We have, however, spoken to Dr Neven on the telephone, and we have seen a related paper of his on gains and losses to be expected from the Single Market programme.

2. The competitiveness paper, when published, is unlikely to have as strong or as general a conclusion as that referred to by Sir Trevor - that the UK is in a second position in Europe behind Spain. However, on the telephone, Dr Neven said that he found the UK to be in a "pretty good position in a number of industries", and the UK's position has "improved tremendously in the 1980s". In particular, he found that the UK performed well in industries intensive in human capital. According to the paper we do have, these are chemicals, pharaceuticals, transport equipment, and electrical and mechanical machinery.

3. Dr Neven has performed a standard analysis of competitiveness, assuming technology is the same in the different countries and comparing labour costs and value added per worker in different industries at a fairly disaggregate level. He has used data from Eurostat (the EC source) and the US Bureau of Labour Statistics.

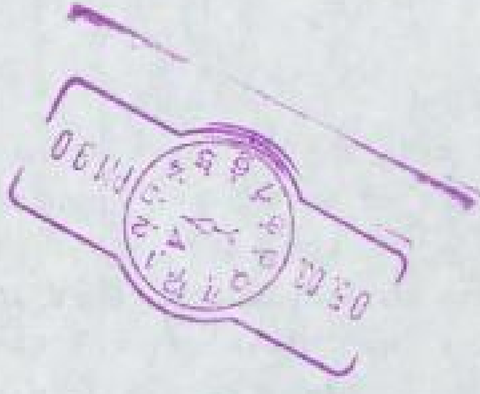
4. The paper on gains and losses from the Single Market examines the possible exploitation of comparative advantage and economies of scale. The conclusions are favourable to the UK. The main beneficiaries of 1992 will be the Southern European countries, which will benefit both from a better exploitation of their comparative advantage and from a better use of scale economies to a much greater extent than the countries of Northern Europe. Northern Europe has little to expect from the Single Market, with the exception of the UK, which can expect some gains, because it is less integrated and has an unexploited comparative advantage in industries intensive in human capital.

5. Dr Neven finds a high share of R&D personnel in total employment in the UK, and a high share of graduates among R&D personnel. This suggests to him that human capital is used intensively. His calculations show that labour costs in the UK are 25 per cent below the Northern European average, indicating that the price of human capital is low (i.e. lower wages of graduates/scientists etc.), and therefore that there is scope in the Single Market for specialization in industries intensive in human capital (listed above - para. 3), where the net trade position of the UK is currently negative.

6. Dr Neven also observes that wages in the UK tend to be lower, in comparison with the continent, in industries where non-tariff barriers are high, and thus "UK industries which have been prevented from exporting to the continent because of NTBs should be in a favourable position to increase their exports when these barriers are removed". Beverages, foodstuff, metals, electrical and mechanical machinery and motor vehicles are cited as industries with the highest NTBs.

7. We will have to await publication, but we have the impression that the competitiveness paper will not provide a particularly useful source of briefing points.

Econ Pol: Strategy.
Pt 21



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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

24 January 1990

PRIME MINISTER'S MEETING WITH SIR TREVOR HOLDSWORTH

Sir Trevor Holdsworth came to see the Prime Minister yesterday to discuss the general economic position, and in particular pay developments. The meeting was at his initiative and followed an earlier brief discussion at a social event.

The meeting was conducted in a very friendly atmosphere. Sir Trevor's general message on pay, delivered a little diffidently, was to ask that the Government should 'trust business'. From time to time he acknowledged that the recent trend unit labour costs did point to a potential problem, but for the most part he implied that the aggregate figures were misleading and that what was happening on the ground in pay negotiations in business was more encouraging. '90 per cent of our managers recognise the problem and realise what they have got to do - but give them a chance'. At the end of the meeting Sir Trevor handed over the enclosed draft of the paper he would be putting to today's meeting of the CBI Council. At a couple of points in the discussion he referred obliquely to the CBI's allegation of 'inflationary own goals' by the Government but he did not come out at all directly with it in the way that the Council paper and other recent CBI comments do.

The Prime Minister did not respond directly to the plea to give business a chance. She noted that Sir Trevor seemed not to be as worried as she was and said that, if the pay issue was raised with her in Parliament and elsewhere, she would continue to point to the trade off between high wage costs and jobs.

Other points that came up in the discussion were:

- the CBI quarterly survey to be published next Monday would be generally encouraging. Confidence was less, with growth expected to be only just positive, but investment was holding up. Exports were continuing to do very well. And there was no upward shift in the outlook for output prices.

- a recent competitiveness study by INSEAD had put the UK at second position in Europe behind Spain. Sir Trevor was looking into the details. (I think the Prime Minister would

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find it helpful to have a note on this study.) Sir Trevor said that British industry was not looking to the Government to ease its position by a depreciating exchange rate. Indeed, business was strongly supportive of the Government's counter inflationary approach, and had no major complaints on interest rates.

- the Prime Minister pointed to the importance of improving our record on training; a more positive approach was needed. Sir Trevor said he thought UK training performance was improving, and particularly welcomed the development of TECs. He also made bullish comments about the UK record on research and development, but said it was important to recognise there was no great spin off benefit from large expenditure on defence R & D.

- The Prime Minister expressed concern about high levels of UK imports of straight forward products - eg cotton wool and chipboard - that UK industry really ought to be able to produce competitively. Sir Trevor was optimistic about the future trends in UK trade in cars; he could foresee the UK industry building up to produce 2 - 2.5 million units. The great strength of Japan continued to be their production, engineering and application skils. This was an area of major skill shortage in the UK.

- both the Prime Minister and Sir Trevor expressed concern about 'short-termism' by the financial institutions. Sir Trevor said that management and ownership had grown too far apart in this country. Amongst the financial institutions Sir Trevor said that life companies took the longest term view, but pension fund managers were dominated by requirements of quarterly performance. Sir Trevor thought that increasingly wide share ownership would help but that the process would be slow. The Prime Minister asked whether it was possible for business leaders to influence the behaviour of the managers of their own company pension funds; Sir Trevor said it was but had become more difficult with the growth in the number of member trustees.

PAUL GRAY

John Gieve, Esq.,
HM Treasury

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Director-General
John M M Banham

Deputy Director-General and Secretary
Maurice Hunt

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C 2 90 (Summary)

TO THE COUNCIL FOR THE MEETING ON 24 JANUARY 1990

Pay and Competitiveness

1 The 1989 CBI Pay and Performance Presentation demonstrated the substantial achievements made by industry in the 1980s to improve efficiency, competitiveness and profitability and highlighted the challenges in the years ahead.

2 More recently, the rise in pay settlement levels and unit labour costs coupled with the downturn in consumer demand are squeezing the manufacturing sector. Manufacturing productivity growth is tending to slow and economic growth has fallen back from the high levels of the 1980s.

3 The present inflation is not pay led; factory gate price increases are low compared to increases in mortgages and other Government imposed charges.

4 Public service settlements continue to follow those in the trading sector, without compensating improvements in performance or reductions in manning levels.

5 Members' views are sought on the following: should the CBI

a) acknowledge that a problem of performance not fully off-setting pay rises in the trading sector is emerging, which threatens competitiveness, while insisting that it should not be misread <u>either</u> as indicating that management have not tackled pay issues <u>or</u> as the underlying cause of present inflation;

b) identify <u>all</u> the factors contributing to current inflation and publicise the findings to counter the pay-led argument;

c) build on the message of the 1989 Pay and Performance presentation, by providing information about good practice on performance measurement and its use in pay negotiations;

d) oppose anything approaching a 'pay norm' as inappropriate and as setting a figure that will be seen an entitlement, likely to boost rather than ease inflation;

e) press for the easement of Government-imposed charges that are contributing to inflationary pressures on pay via the RPI;

f) carry forward work on public service pay, stressing the need for performance there to be seen to justify increases too.

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CBI

C 2 90

TO THE COUNCIL FOR THE MEETING ON WEDNESDAY, 24 JANUARY 1990

POLITICAL ISSUE OF THE DAY:

PAY AND COMPETITIVENESS

1 The CBI supports the objective of a high performance, high pay economy. A continuing improvement in our unit labour cost competitiveness is necessary for the attainment of this goal. This was the central message of CBI's 1989 Pay and Performance Presentation. With pay settlements now running at their highest level for eight years - 8.3% (Q3) in manufacturing and 8.6% in services - and concern that productivity growth will slow over the next 12 months, the danger is that labour costs will rise disproportionately in 1990, putting pressure on margins and prices.

2 The purpose of this paper is to report on members' reaction to the Pay and Performance presentation, to assess the developing pay scene and to suggest how CBI might respond.

The Present Pay Scene

3 In a wide ranging assessment, the 1989 Pay Presentation demonstrated the substantial achievements of the past decade and highlighted the challenges for 1990 and the years ahead. It emphasised that in every year since 1980, CBI Pay Databank responses had shown over 25% of manufacturing pay settlements incorporating revisions of working arrangements as part of the deal. Changes made included the removal of restrictive practices and their replacement by more flexible arrangements, appropriate manning of new technology and reductions in the numbers employed. Not all of the changes had been directly linked to pay settlements; in a number of cases the improvements have been the straightforward result of tighter management: but in all cases they should have operated to assist unit labour cost competitiveness.

4 More recently, there had been a substantial increase in investment levels. Manufacturing investment estimates for the second quarter of 1989 totalled over £3.1bn, 13.2% up on the previous quarter and 7.8% up on the same period in 1988. A survey conducted in the middle of the year indicated and Pay Databank figures confirmed that employers were expecting

this investment to achieve further significant productivity improvements in the period ahead.

5 The combination of changes in working practices and substantial investment were shown to be creating the potential for improved competitiveness through a narrowing of the gap between productivity in the British economy and that achieved by major competitors.

6 Responses to the Pay and Performance Presentation supported the need to maintain progress on productivity and unit labour costs. However, members also stressed that:

- inflationary pressures were more complex now than simple retail prices, which inadequately reflected some cost-of-living elements for many employees - notably the impact of interest rates rises on many newer mortgage holders;
- uncertainty about inflationary pressures was hampering the desirable growth of 2 and 3 year settlements;
- future investment plans were being scaled down, which may affect maintenance of productivity improvement beyond the next 12 months;
- labour shortages were occasionally prompting distortions to pay structures which may not be sustainable;
- despite the CSEU's campaign in engineering, there was no major pressure on hours of work.

7 A further cause for concern to CBI over recent years has been developments in the public services. Data is limited and productivity more difficult to assess than in manufacturing, but settlements reported have been running at comparable levels to those in the productive sector, and little evidence of comparable performance improvements has been shown.

8 Earnings growth across the public sector as a whole appears to have closely shadowed that in the private sector throughout the decade. The New Earnings Survey figures for median earnings for men in the public sector show an increase of 152% between April 1979 and April 1989, compared with 151% in the private sector - notwithstanding that major productivity improvements to finance pay rises have been a feature of the private sector rather than the public.

9 Concern about what has been going on in the public services must be more acute because of the double burden created for manufacturing: there is not only the possible labour market

pressure but the fact that manufacturing ultimately has to carry much of the cost of the consequent pay bill.

10 So far as private services are concerned, whilst reservations can again legitimately be expressed about output measures, the figures here also suggest a rise in pay costs which is substantially greater than growth in output. Settlement figures, showing the anticipated effect on average earnings, are not far out of line with output growth: but there has been a significant increase in the numbers employed - with obvious implications for total pay costs. The adverse implication for unit labour costs is clear : and whilst labour costs are less important across the private services as a whole they still represent over 25% of sales revenue in more than two thirds of service companies, so concern is surely justified.

Recent Developments

11 The economic situation has changed in recent months. There is now clear evidence from CBI surveys and Government figures that consumers' demand growth has slowed considerably. In the three months to November, retail sales were up just 1% on a year earlier, compared to growth rates of 8% recorded early in 1988, and manufacturing is feeling the squeeze. The CBI Monthly Trends Enquiry shows that manufacturers' order books have been considered 'below normal' since May. The latest results for November show that most manufacturers expect virtually no increase in output in the four months ahead. Manufacturing stocks are increasing, whilst CBI's Distributive Trades Survey for November 1989 showed the highest stock levels since the survey began (in 1983).

12 The steady economic growth of the 1980s, remarkable by Britain's historic standards, has come to a halt for the time being and output is now generally forecast to grow by very little in 1990, picking up only gradually in 1991.

13 Pay levels are not yet reflecting this gloomier domestic outlook. CBI's Databank shows that settlements continue to be fairly narrowly bunched around the RPI rate and, whilst the average may have stopped rising, it has, at best, plateaued at just over 8%. Most respondents in manufacturing believe that productivity improvements of around 6 or 7% have been achieved over the last year, making their settlements largely self-financing: and that they can continue the same rate of progress into the year ahead.

14 Evidence is now emerging that this productivity expectation may be over-optimistic. The trend in productivity achievement recorded in CBI's Databank is now downwards,

whilst pay rises remain unchanged, confirming the adverse movement in unit labour costs. Meanwhile, investment, to which most employers had been looking as the main source of further productivity improvements, is no longer growing. It is expected to be no higher in 1990 than in 1989, with only modest growth forecast thereafter.

15 The uncompetitive trend in Britain's unit labour costs is not yet adversely affecting exports, where volume growth of non-oil exports has averaged 7% per annum since 1987 - double the average growth of the previous 16 years. But, as UK unit labour cost levels were close to those of competing nations before the most recent deterioration, this achievement may now be in jeopardy.

MANUFACTURING UNIT LABOUR COSTS - INTERNATIONAL COMPARISONS

Percentage annual rate of increase on previous 12 months

	1986	1987	1988	1989*	Average 1985-9*
West Germany	+4.0	+2.9	0	+0.5	+1.8
USA	+1.0	-1.0	+1.0	+0.5	+0.4
Japan	+4.0	-2.9	-3.0	-1.75	+0.9
France	+2.0	0	-3.0	+2.0	+0.25
Italy	+2.0	+3.0	+1.0	n.a.	+2.0
UK	+4.4	+1.4	+2.8	+4.0	+3.2

* estimate

Source: CBI, DE, OECD

The Implications

16 What the figures do <u>not</u> show (and as the government now appears to acknowledge) is that present inflation is pay led. Pay Databank responses show the causal effect working much more strongly in the other direction. The cost of living dramatically increased in importance as an upward pressure on pay, being cited by 59% of manufacturing employers in 1988/9 compared with 23% a year earlier, as mortgage rate increases affected their employees' disposable incomes.

17 In fact, although employers face this unit labour cost pressure, the rate of increase in factory gate prices has fallen back to below 5% per annum (4.9% in November 1989), while both the July and October 1989 Industrial Trends Surveys showed a slower rate of price increases than a year earlier. Prices of manufactured goods in the shops are rising at 4% (November). Expectations for the coming 4 months show no upward movement as a result of the labour cost pressures now emerging: the indications are that employers will have to accept reduced margins, as competitive pressures limit the scope for price increases.

18 What this experience indicates is that pay rises can best be linked to performance when inflation is low and stable. Pay Databank evidence is that in recent years of lower inflation employers were having considerable success in building this link. The main influences on settlements in 1986 and 1987 were performance factors - profits and productivity - and labour market considerations.

19 As mortgage rates began their sharp upward movement, however, the picture changed. The mortgage cost element in the RPI was running at close to or above 50% throughout the first 3 quarters of 1989, and other charges outside employers' control - rent, rates and water - were also rising at less spectacular but well above average levels. This has made it more difficult for employers to concentrate bargainers' minds on performance factors : the cost of living has again become the main focus of attention, whilst labour market pressures have not yet eased, and this is reflected in settlement levels.

20 Meanwhile, public service settlements continue to shadow trading sector settlements, in a way which does little to encourage greater realism amongst workforces generally.

Proposed CBI Response

21 If pay rises run out of line with productivity improvements, the scene is set for growing pressure on margins and the possibility of a reversal to the recent trend in factory gate prices. In these circumstances, international competitiveness will be adversely affected, and Ministers will tend to discount the 'own-goal' impact on inflation of interest rate rises and other Government-imposed charges, insisting that pay rises are a more suitable explanation for the RPI rate.

22 The task for CBI is to help members reinforce the link between pay and productivity: by drawing attention to the real problem; by encouraging greater awareness of possible approaches to it; and by both identifying inflationary

pressures on pay and making the case for their easement wherever possible.

23 The following course of action is proposed : CBI should

a) acknowledge that a problem of performance not fully off-setting pay rises in the trading sector is emerging, which threatens competitiveness, while insisting that it should not be misread either as indicating that management have not tackled pay issues or as the underlying cause of present inflation;

b) identify all the factors contributing to current inflation, including interest rates and other Government-imposed charges, and publicise the findings to counter the pay-led argument;

c) build on the 1989 Pay and Performance presentation, by highlighting the realities of the current economic situation and prospects to members and the need to relate those to pay, and by providing information about good practice on performance measurement and its use in pay negotiations;

d) oppose anything approaching a 'pay norm' as inappropriate and as setting a figure that will be seen an entitlement, likely to boost rather than ease inflation;

e) press for the easement of Government-imposed charges that are contributing to inflationary pressures on pay via the RPI;

f) carry forward work on public service pay, stressing the need for performance there to be seen to justify increases too.

PRIME MINISTER

MEETING WITH SIR TREVOR HOLDSWORTH: 23 JANUARY

You are seeing Trevor Holdsworth for half an hour tomorrow morning. The meeting is at his initiative; he telephoned me a couple of days after the Plowden Group dinner to say he thought the discussion then about wages/inflation had perhaps not been as full as it might have been, and that he would like a further word with you about this. What he really means is that his performance at the dinner was ineffectual, and he wants the chance for another go.

I have agreed with him that this will be a private meeting, hopefully without any publicity, and that he will come alone.

You will want to consider whether to give him the chance to have his say first. But you will want to emphasise to him the line you have already made clear in the House; there is nothing wrong with high wages as such, but the problem is high and rising wage costs.

I am enclosing notes you have already seen for Questions purposes. For most of the countries the figures in the table do not go beyond 1989 Q2, but it is clear the UK started to run way ahead of the others in Q3; and our latest figures for the three months to November 1989 continue to show an annual growth of 5.6 per cent.

I also enclose last Thursday's Times article by John Banham, CBI Director General. He too defines wage costs as the potential problem. But he implies that they have not thus far become an actual problem; whereas in fact they have. It may be that Ford or any other individual employer feels they can afford a high wage increase because of high productivity growth. But in aggregate it is clear that UK firms are now conceding wages in excess of productivity.

You will recall that Trevor Holdsworth's other preoccupation these days is as Chairman of British Satellite Broadcasting. You may therefore want to ask him how confident he feels about their planned Spring launch. You could also ask him more generally what are his main impressions as he comes towards the end of his two-year stint as President of the CBI.

PG

22 January 1990

jd c:holdsworth

chex.md/aa/60 **COVERING SECRET**

7 (A-J.) D

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

10 February 1989

Paul Gray Esq
No.10 Downing Street
London SW1

Dear Paul,

PAPER FOR ECONOMIC CABINET

I attach a draft of the Chancellor's paper for the Economic Cabinet next Thursday. He himself will be working further on the draft over the weekend, but would welcome any comments the Prime Minister has. I should be grateful if you could pass these on to me as soon as possible on Monday morning so that we can get the paper circulated on Monday evening.

Yours
Alex

A C S ALLAN
Principal Private
Secretary

It needs to bring out more clearly the key real issues on which ... and i.e. the danger that the economy is still going much too fast. MT

Also needs to point out that as growth has ballooned the reverse this year, so falling growth could prick the balloon next year if it occurred. My worry is that it is still going too fast.

Note
AT passed on the PM's comments to Alex Allan.
PRCG 13/2

A

DRAFT

ECONOMIC STRATEGY

Memorandum by the Chancellor of the Exchequer

Growth in the UK, which had been stronger in 1987, accelerated further in 1988, largely as a result of an investment boom, but also reflecting continued strong consumer demand. With profitability now at its highest levels since the 1960s and with continued rapid growth in productivity, companies are in a very strong position and have been investing heavily to meet future demand. Consumers have seen their real incomes rise strongly and have felt more confident about the future; as a result they have been prepared to finance their spending by borrowing more.

2. As a result, total domestic demand rise faster than the economy's capacity to supply, leading to a re-emergence of inflationary pressure, manifesting itself both directly in a pick-up in the underlying increases in the RPI, and indirectly in a sharp growth in imports and hence a widening current account deficit.

3. Since the summer, monetary policy has been tightened considerably to deal with the emerging inflationary pressure. The evidence is mounting that this tightening is starting to bring the economy back to a sustainable path, but there is still some way to

B.

go. The RPI exaggerates the extent of the rise in prices because of the perverse inclusion of mortgage interest payments. But even so, getting inflation on to a clear downward path may mean keeping interest rates high for some time. Fiscal policy has been tighter than forecast over the past year and we now seem set for a Public Sector Debt Repayment greater than the £10 billion I indicated in the Autumn Statement.

4. I am sure, in the circumstances, that we should aim for a cautious approach to the Budget. Sound and prudent financial policies are essential if we are to maintain the confidence of the markets and sustain the improvement in economic performance of recent years. If as I expect, we succeed in reversing the recent rise in inflation, while continuing our policies to improve the efficiency and flexibility of the economy, the prospect remains a very good one.

Economic prospects

5. As in the UK, growth in the rest of the world in 1988 was more buoyant than expected a year ago, exceeding expectations in each of the major industrial countries, in most cases substantially so. World trade in manufactures probably grew by 10 per cent. Even those European economies that have been sluggish in recent years are now experiencing faster growth.

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Partly as a result, consumer price inflation edged up a little in a number of countries and most commodity prices have risen.

6. The latest indicators suggest that activity in the major economies remains strong, though increases in short term interest rates to counter rising inflation may lead to some slow down through 1989. GNP growth may fall from 4 per cent in 1988 to a still healthy 3 per cent this year. World trade growth should still be high.

7. One threat to this prospect is that the persistence of sizeable current account imbalances between the largest economies could lead to renewed turmoil in financial markets. Domestic demand growth in the US needs to slow, and the US Government needs to reduce its Budget deficit; at the same time, the surplus countries - Germany and Japan - need to remove the obstacles which restrict the growth of their domestic markets.

8. The UK has experienced a sharper acceleration of output than most of its G7 partners, with unemployment falling faster than in any other major country. In spite of the major problems in interpreting recent macroeconomic statistics it looks as if we have had two years with GDP growth at about 4½ per cent, the first time this has happened since the mid-sixties. Domestic demand probably grew considerably more quickly than this in 1988, mainly because of the strength of investment. It seems likely that the growth of total fixed investment will have been well into double

should not ignore consumption at c7/10%.

D

figures last year - the largest increase for almost 25 years. Indeed once the full figures are available it is possible that growth of investment even surpassed the 1964 growth rate - previously the strongest post-war year on record. At the same time, productivity in manufacturing has continued to grow rapidly.

9. Apart from fixed investment, the housing market has been the other major source of rapid demand growth. A significant house price bubble emerged last year and with it a rapid turnover in housing. It is likely this had a significant effect on consumption in general and spending on durables in particular.

10. As already mentioned, the increase in inflationary pressure has been countered by the only effective means: a tightening of monetary policy via higher short term interest rates. There are now increasing signs that this firm action has begun to check the growth of spending by households. Growth of the narrow measure of the money supply, MO, has begun to slow down appreciably. The housing market has cooled down markedly, particularly in the South East, with both house prices and lending for house purchase rising much less rapidly than in the middle of last year. The growth of retail sales has moderated, and sales of certain consumer durables have fallen. Indicators of consumer confidence suggest that expenditure growth in the year ahead will be modest. The personal sector savings ratio should begin to recover.

11. Meanwhile, company sector saving remains high and the signs are that the very strong investment performance of the last two years will continue in 1989, though growth will probably be at a less heady pace. The rate of return on capital is at its highest level for over twenty years, and the extra investment that this is generating will help to underpin the supply side improvements of recent years.

12. The latest rise in the mortgage rate will almost certainly lead to inflation as recorded by the RPI rising above 7 per cent for some months (although excluding mortgage interest payments the rate should remain below 6 per cent). But as the effects of the rises in mortgage rates during last year begin to drop out, RPI inflation itself should fall back to well below 6 per cent by the fourth quarter of this year. The blip in inflation during the first half of this year will undoubtedly cause us considerable problems. We must clearly do everything in our power to ensure that it does not lead to a pay explosion.

13. The increase in underlying inflation - whether measured by the RPI less mortgage interest payments or by producer prices - is less worrying, but at over 5 per cent is still much too high. We will have to maintain the present very tight monetary policy long enough to ensure that it is put firmly on a renewed downward trend.

14. The sharp worsening of the current account deficit may be exaggerated to some extent by the published figures. The preliminary estimate published for 1988 is £14½ billion, but the "balancing item" in the balance of payments - which consists of unrecorded flows to the UK - for the first three quarters (the latest available period) was even greater than the recorded deficit. The slow down in domestic demand will lead to a reduction in the current account deficit, but this is unlikely to occur quickly. The continued strong growth of investment could keep imports of capital goods high, and it may take a little while for the adverse effects on trade performance of very high capacity utilisation in some industries to unwind. Even though the deficit could fall from now on, the outturn for 1989 as a whole might be close to that for 1988.

15. To summarise, following a period of above average growth the likelihood is that growth will be somewhat below the recent trend in the near future. GDP growth could be [2½] per cent in 1989, though with the statistics for the recent past in such disarray and the economy at a turning point the forecast is even more uncertain than usual.

<u>Fiscal prospects</u>

16. In last year's Budget I announced major tax reforms, including cuts in both the basic and higher rates of income tax.

Yet despite this I budgeted for a Public Sector Debt Repayment (PSDR) in 1988-89 of some £3 billion, or ¾ per cent of GDP. In the event, the public finances have turned out considerably stronger. The forecast I gave in the Autumn Statement was for a PSDR of £10 billion, or 2 per cent of GDP. Later information suggests that the surplus will exceed even this.

17. This remarkable improvement in the fiscal position - no other major country enjoys a comparable surplus - owes much to the buoyancy of the economy, as well as somewhat higher privatisation proceeds than originally planned. Given the continuing strength of domestic demand, the need for a cautious approach to policy, and market expectations, it is essential to maintain a prudent fiscal stance. In present circumstances I believe we must aim for a sizeable PSDR in the coming financial year.

18. On this basis I expect the scope for reductions in taxation to be very limited this year. It may prove best to do little more than offset the natural tendency for the non-oil tax burden to rise as a result of fiscal drag. Looking further ahead, the return to a sustainable growth rate may lead to some unwinding of the favourable cyclical effects on public finances which we have recently experienced. So future reductions in taxation will depend crucially on our continued ability to restrain the growth of public expenditure.

H.

Summary and conclusions

19. Output growth in the last two years has been faster than we can sustain in the medium term. Some slow down is inevitable. With the current account likely to improve only rather slowly, we must avoid taking any risks which damage the credibility of our policies. This means a cautious Budget and a further year of substantial budget surplus.

20. I would welcome colleagues' views on the Budget against the background of the fiscal and economic prospects I have outlined.

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ANNEX 1

	1981	1982	1983	1984	1985	1986	1987	1988	1989(1)
World GNP,(2) in major 7 economies (per cent change)	1½	-½	3	5	3½	2½	3½	4	3
UK GDP, (2) (per cent change)	-1	1¾	3½	1½	3¾	3¼	4½	4½	2½
Domestic demand,(2) (per cent change)	-1½	2¼	4¼	2½	2¾	4	4¾	7	2½
Retail prices Q4 (per cent change) on a year earlier	12	6	5	5	5½	3½	4	6½	5½
Interest rates (average 3-month interbank)	14	12½	10	10	12	11	9½	12½	12 7/8(3)
Unemployment (UK, per cent of working population excluding school leavers)	8½	10	11	11	11	11¼	10¼	8½	7½
Sterling index	117	113½	105½	100½	100	91½	90	95½	97¼(3)

(1) Provisional pre-Budget figures

(2) At constant prices

(3) February 6

J.

ANNEX 2: DIRECT EFFECTS OF TAX CHANGES

A. Direct Taxes: Indexation

The RPI increased in the year to December 1988 by 6.8 per cent. With indexation by this amount and statutory rounding, the figures for the main allowances and other thresholds would be:

Personal allowances	1988-89	1989-90
Single and wife's earned income allowance	2,605	2,785
Married allowance	4,095	4,375
Tax rate bands		
25% rate	19,300	20,700
40% rate	over 19,300	over 20,700

The total revenue cost of indexation of income tax (included in the forecast) is £1,455 million in 1989-90.

B. Indirect Taxes: Indexation

The effects of 6.8 per cent revalorisation of the excise duties (including VAT effects) are as follows:

	VAT inclusive price change	Yield in 1989-90 £m	RPI impact % points
Beer	1.5p/pint	140	0.07
Wine	6.0p/75cl light wine	45	0.04
Spirits	37.0p/bottle	65	0.04
Tobacco	6.5p/20 king size	235	0.14
Petrol	7.3p/gallon	440	0.12
Derv	6.1p/gallon	95	0.01
VED	£6.80/car	155	0.05
Overall effect, (including minor duties)		1225	0.48[1]

[1] Figures do not sum due to rounding

PRIME MINISTER

ECONOMIC POLICY

I had a useful talk over lunch with Terry Burns about the present state of the economy. Terry spoke very frankly, and you may find it helpful to have his summary assessment.

This boiled down to:

- the present stance of policy, particularly on interest rates, is absolutely right. There is nothing further or different that we should be doing at the moment;

- he continues to be surprised at the strength of economic growth this year. It is too soon to assess just how the economy is responding to the higher interest rates, but there are clear signs, particularly in the housing market, that they are having the expected effect. He would expect (hope) that import growth will slow down within the next couple of months;

- he was not as optimistic as the Chancellor about the prospects for achieving a "soft landing". Given the strength of the growth in demand this year, we may need to face up to two years of quite slow growth in order to achieve the counter-inflation objective;

- that means there will be some difficult times ahead. We will need to be patient, sitting on our hands for quite a long time and resisting the temptation, e.g. to reduce interest rates;

- on the fiscal front, the Budget judgment will need to be straight down the middle, and the contents frankly rather dull. He confirmed my impression that the revolutionary idea the Chancellor put to you recently for the conduct of monetary policy reflected his wish to find something exciting to include in the Budget. (Senior Treasury

officials are very pleased with your reaction to that proposal and had themselves made the same points to the Chancellor as you did.)

- he confirmed the point Alan Walters made to you that, as the economy slows down, the public sector surplus could quickly disappear. In a way we should not worry about that, because a public sector surplus and debt repayment were not necessarily good things in their own right. But given that he puts total public sector asset sales within public expenditure as high as £11 billion, the prospect of a receding overall Budget surplus meant we had to take a very tough line on public spending. And, given the extent of the tax reductions in the 1988 Budget - the full effect of which will not work through until next year - he currently sees little if any scope for tax reductions over the next 2-3 years.

Good

PRCG.

PAUL GRAY

16 December 1988

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bc: BG

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

25 November 1988

INTEREST RATES

It may be helpful to record that, when the Chancellor came to see the Prime Minister yesterday evening, they agreed that the Bank of England should take action at noon today to raise interest rates by 1 per cent following publication of the October trade figures at 1130.

PAUL GRAY

Alex Allan, Esq.
H.M. Treasury

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Meeting Record

SECRET AND PERSONAL

SUBJECT CC MASTER

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

18 July 1988

Dear Alex,

The Prime Minister held a meeting this afternoon with the Chancellor to discuss the economic situation in the light of the June Treasury forecast. Others present were Sir Peter Middleton, Sir Terence Burns and Professor Brian Griffiths.

I should be grateful if you would ensure that this record of the discussion is seen only by those with a direct operational interest.

The Chancellor opened the discussion by introducing the paper attached to your letter to me dated 15 July. The development of the economy was generally satisfactory, but the paper focussed on the two problem areas, namely the rate of inflation and the balance of payments current account deficit. Inflation was the main concern, and once the necessary action had been completed on that front other aspects would come right. The fiscal position was very strong, with the public sector now in surplus even after disregarding privatisation proceeds. The growth of private sector demand in recent months had been significantly greater than forecast, with the high degree of confidence exhibited in an investment boom and strong growth of personal consumption. The current account deficit reflected an excess of private investment over private savings, which could not go on for ever but was sustainable for a period of time.

Continuing, the Chancellor said that the action already taken on interest rates would lead in August to the largest increase in mortgage rates for four years, which should have a significant dampening effect on the housing market. MO growth would also peak this month, and would gradually come down from now on as a result of existing levels of interest rates. Nonetheless, further action to tighten monetary conditions through interest rate increases might be needed.

In discussion the following points were raised:

(i) It was most unusual to have the combination of a very strong fiscal position and a current account deficit. A key policy question was whether the

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private sector deficit should be allowed to work itself out through the operation of market forces or whether there was a need for Government action to correct it. One view was that it was too soon to conclude that private sector savings would not re-adjust in response to the tightening of monetary conditions already undertaken. On the other hand, it was essential that the Government should not be seen to be complacent in the face of a large current account deficit which showed no immediate signs of narrowing;

(ii) the emergence of the current account deficit raised the question whether the supply side performance of the UK economy had improved sufficiently. It had to be recognised, however, that a number of the supply side improvements would take several years to work through and have their full impact;

(iii) it was common ground that the fundamental requirement was to get inflation down by a tightening of monetary policy. But it was not clear how far this approach would also serve to reduce the current account deficit. Tighter monetary conditions could, for example, imply a higher exchange rate than would otherwise result. A key factor was the extent to which private sector borrowers, who had increased their levels of debt following liberalisation in access to sources of credit and lower levels of interest rates, would react to the disciplines imposed by increases in interest rates. Their response would determine the extent to which the personal savings ratio recovered and consumption was curtailed;

(iv) all the recent increases in interest rates had been in steps of ½ per cent. It was arguable that this process merely served to lead the markets to expect further moves. This could result in the total increase being greater than if rates were increased in larger, more decisive steps which gave stronger signals of the authorities' determination to get inflation down. On the other hand, it would always be possible for the authorities to hold to the tactics of ½ per cent increases but at the end of the desired process of adjustment make clear their view that sufficient tightening had been achieved. It was also difficult to form a firm judgement on when the "right" level of interest rates had been reached, and continuing to move in ½ per cent steps gave the authorities greater flexibility to tighten conditions further if this was judged to be necessary;

(v) it was important to consider the quality of the present large increase in investment; investment was not a good thing in its own right, only if it

was productive. The impression was that the bulk of current increases in manufacturing investment were to be welcomed, particularly as under the present fiscal regime artificial incentives to invest had been removed. The one area of worry, however, was the high level of investment in the housing sector;

(vi) in considering action to stimulate the level of private sector saving, regular consideration needed to be given to ensuring that rates offered on national savings instruments were appropriate. Work was in hand on a new national savings product which it was planned to launch at the end of the year.

Summing up the discussion, the Prime Minister said that the fundamental requirement was to get inflation down. The paramount need was to tighten monetary policy through increases in interest rates sufficient to ensure that MO growth moved quickly down to well within its target range. Serious attention also had to be given to the balance of payments current account position, which was a political touchstone. In the light of progress achieved over the next few months, decisions in the run up to the next Budget on the stance of fiscal policy would need to take into account whether it was necessary to boost the level of public sector savings to offset a continuing low level of private sector savings.

Yours,
Paul

PAUL GRAY

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

PRIME MINISTER

SEMINAR WITH THE TREASURY: 18 JULY

The papers are as follows:

Flag A - The Treasury discussion paper.

Flag B - The detailed Treasury June Economic Forecast. This is in two parts; a note on the effect of a faster rise in interest rates than assumed in the based forecast (which you have already looked at) and the full forecast document (which I don't think you had time to go through last weekend).

Flag C - Comments by Brian Griffiths.

Flag D - The Morgan Guaranty note on the implications of social security trends for fiscal policy (which you have seen but not yet studied). It focusses on the US position; but I think there is an important read across to the UK.

We have scheduled 1½ hours for the meeting. You will obviously want to focus on the policy prescriptions that emerge from the forecast. But I suggest it would be worth spending the first half hour standing back a bit and considering where the UK economy has now got to. Possible issues include:

(i) How far has supply performance really improved?

(ii) How far have the old rigidities and inflexibilities been removed?

(iii) Is the major shift we have seen in the private sector savings and investment balance a cyclical phenomenon or a more fundamental structural change?

(iv) Can we, as the Treasury discussion paper implies, be relatively relaxed about an external deficit which

reflects private sector flows and allow it in large part to be self-correcting?

This last question provides a good way into the key policy issues. My impression from discussions with Terry Burns is that senior Treasury officials are a good deal less relaxed about the external position than the Chancellor is. But whether that will emerge in the discussion is another matter.

I suggest the conclusions we should be working towards are:

(i) It is right to avoid any panic fiscal action between budgets.

(ii) Decisions on the precise fiscal stance for the 1989 Budget need to be taken much nearer the time. But the structural changes in the economy - particularly lower personal sector savings - point to the need for significantly larger public sector surpluses. Given the private sector behaviour patterns of five years ago a balanced budget looked to be an extremely prudent stance; but if the private sector is moving into a position of structural deficit, we should be considering broadly balancing it by a public sector surplus.

(iii) The immediate priority is monetary policy. There is only the one instrument of interest rates. So far this year we have allowed it to be directed too much towards an exchange rate objective and too little towards countering inflation. That balance must now change, and we should further increase interest rates until we are confident that M0 growth is under control. If that can be achieved without putting upward pressure on the exchange rate, all well and good. But if the market decides to take the exchange rate up we should accept that consequence.

PRG.

PAUL GRAY

15 July 1988

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CONFIDENTIAL

A

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

15 July 1988

Paul Gray Esq
No.10 Downing Street
London SW1

Dear Paul,

PRIME MINISTER'S SEMINAR ON THE ECONOMY

... I attach a note for discussion at Monday's meeting.

Yours
Alex

A C S ALLAN

ECONOMIC SITUATION

Output and Demand

1. The economy has continued to perform well. We seem to be heading for another year of 4 per cent growth.

2. It is now widely acknowledged that supply performance has improved. The clearest sign is that productivity continues to grow at an exceptional rate. The supply reforms introduced since 1979 have been largely responsible for this improvement.

3. Even so demand growth has outpaced the sustainable rate of output growth. And by even more than we expected at Budget time, despite the maintenance for most of the time of high real interest rates and despite the tightness of fiscal policy. This rapid growth of demand has been accompanied by a sharp deterioration in the current account of the balance of payments. There has also been some worsening of indicators of domestic monetary conditions; and MO growth is currently well above the top of its target range.

4. It is now clear that the stock market crash has not had the adverse effects on spending that many people feared - thanks in large part to the prompt action taken by the authorities of the major nations in reducing interest rates.

5. In addition, the huge inflow of capital into the UK over the past year has increased domestic demand and contributed to the current account deficit. This inflow is a reflection of confidence in UK economic performance, but it has increased the problems of economic management.

6. Some of the domestic demand growth is welcome. Higher profitability and fuller utilisation of capacity have produced a long overdue investment boom which, in time, will enhance supply capacity and further improve economic performance.

7. More worrying has been the continued rapid growth of consumption. Although the strength of personal disposable income has been a major factor, a declining savings ratio has also played an important part.

8. But the recorded growth of investment and consumption falls short of a full explanation of the growth of demand. The situation is complicated by the poor quality of the statistics and consumption, investment, or exports could all be stronger than is being officially recorded.

9. We expect some slowdown of domestic demand and output over the next year, especially in the light of the recent monetary tightening - but inevitably there are major uncertainties.

Inflation

10. Inflation as recorded by the RPI is expected to average 5½ per cent in the fourth quarter of this year. It may peak in mid-1989 at over 6 per cent before resuming its downward trend.

11. The RPI inflation profile is heavily influenced by changes to the mortgage rate: this is a damaging anomaly, since a tightening of monetary policy initially puts up measured inflation. Mortgage rate effects may be adding more than 1 per cent to recorded inflation in mid-1989 - the exact amount depending upon the path of interest rates. Excluding mortgage interest rates, inflation shows a much flatter profile (see table 1).

12. World commodity prices are also having an influence on inflation. They have been rising very rapidly, albeit from a very low level. It is not only in the UK that analysts underestimated the effect of the stock market crash.

13. General cyclical pressures are also pointing to higher inflation: it is normal for inflation to shadow the economic cycle but with a lag.

14. The task now is to make doubly sure that we keep downward pressure on the underlying inflation rate.

15. We have wanted to tighten domestic monetary policy for some time now. But this was hampered by the strength of sterling and the dangers of an exchange rate 'bubble' emerging. Since the pressure on sterling has eased it has been possible to increase interest rates by 2½ per cent, and they may well have to go higher. We will need to watch carefully the trend of MO.

16. It is important to dampen the housing boom which has been an important factor in credit creation. Higher mortgage rates are a crucial part of the tightening of monetary policy.

17. Some argue that higher interest rates will do nothing to slow growth of credit. But they have an important effect on monthly mortgage payments which will absorb spending power. And higher interest rates mean a higher return to savers which should act as an incentive to save. Higher interest rates will also restrain the growth of company spending, particularly on stocks.

18. The projections for next year have some clear similiarities with the inflation 'blip' in 1985 - some temporary increase in general inflationary pressures combined with the short-term adverse consequences for the RPI of higher mortgage rates.

Balance of Payments

19. The forecast shows a current account deficit for this year - and the next two years, although distant-year forecasts are highly uncertain - of close to 2 per cent of GDP. The sharp deterioration this year has a number of aspects: the rundown of oil revenues; the rapid growth of UK domestic demand relative to other countries; and the pressure on relative cost competitiveness stemming from the large capital inflows and the strength of sterling.

20. This outlook for the current account coincides with a progressive tightening of fiscal policy. For this year it now seems we will have a public sector debt repayment of some £7 billion. In other words even excluding privatisation proceeds we look like having a Budget surplus.

21. It follows that any current account deficit is the counterpart of a private sector deficit; in other words the investment being undertaken by the private sector exceeds its own internally generated savings. Part of the investment is being financed by a net inflow of capital from overseas (*).

22. A private sector deficit is unusual in the UK. The private sector has hitherto been in sustained surplus since the early 1950s. (Between 1946 and the early 50s there was a private sector deficit following the exceptionally high liquidity accumulated during the war).

23. But in a world of mobile capital there is no iron law that some countries always run private sector financial surpluses and others always run private sector financial deficits. The pattern can change and depends upon the investment opportunities available as well as savings behaviour.

24. A large part of the move into deficit reflects a rising investment ratio. This can be attributed to higher productivity, higher profitability and higher utilisation of capacity.

25. Part of the deficit also seems to reflect a lower private sector savings ratio, and particularly a sharply declining personal sector savings ratio. We expected low inflation to reduce the savings ratio but have been surprised by the extent of the fall. The buoyant housing and mortgage market has almost certainly played a part. Our view is that there are some temporary factors at work. In time we will see some correction although the timing is inevitably highly uncertain.

(* The story is, however, complicated by the residual error in the national accounts. The recorded figures show a private sector surplus. On the assumption that the public sector finances are measured reasonably accurately, either the private sector must be in deficit or the current account in balance.)

26. Part of the strength of investment and the weakness of savings is probably cyclical. The tightening of monetary policy to keep underlying inflation on a downward path should, in time, reduce the current account deficit. But part of the deficit may reflect medium-term trends in savings and investment behaviour and be sustained for some years. But by its nature a private sector deficit is unlikely to become very large. Its scale is limited by the willingness of lenders to finance it and of borrowers to take on increasing debt service obligations.

27. If this is the case, what is the role of government? One theoretical possibility is to run even larger budget surpluses to compensate for the private sector deficit. To some degree this is what we have done with downward revisions to the PSBR path in successive editions of the MTFS. But before deciding to make a change in fiscal policy on these grounds, we must be sure that the private sector deficit will be sustained. Trying to adjust the budget deficit to short-term swings in private sector behaviour would be tantamount to a return to old-style neo-Keynesian demand management. It would also mean foregoing the lasting supply side benefits of lower taxation, and would almost certainly in practice lead to irresistible pressure for increased Public Expenditure.

28. A second possibility is to encourage a lower exchange rate. This would be a serious error; it would be inflationary and it would disrupt the smooth flow of international capital. We must make clear that we reject this route.

29. A third possibility is a return to credit controls in an attempt to increase private sector savings. But this would be impossible given today's flexible and innovative financial markets.

30. The conclusion must be that we should concentrate on keeping our own house in order and in particular making sure that we pursue monetary policy in a manner that will gradually deliver our ultimate objective of stable prices. It may be awkward for us that the private sector runs a current account deficit, but this will correct itself in time and any attempt by us to act to correct it abruptly risks making things a good deal worse.

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Table 1

Inflation

	RPI Total	RPI excluding mortgage payments
1982	8.6	8.5
1983	4.6	5.2
1984	5.0	4.4
1985	6.1	5.2
1986	3.4	3.6
1987	4.1	3.7
1988 F	4.6	4.4

(F: forecast)

C 3 (A-C)

PRIME MINISTER 15 July 1988

SEMINAR ON THE ECONOMY

The two most significant statistics in the Treasury June forecast are:

- the rise in the forecast rate of inflation (RPI) to 6.4% in July 1989
- the size of the current account deficit for 1988, 1989 and 1990 and the extent of the revision since the Budget earlier this year.

Current Balance Forecast

	FSBR 1988	June 1988
1988	-3.9	-9.3
1989	-4.6	-10.1
1990	-4.3	-9.0

The two interesting issues are: What went wrong? What to do about it.

What Went Wrong?

Demand has outpaced output. Whereas domestic demand (consumption plus investment plus public spending) was expected to grow by 4.2% in 1988 it is now forecast to grow by 5.8%.

What is the source of this extra spending? It is primarily unexpectedly high consumer spending (following a rapid fall in the saving ratio) and high corporate investment. Fiscal policy is in good shape. The unexpected strength of demand is weak monetary policy. The reason for this is that exchange rate stability and not counter inflationary policy has been the major objective of policy. Our experience is the direct consequence of the Plaza and Louvre way of thinking. The result is that MO is outside its target range, interest rates have fallen too rapidly - with the result that inflation is rising and the balance of payments moving into deficit.

What to do about it?

The Chancellor rightly rules out controls and any change in fiscal policy until the next Budget. The emphasis therefore is placed on interest rate policy and the key indicator of success is the reduction in the growth of MO.

The crucial question which needs to be asked is:

> **Does getting MO within target range take precedence over other aspects of policy? (eg exchange rate stability).**

You need to make to very clear that getting inflation down is the priority of policy, that this depends on getting MO to near the middle of the range (1-5%) and that this may require even higher interest rates.

In terms of the current account deficit there is one ominous sentence - paragraph 26 - "But part of the current deficit may reflect medium term trends in savings and investment behaviour and be sustained for some years".

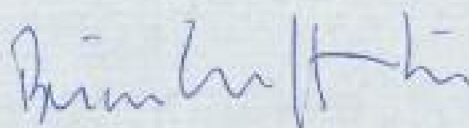
C

A balance of payments deficit for some years (3, 4, 5 ...?) as a target of policy?

In the seminar you held with the Chancellor before the Budget he argued that it was perfectly feasible to run a smallish balance of payments deficit because private sector investment was greater than private sector saving. The period since the Budget and the June forecast for the current account suggests that it would be very unwise for us to target a balance of payments deficit for some years. Much better to go for a current account.

This is something everyone understands and are prepared to accept. The real danger with planning to run a continuing deficit is that it is difficult to distinguish a private sector market led deficit (the result of investment being greater than saving but with the private market voluntarily financing such a deficit) from one resulting from the creation of excess demand.

The experience of the past year does not augur well.



BRIAN GRIFFITHS

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Sir Peter Middleton KCB
Permanent Secretary

Covering SECRET

P Gray Esq
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SW1

7 July 1988

Dear Paul

TREASURY ECONOMIC FORECAST

... I enclose two copies of this year's summer forecast, one for the
... Prime Minister and one for Brian Griffiths. I also enclose a note on the effects of a faster rise in interest rates than that assumed in the forecast. As usual, these copies are on a personal basis for the Prime Minister, Brian Griffiths, Nigel Wicks and yourself only.

Yours ever,

Stephen

S D H SARGENT
Private Secretary

TREASURY FORECAST : EFFECTS OF A FASTER RISE IN INTEREST RATES

The June forecast assumed a gradual rise in base rates, of ½ per cent per quarter, to reach 10½ per cent in April 1989. This note sets out the implications for activity, inflation and M0 growth of a quicker rise than this.

2. Table 1 shows the interest rate assumptions for both the main forecast and for a variant assuming a quicker rise in base rates. This exercise assumes that the higher interest rates between now and the beginning of next year go with the same exchange rate path as in the main forecast.

TABLE 1 : INTEREST RATES

	June Forecast		Variant	
	Base rate	Mortgage rate	Base rate	Mortgage rate
1988				
July	9	9¾	9½ then 10	9¾
August	9	10½	10½	11¾
September	9	10½		
October	9½	10½		
November	9½	11		
December	9½	11		
1989				
January	10	11		
February	10	11½		
March	10	11½		
April	10½	11½		
May	10½	12		
June	10½	12		

3. It is worth bearing in mind that base rates at 10 per cent are already 1 per cent higher than the level assumed in the forecast for the whole of the third quarter. The short term prospects for the mortgage rate and RPI inflation are therefore already less favourable than in the June forecast, even before the effects of a further rise in base rates, to 10½ per cent, are considered.

(i) **Activity effects**

4. Because the difference between the two cases is in the timing of the rise in base rates the overall economic effects are fairly

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modest. With the higher interest rates consumers' expenditure and real GDP are approximately ¼ per cent lower in 1988. The effects on the current account and the PSDR come through after a short lag, so that most of the effects are in 1989, when both the current account deficit and the PSDR are between £¼-½b. lower (on the assumption that the exchange rate is fixed).

(ii) Inflation effects

5. With the exchange rate path the same as in the main forecast and little change in activity, the effect on the RPI of the faster rise in short term interest rates therefore depends critically on the behaviour of the mortgage rate. (The RPI less mortgage interest payments is little changed in the variant.)

6. The current level of mortgage rates is not sustainable and lenders have now begun to announce increases. With base rates at 10 per cent some large societies' mortgage rates are now below base rates compared to a normal positive differential of 1¼-1½ points. The reason for this is clear; changing rates is costly and societies have been waiting for further developments. But even without another rise in base rates those societies which have not already done so, are likely to announce changes in rates to existing borrowers effective from August 1. With no further rise in base rates from 10 per cent our judgement, based on informal contacts with the Bank and earlier with the Building Societies Association, is that mortgage rates will probably rise by around 1½ points. Should a further rise in base rates to 10½ per cent occur before 1 August, or be considered probable during August, mortgage rates would probably move by two points. This is the assumption in the variant This compares with the June forecast, which had mortgage rates reacting, with one month lags, to half point rises in base rates occurring on the first day of each quarter. (The final level of 12 per cent for mortgage rates in the June forecast, reached in May 1989, is ¼ point higher than that in the forecast variant. This is because the establishment of the full 1½ point differential between base and mortgage rates embodied in the June forecast is not thought likely in the light of the latest information.)

7. Table 2 shows the monthly path for RPI inflation. With the earlier rise in the mortgage rate in the variant, inflation reaches

5¾ per cent in the third quarter of 1988 (including the crucial uprating month of September) and goes above 6 per cent in the first quarter of 1989. But the boost to RPI inflation also drops out more quickly than in the June forecast. By the Autumn of 1989 the monthly profile is lower in the variant than in the June forecast. From the second quarter of 1990 the two inflation paths would be identical.

TABLE 2 : RPI INFLATION

	June forecast	Variant
1988		
August	5.1	5.7
September	5.1	5.7
October	5.0	5.5
November	4.8	5.2
December	5.6	5.9
1989		
January	5.6	5.9
February	5.9	6.2
March	5.9	6.2
April	6.1	6.1
May	6.2	6.2
June	6.3	6.3
July	6.4	6.4
August	6.0	5.3
September	6.0	5.3

(iii) **Effects on MO**

8. Table 3 shows monthly profiles for MO growth through 1988-89 on the basis of the June forecast and on the alternative basis of a quicker rise in base rates. Note, however, that the June outturn for MO appears likely, on latest data, to be around 0.4 per cent higher than assumed in the forecast. This provisional outturn has been incorporated in table 3, and the 0.4 per cent uplift has been projected forward throughout the whole of 1988-89.

9. Table 3 shows that the effect of a quicker rise in base rates is to reduce annual MO growth by about ¼ percentage point by the end of 1988-89, with the annual rate falling to 3¼ per cent in March 1989 compared to 4½ per cent under the June forecast.

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TABLE 3

MONTHLY MO FORECASTS
(percentage change on year earlier, seasonally adjusted data)

	JUNE FORECAST	QUICKER RISE IN BASE RATES	DIFFERENCE (col.1-col.2)
1988		to what - 10½ ??	
June*	7.3	7.3	0.0
July	6.4	6.4	0.0
August	6.3	6.3	0.0
September	5.7	5.6	0.1
October	5.2	5.0	0.2
November	5.2	4.9	0.3
December	4.7	4.2	0.5
1989			
January	4.7	4.1	0.6
February	5.0	4.3	0.7
March	4.5	3.8	0.7

*provisional data

EA1, MG2 DIVISIONS
HM TREASURY
JUNE 6 1988

COPY NO 12

TREASURY ECONOMIC FORECASTING EXERCISE

JUNE 1988

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TREASURY ECONOMIC FORECASTING EXERCISE

The forecast covers the period to 1990 (1990-91 for public finances), embracing two of the three years of the Public Expenditure Survey. For the first time it assesses the implications of the reforms of Local Authority finance, including the introduction of the Community Charge.

2. Table 1 summarises the forecast. The annex compares the main results with the average of outside forecasts.

(i) 1988 should see growth of real GDP of 4 per cent and money GDP of almost 10 per cent, as in 1987. Both real and money GDP growth fall in 1989 and 1990.

(ii) Domestic demand growth rises from the 4 per cent recorded for 1987 to almost 6 per cent in 1988. It falls thereafter as the investment boom eases and as assumed tighter monetary conditions and lower cuts in personal taxation than in recent years restrain consumers' expenditure.

(iii) Following the small recorded deficit for 1987, the current account deficit widens to £9½b. (2 per cent of GDP) in 1988 and £10b. in 1989. There is a small fall in the deficit thereafter as domestic demand decelerates.

(iv) RPI inflation rises to 5 per cent in 1988Q4 and 6¼ per cent in 1989Q2. Much of this rise is the result of the assumed increases in base and mortgage interest rates over the next year. RPI inflation excluding mortgage interest payments remains at between 4½ and 5 per cent from mid-1988 to mid-1989, before falling back.

(v) With activity very buoyant the PSDR (public sector debt repayment) in 1988-89 rises to £7½b. (1½ per cent of GDP). With the stylised assumption that the PSDR stays at this level in subsequent years there is scope for a reduction in the basic rate to 23 pence.

or higher increases in thresholds
or – the best option – a bigger PSDR

(1) MAIN RESULTS

The World economy

3. Growth of world trade and output picked up strongly in the second half of 1987, and the signs are that this buoyancy continued in the first half

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TABLE 1 : SUMMARY OF FORECAST

	AUTUMN STATEMENT 1987	JANUARY 1988	FSBR 1988	JUNE 1988
A THE WORLD ECONOMY				
1. GNP (MAJOR 7 EXCLUDING UK) (per cent change on a year earlier)				
1987	2½	2.8	2.8	2.8
1988	2	2.5	2.6	4.0
1989		1.7	2.4	2.8
1990			3.1	2.7
2. DOMESTIC DEMAND (MAJOR 7 EXCLUDING UK) (per cent change on a year earlier)				
1987	2¾	3.0	3.1	3.1
1988	2	2.8	2.5	4.0
1989		1.8	2.1	2.7
1990			2.8	2.6
3. WORLD TRADE IN MANUFACTURES (per cent change on a year earlier)				
1987	3¾	5.3	5.5	6.0
1988	4	6.0	4.9	10.0
1989		4.1	4.3	5.0
1990			6.6	5.2
B UK ACTIVITY AND DEMAND				
4. GDP VOLUME (non-North Sea in brackets) (per cent change on a year earlier)				
1987	4(4½)	4.3(4.7)	4.3(4.8)	4.3(4.7)
1988	2½(3)	3.1(3.6)	3.2(3.6)	3.9(4.3)
1989		2.4(2.7)	2.6(3.0)	2.9(3.2)
1990			2.5(3.0)	2.0(2.3)
5. VOLUME OF DOMESTIC DEMAND (per cent change on a year earlier)				
1987	4	3.9	4.2	4.1
1988	3½	4.3	4.2	5.8
1989		2.6	3.3	3.1
1990			3.1	1.6
6. UNEMPLOYMENT (UK S.A. EXCLUDING SCHOOL LEAVERS million)				
1987 Q4	2.73	2.66	2.66	2.64
1988 Q4	2.71	2.41	2.41	2.32
1989 Q4		2.34	2.41	2.24
1990Q4			2.45	2.32

	AUTUMN STATEMENT 1987	JANUARY 1988	PSBR 1988	JUNE 1988
C INFLATION AND MONEY GDP				
7. MONEY GDP (MARKET PRICES) (per cent change on a year earlier)				
1987-88	8½	9.9	9¾	9.8
1988-89	7¼	7.5	7½	10.0
1989-90		7.0	6½	7.9
1990-91			6	6.1
8. RPI (excluding mortgage interest payments in brackets) (per cent change on a year earlier)				
1987 Q4	4(3.7)	4.1(4.0)	4.1(4.0)	4.1(4.0)
1988 Q4	4½(4.4)	4.0(3.8)	4.0(3.9)	5.0(4.5)
1989 Q4		4.4(4.2)	3.0(2.7)	5.6(4.5)
1990 Q4			3.4(3.5)	4.1(3.6)
9. GDP market price deflator (per cent change on a year earlier)				
1987-88	4¾	5.0	5	5.1
1988-89	4½	4.8	4½	5.7
1989-90		4.6	4	5.2
1990-91			3½	4.0
D PUBLIC FINANCES				
10. PSBR - £ billion				
1987-88	1.0	-2.8	-3.1	-3.5
1988-89		-3.4	-3.2	-7.4
1989-90		-3.7	0	-7.4
1990-91			0	-7.4
11. PSBR - % OF GDP				
1987-88	¼	-¾	-¾	-¾
1988-89		-¾	-¾	-1½
1989-90		-¾	0	-1½
1990-91			0	-1½
12. ANNUAL FISCAL ADJUSTMENT - £ billion				
1988-89		4.0	0	0
1989-90		2.4	3.7	2.7
1990-91		0.5	0.7	0.7

not enough

H

	AUTUMN STATEMENT 1987	JANUARY 1988	FSBR 1988	JUNE 1988
E MONETARY CONDITIONS				
13. SHORT TERM INTEREST RATES (per cent))				
1987 Q4	9.5	9.2	9.2	9.2
1988 Q4	9.5	9.5	9.0	9.5
1989 Q4		9.5	8.8	10.5
1990 Q4			8.4	10.5
14. MO (per cent change on a year earlier)				
1987-88	4.9	5.1	5	4.9
1988-89	4.3	5.0	1-5	5.1
1989-90		3.0	1-5	1.9
1990-91			0-4	0.9
15. STERLING INDEX (1975=100)				
1987 Q4	72.5	74.9	74.9	74.9
1988 Q4	72.5	77.4	75.5	76.7
1989 Q4		76.0	74.4	74.3
1990 Q4			74.1	72.9
16. £/DM EXCHANGE RATE				
1987 Q4	2.95	2.99	2.99	2.99
1988 Q4	2.94	2.96	3.00	3.05
1989 Q4	2.87	2.88	2.92	2.90
1990 Q4			2.87	2.80
17. RELATIVE UNIT LABOUR COSTS (1980=100)				
1987	75.1	75.5	76.5	76.7
1988	75.4	79.8	79.5	82.1
1989		80.5	80.4	80.8
1990			80.7	80.1
F TRADE AND CURRENT ACCOUNT				
18. VOLUME OF NON-OIL EXPORTS OF GOODS (per cent change on a year earlier)				
1987	6¼	7.0	6.8	6.7
1988	3	4.3	4.2	2.8
1989		3.6	3.6	6.5
1990			5.4	5.0
19. VOLUME OF NON-OIL IMPORTS OF GOODS (per cent change on a year earlier)				
1987	7	7.9	8.5	8.4
1988	4¾	6.4	6.4	9.5
1989		3.3	4.4	6.1
1990			4.9	3.2
20. CURRENT BALANCE £ billion				
1987	-2¼	-2.5	-1.7	-1.6
1988	-3½	-4.6	-3.9	-9.3
1989		-5.3	-4.6	-10.1
1990			-4.3	-9.0

1988. Output and demand have not accelerated as a result of any discretionary loosening of fiscal policy, though real interest rates have fallen and there has been a large rise in international liquidity. While commodity prices continue to rise sharply, consumer price inflation remains low.

4. Even with some slowdown from now on, year on year growth in 1988 will be high, with Major 7 GNP growing by 4 per cent and world trade in manufactures by 10 per cent. Growth should slow in later years, but remain in line with potential. Only a small rise in consumer price inflation is likely. The current account imbalances of the US, Japan, and Germany fall further, though they remain large. The real exchange rates of the major currencies are assumed to remain unchanged. The main risk to this forecast is that growth and inflation could be somewhat stronger in the near future and fall off rather more thereafter.

UK activity

5. Large discrepancies within the national accounts and distortions to trade data make interpretation of recent movements in output and demand difficult. During the last two years the expenditure measure of GDP has grown much more slowly than the output or income measures, and the residual error has increased by 2 per cent of GDP. There are as well massive discrepancies - or "balancing items" - within the sectoral financial accounts, which for both the personal and the industrial sectors amount to between 4 and 5 per cent of GDP. The introduction of the single administrative document (SAD) probably distorted the data for visible trade at the beginning of the year.

6. The tentative conclusions that can be drawn from the statistical fog are as follows.

(i) Trade and production data suggest some moderation in output growth, particularly in manufacturing, during the latter part of 1987 and the beginning of 1988. CBI survey results are consistent with some, though not much, slowdown in growth in manufacturing over this period, but in general suggest more buoyant output than the official statistics. It is more difficult to know what has been happening to manufacturing output since the apparent moderation in growth at the turn of the year. Growth could be picking up in the middle of 1988, notwithstanding fears of capacity shortages and the sharp fall in net exports.

(ii) **Domestic demand** growth was very strong between the first and second halves of 1987, and appears to have grown more strongly in the first half of 1988 than envisaged at budget time. The available indicators show that consumers' expenditure has continued to grow briskly and investment growth has picked up.

7. Domestic demand is expected to grow by just under 6 per cent in 1988. This would be well up on the FSBR forecast for 1988 and recorded growth for 1987, and the highest rate since 1973. DTI and CBI surveys point to investment growth of 10 per cent or more. Consumers' expenditure is forecast to rise by 6 per cent, boosted by budget tax cuts and sustained consumer confidence. There are no signs that the personal sector is yet taking steps to raise the savings ratio from the low levels recently recorded. Even with a significant fall forecast for net exports in 1988 the strength of domestic demand is such that GDP should grow by 4 per cent. If net exports were to fall by even more than forecast in 1988 growth would be below 4 per cent, even with the strong forecast for domestic demand.

8. Growth of domestic demand and output should moderate in 1989 and 1990, though it is not possible to be confident about the precise timing. Consumption growth eases, though the lagged effects of the 1988 tax cuts and the assumed further cut in the basic rate to 23p in the 1989 budget keep RPDI growth high by historical standards. Investment growth falls after 1988, while net exports make little contribution to growth.

The balance of payments

9. The underlying current account deficit has almost certainly widened over the last eighteen months. The deterioration of measured competitiveness and high domestic demand growth together contributed to the sluggish underlying growth of export volumes over the turn of the year, at a time when world trade was growing rapidly. Because output in the tradeable goods industries has continued to rise, albeit at a slower rate, this moderation of export growth probably reflects some switch of sales to the more profitable home market rather than serious capacity constraints. Nevertheless booming domestic demand has led to a very strong rise in import volumes. Strong domestic growth and less favourable competitiveness have adversely affected the balance of trade in services.

10. The forecast discounts a good deal of the poor first quarter performance. Nevertheless the underlying current account deficit widens further from now on as domestic demand continues to grow rapidly and as the lagged effects come through of the recent loss of measured competitiveness - now close to its level before the oil price fall in 1986

and the associated sterling depreciation. The current account deficit is forecast to be £9½b. in 1988 and £10b. in 1989, after which it falls slightly as domestic growth moderates. By 1989 imports are about 20 per cent higher than exports so that exports have to grow by 1¼ per cent more than imports just to keep the visible trade deficit constant.

Financial Conditions

11. At the moment sterling remains strong despite a widespread recognition that current account prospects have deteriorated. Indeed strong capital inflows have probably contributed to the deterioration in the current account through the strong exchange rate and the resulting deterioration in measured competitiveness over the last year. The forecast assumes that some of sterling's present strength is temporary, and envisages a fall to DM3.00 by mid 1989 and DM2.80 by end 1990. This produces an exchange rate index of just under 73.0 at the end 1990. The effect of this fall in the exchange rate on the overall monetary stance is more than offset by assumed rises in base rates to 10½ per cent over the next year. These contribute to slower growth in domestic demand and prices, and cause M0 growth to fall towards the lower half of the MTFS ranges. The assumed pattern of interest rates and exchange rates allows the current account deficit to be financed by a combination of reduced net direct and portfolio outflows, and by substantial increases in overseas sterling bank deposits.

Inflation and money GDP

12. RPI inflation excluding mortgage interest payments has edged above the monthly profile consistent with the FSBR forecast. With the rise in mortgage rates assumed over the next year total RPI inflation rises to 5 per cent in 1988Q4 and 6¼ per cent by 1989Q2 (4 per cent for both periods in the FSBR). Excluding mortgage interest rates RPI inflation is 4½ per cent in 1988Q4 and 4¾ per cent in 1989Q2.

13. With earnings growth a little higher than in 1987, unit labour costs in manufacturing rise by 2-2½ per cent in 1988 and 1989, and somewhat faster thereafter, as productivity growth moderates. Profit margins are expected to rise at about the same rate in 1988 as in 1987, to be virtually flat in 1989, and to fall in 1990 as costs increase and activity slows down.

14. Growth of the GDP deflator has been revised up to 5 per cent for 1987-88. The forecast is for growth of 5¼ per cent in 1988-89 and 5¼ per cent in 1989-90, above the MTFS assumptions for both years. (The recent rise in the exchange rate does not have the short run moderating effect on

the GDP deflator as it does on RPI inflation.) High (and in 1988, rising) earnings growth, and the effect of the investment boom on prices of capital goods (notably for construction) are important factors behind the higher rises than in the 1988 MTFS. The revisions to output and inflation imply much higher than expected **money GDP** growth - 10 per cent in 1988-89 and 8 per cent in 1989-90 (7½ and 6½ per cent respectively in the MTFS).

<u>Public finances</u>

15. Stronger demand and activity together with the first monthly data suggest that the PSDR in 1988-89 could be greater than forecast at budget time. Central government revenues are well up, the forecast outturn for the planning total excluding privatisation proceeds is in line with plans, and there could be an extra £1b. privatisation receipts. With a PSDR of £7½b. there would be a small public sector financial surplus (ie a negative PSFD) for the first time since 1970-71. (The FSBR forecast a small deficit for 1988-89.)

16. The higher forecast level of activity has important implications for public finances in 1989-90. Profits appear still to be growing rapidly. Corporation tax receipts in 1989-90 should therefore be a good deal higher than previously forecast. With upward revisions to those revenues that depend on current demand and activity **the pre-fiscal adjustment tax burden** should continue to rise. But these effects may have worked through by 1990-91, leaving the pre-fiscal adjustment tax burden flat.

17. It is particularly difficult to assess the prospects for **public expenditure** in 1989-90 and 1990-91. Recent forecasts of public expenditure have, if anything, tended to be a little too high, while money GDP has been underestimated, hence unexpectedly large falls in the share of public expenditure in GDP. On the other hand the pressures for additional public expenditure over the next two years appear to be extremely powerful. Even after allowance for the downward pressure on demand-led expenditure from the strong projections for economic activity, the forecast projects overruns on the current plans for 1989-90 and 1990-91 of £2½ billion and £5½ billion respectively (planning total excluding privatisation proceeds). These still leave the share of GGE (excluding privatisation proceeds) in GDP falling over the forecast period from a lower 1988-89 base than in the FSBR.

18. Even with a large planning total overrun the rise in the pre-fiscal adjustment tax burden means that tax cuts are feasible in 1989-90. Assuming that the PSDR in 1989-90 stays close to its forecast outturn for 1988-89 - 1½ per cent of GDP - there is a **fiscal adjustment** of £2½b,

or a bigger PSDR

sufficient for 2p off the basic rate. The non-North Sea tax burden is roughly stable after this assumed cut. With the PSDR, by assumption, kept at the same high level in 1990-91 there is no further cut in the basic rate, but even so the tax burden does not rise.

19. The <u>ex post</u> fiscal stance - as measured by the general government financial deficit, the only internationally comparable indicator - has continued to tighten in the UK relative to the rest of the G7 and is now probably tighter even than in Japan.

TABLE 2 : GENERAL GOVERNMENT FISCAL DEFICITS (per cent of GDP)

	1986	1987	1988	1989	1990
UK*	2.6	1.0	0	-½	-½
G7 (less UK)	3.1	2.5	2½	2¼	2

*Financial years.

(2) THE WORLD ECONOMY

20. The fall in stockmarkets in October has had little apparent effect on world activity so far. In the major industrialised countries output grew particularly strongly in the second half of 1987, with no loss of momentum in the first quarter of 1988. Growth of business investment, exports, and industrial production has been especially rapid. The upswing in investment is expected to be shorter and less strong than previous upswings because the preceding weakness of activity was only modest. Even so, the projected year-on-year real GNP growth rate of 4 per cent in 1988 for the major seven (excluding the UK) has been exceeded only once in the last ten years (in 1984).

TABLE 3 : G7 (EXCLUDING UK) GROWTH AND INFLATION

Percentage changes on a year earlier	1987	1988	1989	1990
Real GNP	2.9	4.0 (3)	2.8 (2½)	2.7
Domestic demand	3.1	4.0 (3)	2.7 (2½)	2.6
Industrial production	3.1	6.5	4.4	3.8
Consumer prices	2.5	3.0 (3)	4.1 (3¼)	3.6

Note: Figures in brackets are OECD published forecasts for G7 <u>including</u> UK.

21. Non-oil commodity prices are rising very rapidly - spot prices, measured in SDRs by the Economist Commodity Price Index, rose almost 50 per cent in the last year. But they had previously fallen to historically low levels in real terms, so their recovery is expected to give only a modest boost to consumer price inflation. There is, however, the possibility that activity will be stronger than forecast and higher pressure of demand could mean faster inflation.

22. The recent strengthening of activity appears to have been world wide and total world trade picked up sharply towards the end of 1987 and is forecast to continue to grow strongly in 1988. World trade in manufactures could grow by as much as 10 per cent in 1988 if imports by the SE Asian NICs continue to expand strongly and other developing countries' imports recover as expected.

TABLE 4 : THE VOLUME OF WORLD TRADE IN GOODS (IMPORTS)

Percentage changes on a year earlier	(Share of 1986 imports)	1987	1988	1989	1990
Total world trade	(100)	5	9 (8)	5 (6)	5
of which:					
- Major seven	(54)	6	9 (8)	4 (5)	4
- OPEC	(5)	-10	7 (-1)	1 (4)	2
- NICs	(6)	23	18 (26)	12 (21)	12
- Other NODCs	(9)	-	7 (5)	4 (6)	4
Total world trade in manufactures		6	10 (8)	5 (7)	5

Figures in brackets are latest OECD forecasts.

(3) TRADE AND THE BALANCE OF PAYMENTS

23. The latest estimates of the **current account** show a deficit of £2¾ billion in the first quarter of 1988, and a cumulative deficit of nearly £3½ billion in the first four months, compared with a deficit of £1½ billion in the whole of 1987. The deterioration in the visibles balance during 1987 continued into early 1988, and the preliminary estimate of invisibles in the first quarter shows a sharp fall in the surplus to £1.2 billion compared with a quarterly average of £2.0 billion in 1987.

24. Underlying trends in export and import volumes have been particularly hard to discern in recent months. Since December the recording of exports has been affected by the change to new Customs procedures on 1 January.

Also, the suspicion that there is residual seasonality in the published figures for both exports and imports has been strengthened by the recorded falls in trade volumes in the first quarter of 1988, an established pattern over the last few years. Both factors have probably reduced recorded trade volumes below their underlying levels in the first quarter. The net effect on the current account is probably small, but the published first quarter figures may slightly overstate the size of the deficit.

TABLE 5 : ADJUSTMENTS FOR RESIDUAL SEASONALITY AND FOR TIMING DISTORTIONS
(£b. 1980 prices)

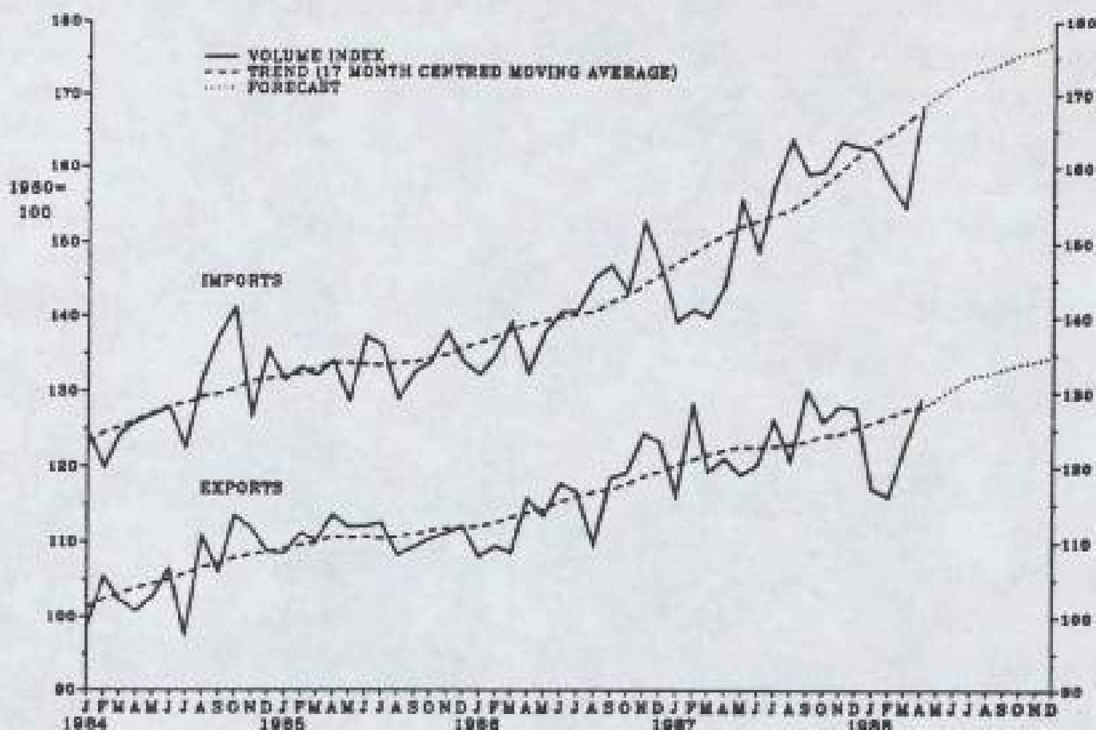
	Non-oil exports				Non-oil imports		
	Published	Adjustments for		Underlying	Published	Adjustment for seasonality	Underlying
		Customs 88	Seasonality				
1987 1	12.4		+0.1	12.5	14.0	+0.2	14.2
2	12.3			12.3	14.9	+0.05	15.0
3	12.9			12.9	16.0	-0.15	15.8
4	13.1	-0.3	-0.1	12.7	16.2	-0.1	16.1
1988 1	12.2	+0.3	+0.1	12.5	15.8	+0.2	16.0

25. Allowing for these distortions, it appears that the growth of export volumes has slowed since the autumn, despite the very rapid growth of world trade. This conclusion is supported by data for manufacturing output in the first quarter, which show slower growth, especially in engineering industries where the fall in exports has been largest. Responses to CBI surveys - in particular to the question on export optimism - are also now pointing to slower growth in exports.

Percentage balances, seasonally adjusted	1987				1988	
	Jan	Apr	July	Oct	Jan	Apr
Optimism about export prospects over next 12 months	18	17	29	17	-8	-11

This suggests that the steady deterioration in cost competitiveness has begun to have a significant effect on exports. The recent fall in imports can probably be accounted for almost entirely by seasonality; the trend still seems to be strongly upwards.

CHART A : TRENDS IN NON-OIL EXPORT AND IMPORT VOLUMES



26. Against a background of rapid UK domestic demand growth and the worsening in competitiveness since last year, some further deterioration in the underlying non-oil visible balance is forecast through the rest of 1988. The oil surplus is expected to fall as a result of a lower sterling oil price and lower oil production. The forecast of the invisibles surplus in 1988 heavily discounts the first quarter outturn, but still shows a fall of around £1 billion compared with 1987. The current account deficit in 1988 is therefore forecast to be £9½ billion.

27. In 1989 the current account deficit is forecast to widen further to £10 billion, as domestic demand continues to grow faster in the UK than in other countries. In later years a slowdown in UK domestic demand growth, following the projected rises in interest rates, and increases in the invisibles surplus are sufficient to bring about a small reduction in the deficit. While this forecast has much larger current account deficits than in earlier exercises, the increases are accounted for by higher domestic demand and less favourable measured competitiveness. The underlying supply performance is no worse than assumed in earlier exercises.

N

TABLE 6 : UK CURRENT ACCOUNT (£ billion)

	Visibles balances Manufactures	Oil	Other	Total visibles	Invisibles	Current balance
1986	-5.3	4.1	-7.2	-8.5	8.6	0.1
1987	-6.5	4.2	-7.3	-9.6	8.1	-1.6
Recent quarterly data						
1987 1	-0.7	1.2	-1.6	-1.2	2.2	1.0
2	-1.6	1.0	-1.8	-2.3	2.1	-0.2
3	-2.1	0.9	-1.9	-3.1	2.2	-0.9
4	-2.1	1.1	-1.9	-3.0	1.6	-1.4
1988 1	-2.9	0.9	-2.0	-4.0	1.2	-2.8
Forecast						
1988	-11.7	3.1	-7.7	-16.3	7.0	-9.3
1989	-13.2	2.8	-8.4	-18.9	8.8	-10.1
1990	-13.2	2.5	-8.5	-19.3	10.3	-9.0

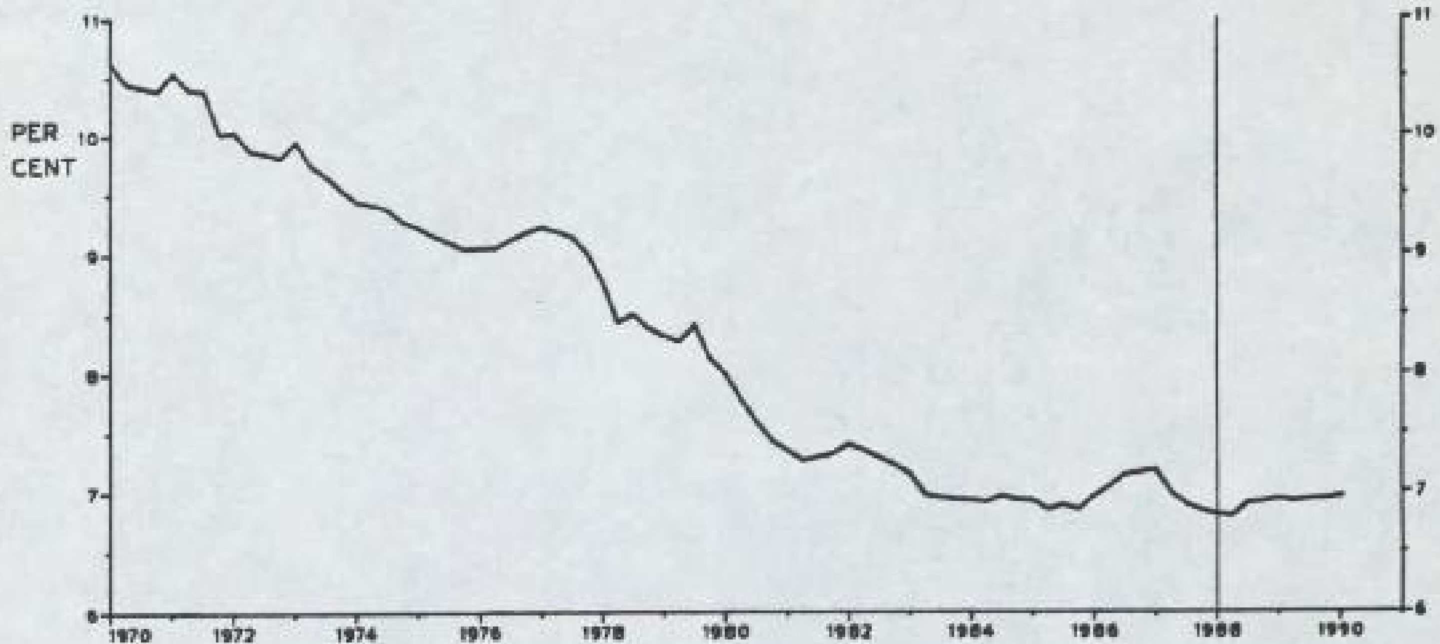
Non oil visible trade

28. The volume of manufactured exports rose by 8½ per cent during 1987 as the lagged benefits of improved competitiveness in 1986 helped UK manufacturers gain an increased share of world trade. However, in the year to the first quarter of 1988, when world trade was growing particularly strongly, recorded manufactured exports were flat. The forecast has given considerable weight to the possibility that the recent sluggishness of exports partly reflects erratic data, and assumes a strong recovery in the second quarter of 1988, in line with the latest monthly data. Nevertheless, with competitiveness expected to be 7 per cent less favourable in 1988 than in 1987 and world trade forecast to grow by less than 5 per cent through 1988, manufactured export volume growth is expected to slow to 4½ per cent in 1988. This implies a substantial loss of world trade share in 1988.

TABLE 7 : COMPETITIVENESS

	Relative unit labour costs 1980=100	Per cent change on a year earlier
1985	85.0	1.9
1986	78.5	-7.6
1987	76.7	-2.3
1988	82.1	7.1
1989	80.8	-1.6
1990	80.1	-0.9

CHART B:SHARE OF UK EXPORTS IN TOTAL WORLD TRADE IN MANUFACTURES



29. The volume of imports of manufactures rose sharply during 1987, reflecting strong growth of domestic demand, the loss of competitiveness and, possibly, in recent months the effects of tightening capacity. As a result the annual growth rate for imports of manufactures is expected to rise from 10 per cent in 1987 to 12½ per cent in 1988. However, through 1988, and in 1989 and 1990, import growth slows as domestic demand growth eases.

TABLE 8 : DOMESTIC DEMAND AND TRADE VOLUMES
(per cent change on previous year)

	Domestic demand volumes		Non-oil trade volumes		Manufactures trade volumes	
	G7 less UK	UK	Exports	Imports	Exports	Imports
1986	3.7	3.8	4.0	5.7	3.1	5.7
1987	3.1	4.1	7.1	8.4	8.5	9.8
1988	4.0	5.8	3.8	10.4	4.3	12.5
1989	2.7	3.1	7.1	6.8	7.3	8.1
1990	2.6	1.6	5.4	3.4	5.6	4.3

30. The appreciation of sterling over the past year is likely to contribute to an improvement in the terms of trade in 1988. Little further change in the manufactures terms of trade is expected over the forecast period, despite the steady projected depreciation of sterling. This is consistent with the broad stability of the manufactures terms of trade since 1981.

31. The manufactures trade deficit is expected to widen to £11½ billion in 1988, compared with £8½ billion at an annual rate in the second half of

1987, as the rapid growth of import volumes relative to export volumes more than offsets the expected improvement in the terms of trade. Although import growth slows in the later years, and is lower than export growth in 1990, this is insufficient to reduce the manufactures deficit. By 1989 the deficit is forecast to have widened to nearly 20 per cent of manufactured exports, compared with 10 per cent in 1987 and 5 per cent in 1985.

32. The deficit on trade in **non-manufactures** was little changed at £7¼ billion in 1987, as falls in world prices of food and basic materials offset the effect of strong growth in the volume of imports relative to exports. The rapid rises in commodity prices forecast for 1988 and 1989 are likely to lead to a rise in the deficit over the next two years, especially in 1989 when the projected depreciation of sterling contributes to the worsening in the non-manufactures terms of trade.

<u>Oil trade</u>

33. The **oil trade surplus** rose slightly in 1987 as a rise in the oil price and a fall in UK demand for oil more than offset the decline in North Sea output. The surplus is forecast to fall steeply in 1988, largely as a result of a lower sterling oil price, though falling production and a recovery in demand for oil also contribute. The surplus falls further in 1989 and 1990 reflecting a continuation of the trends in demand and production.

TABLE 9 : NORTH SEA OIL

	Average North Sea oil price		N Sea output	Oil trade balance	N Sea* taxes
	$/barrel	£/barrel	mm tonnes	- £ billion -	
1986	14.2	9.7	127	4.1	4.8
1987	17.9	10.9	123	4.2	4.7
1988	16.5	9.0	120	3.1	3.6
1989	17.0	9.3	115	2.8	3.7
1990	17.7	9.8	110	2.5	3.4

* Financial years.

<u>Invisibles</u>

34. Latest estimates show a very sharp deterioration in the **invisibles balance** between the third quarter of 1987 and the first quarter of 1988. This is largely accounted for by a decline in the services surplus, reflecting a fall in the surplus on financial and other services, as net insurance earnings have fallen back, and a rise in the travel deficit reflecting high expenditure overseas by UK residents. Net IPD earnings in

the first quarter of 1988 were close to their average level in 1987, but the transfers deficit was erratically large.

35. The low outturn for invisibles in the first quarter of 1988 means that, even with a strong recovery forecast for the rest of the year, the invisibles surplus for 1988 as a whole is likely to be around £1 billion lower than in 1987.

TABLE 10 : INVISIBLES £ billion

	Services	Oil IPD	Non-oil IPD	EC transfers	Other transfers	Total invisibles	Estimated net overseas assets (end-year)
1986	5.7	-1.3	6.3	-0.7	-1.5	8.6	113
1987	5.8	0.5	5.3	-1.8	-1.6	8.1	92
1988	4.7	0.7	4.9	-1.4	-2.0	7.0	92
1989	5.7	1.4	5.5	-1.8	-2.0	8.8	94
1990	6.4	1.7	5.9	-1.8	-2.0	10.3	95

36. The **services surplus** is forecast to recover during the remainder of 1988, but only to around the average quarterly level in 1987. There seems little prospect of any substantial further improvement before 1990. High RPDI and favourable relative prices should lead to continued rises in holiday expenditure abroad, and there may be associated increases in expenditure on foreign airlines. The levelling out in net insurance earnings points to slower growth in the financial surplus than in recent years.

37. Net oil **IPD** earnings should continue to rise, as the fall in production reduces payments abroad by North Sea oil companies. However, the surplus on non-oil IPD seems likely to fall a little in 1988 largely as a result of the appreciation of sterling, which reduces the sterling value of earnings. In 1989 and 1990 the non-oil IPD surplus is expected to recover, in part because the forecast depreciation of sterling helps offset the effect on net overseas assets of the current account deficits. As a result **net overseas assets** are forecast to remain close to their end 1987 level of £90-95 billion throughout the forecast period. (In SDRs net overseas assets fall.) **Net transfers** abroad are expected to remain at around £3½ billion in 1988, but to rise slightly in 1989. This includes a forecast of EC transfers which takes account of the Brussels agreement.

P

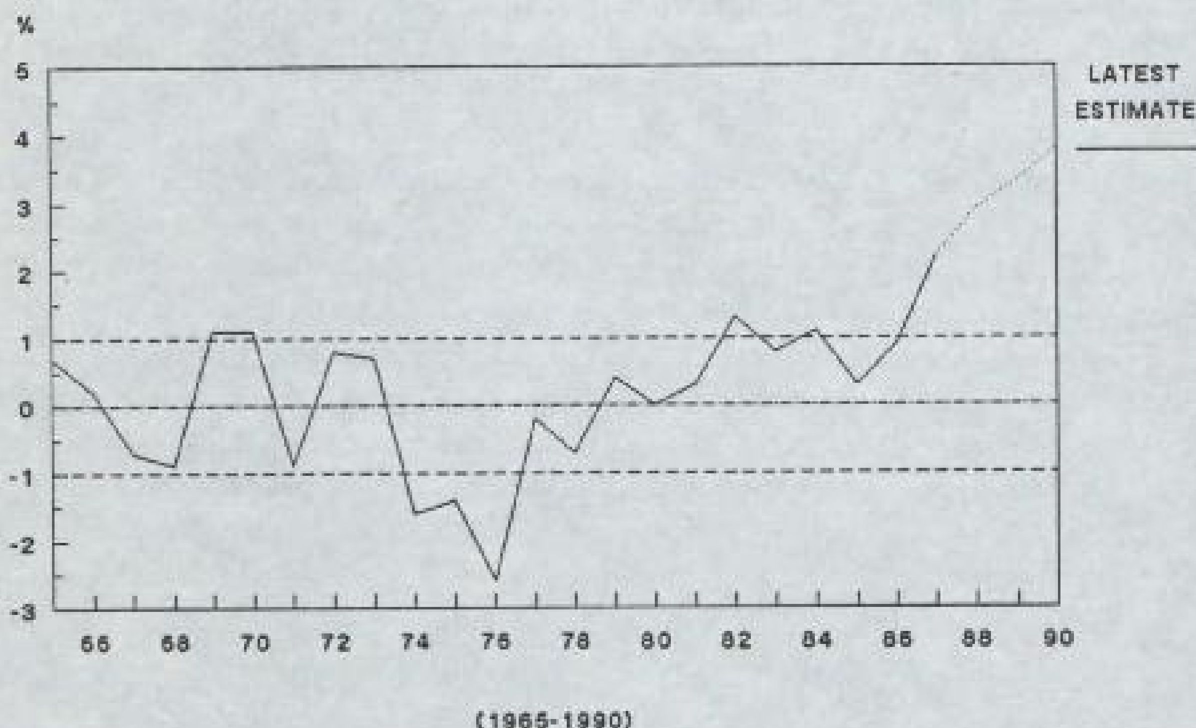
DOMESTIC DEMAND AND ACTIVITY

The State of the National Accounts

38. The forecast incorporates latest estimates for GDP in 1987 and first estimates for 1988Q1, published on June 21. (These are the last to be based on 1980 prices; the 1988 Blue Book and estimates for 1988Q2 will incorporate volume estimates at 1985 prices.) The latest data confirm the increasing disarray in the national accounts. The general incoherence of recent statistics presents considerable difficulties in interpreting economic developments, and increases the margins of error around the forecast. Some of the more acute difficulties are discussed here.

39. The difference between the current price income (GDP(I)) and expenditure (GDP(E)) measures of GDP is the **residual error.** Over the last three years, nominal GDP(I) has grown considerably faster than nominal GDP(E), continuing a trend since the late 1970s. The residual error has risen from around ½ per cent of GDP(E) in 1985 to around 2½ per cent at the start of 1988.

CHART C: RESIDUAL ERROR AS A PROPORTION OF GDP(E)



40. There are analogous problems with real GDP estimates. The average measure of GDP (GDP(A)) has been the principal indicator of overall economic activity. The difference between GDP(A) and GDP(E) is the **compromise adjustment.** However, the disparities between GDP(A) and the

other measures of GDP have become particularly acute over the last three years. (See Table 11 and Chart D.) Recorded GDP(E) volume growth over the year to 1987Q4, was around 2 per cent lower than the income and output estimates. There is no sign that the discrepancies have begun to narrow. First estimates for 1988Q1 show that the compromise adjustment has widened further. There must be a strong presumption that real expenditure growth, especially domestic demand, has been much stronger over the last two years than official statistics reveal.

<u>**The residual error and compromise adjustment in the forecast**</u>

41. Previous forecasts have extrapolated the **residual error** as a constant proportion of nominal GDP(E). This convention would imply a sharp slow down in growth of income in 1988 relative to expenditure, a striking reversal of behaviour over the last three years. Most of this relative slow down in income would arise solely from the judgement on the residual error, since the total of expenditure components is forecast to grow at broadly the same rate in 1988 as in 1987. Among other things, slower income growth would involve gross trading profits growing substantially more slowly in 1988 than over the last three years, despite the fact that profit margins continue to rise in the forecast, and demand and activity remain buoyant. The forecast has, therefore, broken with previous conventions and has extrapolated some increase in the residual error. (See Chart C).

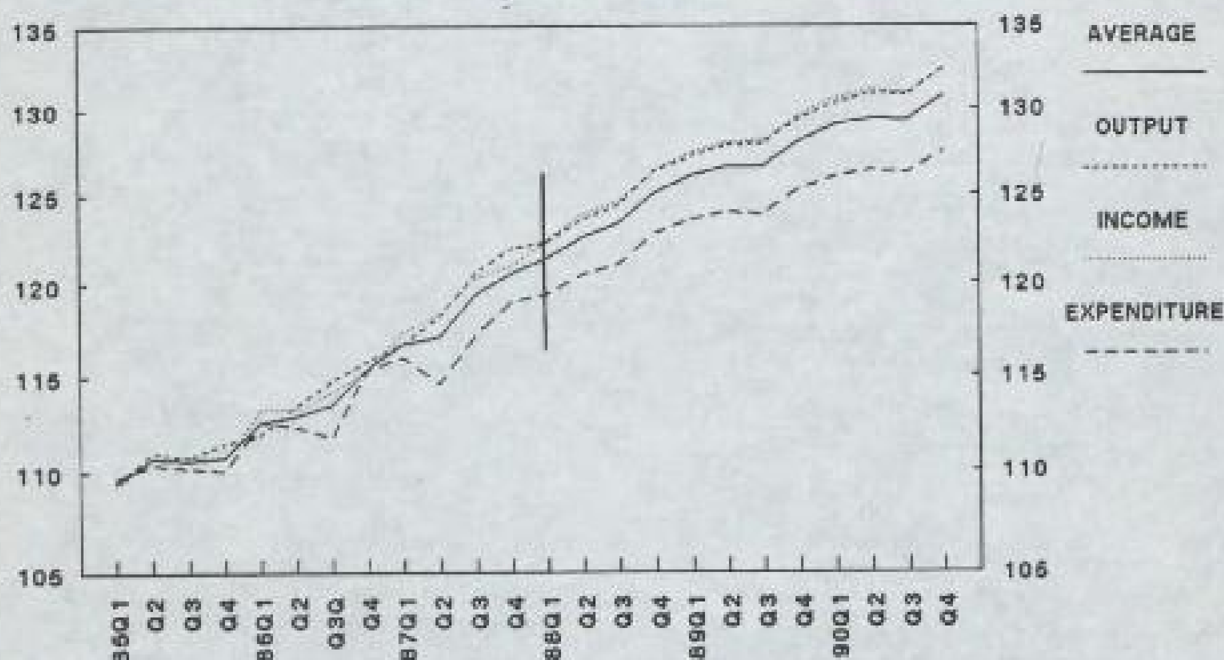
42. A similar problem arises with the **compromise adjustment**. The forecast has usually assumed that all three measures of real GDP will grow broadly in line with the expenditure measure over the future, ie that the compromise adjustment would be a constant proportion of GDP(E). The present forecast, however, has projected a rising compromise adjustment in line with the trend over the 1980s, about ¼-½ per cent per annum. This partly discounts the particularly rapid widening between the measures over the last three years. If anything, therefore, the forecast may understate the growth in GDP(A).

Q

Table 11: GDP GROWTH per cent change on a year earlier

		GDP(O)	GDP(I)	GDP(E)	Average measure of GDP(A)	Compromise adjustment (% of GDP(E))
	1984	3.3	2.1	1.8	2.5	0.6
	1985	3.8	3.2	4.0	3.6	0.3
	1986	2.9	3.5	2.6	3.0	0.6
	1987	4.8	4.6	3.3	4.2	1.5
	1987Q4	5.4	5.0	3.2	4.4	1.3
	1988Q1	4.8	4.4	2.9	4.0	1.8
Forecast	1988	3.9	4.4	3.5	3.9	1.9
	1989	3.3	3.3	2.8	3.1	2.2
	1990	2.4	2.3	1.9	2.2	2.5

CHART D: REAL GDP - OUTPUT, INCOME, EXPENDITURE AND AVERAGE, 1980=100



Sectoral financial data

43. The national accounts measures sectoral financial deficits and surpluses (or net acquisitions of financial assets - NAFA) from income and expenditure data. Separate and independent estimates of the deficits/ surpluses are derived in the financial accounts from analysis of financial flows. Table 12 shows that the two methods produce very different pictures. The national accounts show the personal sector moving into very

large deficit in 1987, while the company sector has built up a large surplus in recent years. The financial accounts suggest that the personal sector position has been a good deal stronger (with a significant surplus in 1987, though lower than in previous years), and that the industrial and commercial company sector was actually in deficit in recent years.

TABLE 12 NET ACQUISITIONS OF FINANCIAL ASSETS (NAFA)* (£billion)

		1985	1986	1987	1988	1989	1990
Persons	National Accounts	6.5	0.7	-6.7	-11.9	-14.9	-14.7
	Financial Accounts	16.6	16.4	13.3	5.6	4.0	5.3
	Balancing Item	**-10.1**	**-15.7**	**-20.0**	**-17.5**	**-19.0**	**-20.0**
ICCs	National Accounts	6.1	6.4	12.2	8.0	8.3	10.9
	Financial Accounts	- 0.1	- 0.5	- 4.5	- 2.0	- 2.7	- 1.1
	Balancing Item	**6.2**	**6.9**	**16.7**	**10.0**	**11.0**	**12.0**
FCs	National Accounts	1.5	5.3	6.6	7.7	9.7	10.4
	Financial Accounts	1.4	6.7	- 3.2	- 6.8	- 5.9	- 8.0
	Balancing Item	**- 0.1**	**- 1.4**	**9.8**	**14.5**	**15.6**	**18.4**
Total Prvt Sector	National Accounts	14.1	12.4	12.1	3.8	3.1	6.6
	Financial Accounts	17.9	22.6	5.6	- 3.2	- 4.5	- 3.8
	Balancing Item	**- 3.8**	**-10.2**	**6.5**	**7.0**	**7.6**	**10.4**
Public Sector	National Accounts	-10.1	- 8.8	- 5.1	+ 1.9	+ 2.3	+ 2.3
	Financial Accounts	-10.3	-9.5	- 5.9	+ 5.1	+ 1.3	+ 1.3
	Balancing Item	**0.2**	**0.7**	**0.8**	**- 3.2**	**1.0**	**1.0**
Overseas Sector	National Accounts	- 3.3	- 0.1	1.6	9.3	10.0	9.0
	Financial Accounts	- 7.8	-12.3	1.4	2.0	5.0	4.0
	Balancing Item	**4.5**	**12.2**	**0.2**	**7.3**	**5.0**	**5.0**
GDP Residual error	**(Sum of balancing items)**	**0.8**	**2.7**	**7.5**	**11.0**	**13.7**	**16.4**

* Table not completely consistent : following publication of national accounts estimates, CSO will not be providing fully reconciled sectoral accounts until 27 June.

44. These separate estimates of **personal sector NAFA** have markedly different implications for the personal savings ratio. National accounts data show that recorded growth in personal sector spending has persistently outstripped growth in recorded personal disposable income over the last eight years. The savings ratio has fallen from an average of 14 per cent in 1980 (a post-war peak, after a steady upward trend since the 1940s) to 4½-5½ per cent over the second half of 1987 and early 1988. The fall in the savings ratio has been especially steep over the last two years, which runs counter to long run historic experience. The savings ratio normally rises when growth in RPDI is above trend.

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45. The financial accounts estimates, however, cast some doubt on the extent of the recorded fall in the savings ratio. If they are more correct, there are probably substantial unrecorded income flows (or, though this is less likely, lower spending) for the personal sector, and the savings ratio will have been rather higher than official estimates show.

46. The financial accounts suggest the opposite for the company sector, namely that spending (on investment and stocks) has probably been higher than the national accounts indicate. Company income could also be lower, though given recent corporation tax receipts, this, too, is less likely.

47. It is impossible to say which set of accounts are nearer the truth. For some sectors, where the procedures for recording income and expenditure are known to be poor (and the public sector is a good example), the financial data almost certainly give a better idea of the outcome. The opposite could well be the case with the personal sector. In the financial accounts the personal sector is the residual sector, so that all errors and omissions in the other sectors' financial accounts wash up here. Moreover they contain a potentially serious anomaly in that they include the transactions of some UK dealers in UK equities and gilts. On this latter account, at least, the financial accounts probably overstate the personal sector surplus.

48. For the forecast, it has been necessary to use the national accounts estimates. Nonetheless, the balancing items are projected to grow broadly in line with recent trends. This effectively gives some weight to the measures based on financial data.

Indicators of activity in the first half of 1988

49. Data for the first few months of 1988 present something of a conundrum. **Net exports** have probably fallen, even after making considerable allowance for distortions, and recorded **manufacturing output** flattened out between 1987Q3 and 1988Q1. Provisional estimates for manufacturing output in April show a marked pick-up, to the highest level since 1974. Some seasonal adjustment problems may have depressed the early numbers in 1988. Certainly they are lower than recent CBI output indicators and general optimism among manufacturers would suggest. On the other hand, the sluggish output figures in 1988Q1 are consistent both with developments in exports and, much more tentatively, with evidence from manufacturing employment.

50. Depressed manufacturing output contributed to a marked slow down in

growth in GDP(O) in the first quarter. It rose by ¼ per cent in 1988Q1, compared to 1 per cent in 1987Q4 and 1½-2 per cent in both 1987Q2 and Q3. Within the total, **construction output** is estimated to have risen 5½ per cent between 1987Q4 and 1988Q1, after 3½ per cent growth in each of the previous two quarters. This strong growth in construction is consistent with both evidence on housing starts and buoyant business investment in new buildings and works. The growth in construction by itself accounts for the growth in total GDP in 1988Q1.

TABLE 13 : LATEST INDICATORS OF ACTIVITY

	Manufacturing output (1980=100)	Retail sales volumes (1980=100)	New car registrations (000's)	Private sector housing starts (000's)
1980Q3	111.2	131.7	532.5	48.1
Q4	112.5	133.4	527.4	50.1
1988Q1	112.5	135.3	527.8	56.3
April	114.8	136.4	498.4[1]	52.8[1]
May	N/A	136.7	N/A	N/A

[1] At a quarterly rate.

51. **Domestic demand**, on the other hand, continues to be fairly buoyant. **Consumer spending** rose by around 1½ per cent in 1988Q1, the same as in 1987Q4, though a touch slower than the average 2 per cent in 1987Q3 and Q4. **Retail sales** volumes for April and May suggest the spending boom has continued into the second quarter of this year. **New car registrations** in the three months to April were lower than at the turn of the year, but still 10 per cent higher than a year ago. **Investment** has also picked up sharply. It rose by 3 per cent in the first quarter, after 4½ per cent growth in 1987Q4.

52. The conjunction of buoyant domestic demand, depressed exports and apparently slowing output growth present problems of interpretation, which are obviously exacerbated by the difficulties with the national accounts. If the output estimates and the depressed net export figures are broadly correct, then the supply side performance of the economy may have been worse than expected. This might imply that capacity constraints and overheating were emerging. If, on the other hand, output estimates understate actual growth (and, for manufacturing at least, CBI evidence suggests that they may), then depressed export growth may indicate that, while domestic demand growth is continuing apace, competitiveness pressures (associated with sterling appreciation) are depressing net exports.

53. The forecast puts more weight on the latter interpretation. There is little evidence of widespread capacity constraints. Recent CBI surveys point to very high capacity utilisation, but also report the view of companies that capacity is adequate to meet expected demand in 1988. In addition, with an investment boom already underway, capacity should not be a significant problem. Nor is there evidence of any strong pick-up in inflation, which has emerged on previous occasions of high capacity utilisation.

54. There are rather more signs that competitiveness may be inhibiting exports and output. In the manufacturing sector, the output of the investment goods sectors fell sharply in 1988Q1, (partly as a result of industrial disputes) despite strong investment. There was, however, some recovery of output in April. Car production fell and imports rose in the first few months of 1988, with both Ford and Vauxhall substituting imports for domestic production for competitiveness reasons, decisions possibly accelerated following earlier industrial disputes.

The Forecast

Personal Income and Expenditure

55. Consumer spending has grown faster than expected over the past three years. The most likely explanation is that lower inflation expectations, and increased wealth (especially increased housing wealth), have both reduced the perceived need for saving relative to income and increased the borrowing capacity of the personal sector. There has been increased demand for (and supply of) credit, following financial deregulation and greater competition among financial companies. With house prices expected to rise substantially through 1988, and a big increase in RPDI following the 1988 Budget tax reductions, the forecast has faster growth of consumer spending this year (6 per cent) than last (5 per cent). The recorded savings ratio is expected to fall slightly. With smaller tax reductions assumed for the 1989 Budget, a slow down in the growth of house prices, higher interest rates and slower growth in real earnings, consumer spending growth should moderate markedly in 1989. The savings ratio should then begin to pick up, though only slightly.

TABLE 14 : PERSONAL INCOME, EXPENDITURE AND SAVING

	Real personal disposable income	Real consumer' expenditure	Personal savings ratio
1985	2.4	3.8	9.4
1986	3.4	6.0	7.2
1987	3.3	5.2	5.4
1988	5.6	6.1	5.0
1989	3.2	3.8	4.4
1990	2.5	2.5	4.4

56. **Persons' investment in dwellings** is estimated to have increased considerably faster than personal disposable incomes in 1986 and 1987. Continued buoyancy in the housing market, now reflected in upward revisions to investment estimates for late 1987/early 1988, along with recent data on housing start and completions, point to a further substantial increase (14½ per cent) in 1988. However, higher mortgage rates and slower increases in RPDI are expected to lead to a slowdown in housing investment in 1989 and beyond.

Company Income and Expenditure

57. **Recorded business investment** was sluggish in 1987, rising by only 4½ per cent, after a fall of 3 per cent in 1986. But there are now distinct signs of a pick-up in investment around the end of 1987 and early-1988. The forecast for 1988 and 1989 is based largely on the June DTI Intentions Survey. This suggests a rapid increase in manufacturing investment in 1988 (about 16 per cent) with a further, but smaller, increase in 1989 (6½ per cent). The DTI Survey also points to fairly strong growth (about 11 per cent) in investment by the construction, distribution and selected service (including financial) industries in 1988, after a similar increase in 1987. Growth in these sectors slows to 5 per cent in 1989.

TABLE 15: GROSS DOMESTIC FIXED CAPITAL FORMATION (percentage changes on previous year)

	1986	1987	1988	1989	1990
Business	- 3.2	4.7	11.1	4.4	0.5
of which:					
North Sea	-15.1	-21.6	7.9	8.0	12.3
Manufacturing	- 5.4	4.3	16.4	6.2	- 3.6
Other business*	- 2.2	6.9	9.3	2.8	1.1
Private dwellings	4.9	6.7	10.3	- 0.5	0.1
General government	6.8	- 4.5	8.4	- 0.1	3.2
Total Investment	- 0.3	3.9	10.6	2.8	0.7

* Includes public corporations

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58. Though stockbuilding was very high in 1987H2, it increased only slightly in 1987 as a whole. The forecast assumes that the long run decline in stock-output and stock-sales ratios continues. This gives stockbuilding of £1-1¼b. (1980 prices) in both 1988 and 1989.

59. Non-North Sea industrial and commercial companies' profits net of stock appreciation showed further strong growth (about 20 per cent) in 1987. Since 1984 profits growth has averaged 26 per cent a year. With buoyant domestic demand and output growth in 1988 allowing some further growth in margins, 1988 should be another good year for profits with growth of 17-18 per cent. Profits may grow more slowly in 1989 and beyond as economic activity slows down. Margins are expected to rise only slightly in 1989 and to fall back a little in 1990. Despite the rise in company sector spending, ICCs net acquisition of financial assets remains in comfortable surplus throughout the forecast. Net company income, which approximates the Corporation Tax base, grows more slowly in 1988 and 1989 than in the previous two years.

TABLE 16: THE FINANCIAL POSITION OF COMPANIES

(a) Profit shares and rates of return

(per cent)	Total	Non-oil	Non-oil (excl privatised) companies	Rate of return on assets, non-oil ICCs*
1973-85 average	13.5	10.4	10.4	5.5
1986	17.2	14.7	13.5	9.0
1987	18.8	16.1	14.4	10.3
1988	19.2	17.3	15.5	11.8
1989	20.0	18.2	16.2	12.1
1990	20.2	18.5	15.8	11.9

(b) Growth of profits and net income (per cent change on a year earlier)

	Non-North Sea Industrial and Commercial Companies*		Financial Companies
	Gross Trading Profits**	Net Income	Net Income
1986	22.7(23.0)	27.0	24.6
1987	20.3(16.5)	30.4	18.8
1988	18.4(18.4)	17.3	17.4
1989	13.9(13.4)	10.3	11.1
1990	8.0(3.7)	4.5	6.9

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

** Net of stock appreciation.

Sectoral surpluses and deficits

60. The forecast of sectoral surpluses and deficits, on a national accounts and financial accounts basis, is shown in Table 12. Continued fast growth in house prices in 1988 (over 20 per cent in 1988, slowing to around 10 per cent in 1989), sustained high levels of investment in dwellings and only small increases in the saving ratio mean that the **personal sector's net acquisitions of financial assets,** on a national accounts basis, will be in even larger defict in 1988 than in 1987 and remain in deficit throughout 1989-90. This is unprecedented since the 1950s. The company sector is expected to run persistent surpluses. The overseas sector reflects the forecast pattern of persistent current account deficits.

Aggregate Demand and Output

61. **Domestic demand** growth is likely to be substantially higher in 1988 than 1987. But GDP growth is expected to remain at 4 per cent in 1988 (4½ per cent excluding oil) due to weaker net exports of goods and services. GDP growth is likely to fall to 3 per cent (3½ per cent excluding oil) in 1989, and slow further in 1990.

TABLE 17: EXPENDITURE AND OUTPUT
(percentage changes on previous year)

	1986	1987	1988	1989	1990
Domestic demand	3.8	4.1	5.8	3.1	1.6
Export of goods and services	3.2	5.7	1.9	5.3	3.9
Import of goods and services	6.3	7.6	9.0	6.2	3.3
Compromise adjustment	0.3	1.0	0.5	0.3	0.3
GDP(A)	**2.9**	**4.3**	**3.9**	**2.9**	**2.0**
Non-oil GDP	2.9	4.7	4.3	3.2	2.3
Manufacturing	0.2	5.4	5.0	3.2	1.8

(5) PRICES AND EARNINGS

Producer Prices

62. **Producer prices (excluding food, drink, and tobacco industries)** rose by 4.8 per cent in the year to 1988Q1 with continued strong growth in profit

margins augmented by slowly rising unit labour costs. Producer price inflation is unlikely to ease significantly over the rest of this year. Domestic demand remains strong, so that margins continue to rise through 1988, though a little more slowly than through 1987. In addition, import costs are expected to increase as a result of strong growth in world commodity prices, and nationalised industry charges are expected to increase, after falling through 1987.

63. Producer price inflation is expected to be around 4¾ per cent by end-1988. It may fall back to about 4 per cent by end-1989, mainly because of an assumed slight squeeze on margins, as output and demand growth slows. Other upward pressures on producer prices through 1989 are quite strong, especially import prices and unit labour costs. (The latter are pushed up by a slowdown in productivity growth, as output growth itself moderates.)

TABLE 18 : COSTS AND PRICES IN MANUFACTURING

(percentage changes on previous year)

	Unit labour costs	Costs of materials and fuels	Estimated total costs	Domestic producer output prices*
1986 Q4	0.7	- 5.6	0.1	3.9
1987 Q4	1.6	5.8	1.3	4.9
1988 Q4	1.8	6.1	2.0	4.7
1989 Q4	3.9	3.1	4.6	4.0
1990 Q4	3.1	3.4	3.4	2.4

* Excluding food, drink and tobacco.

Retail Prices

64. RPI inflation is expected to pick up to 5 per cent by end-1988, as a result of higher mortgage rates and nationalised industry prices. It should rise further to around 6 per cent by mid-1989, with mortgage interest rates again the main impetus, though local authority rent and rate increases also contribute to the rise.

65. Thereafter, RPI inflation abates as mortgage interest rate increases introduced through 1988 and early 1989 drop out of the calculation.

TABLE 19 : COMPONENTS OF THE RETAIL PRICE INDEX

	1986Q4	1987Q4	1988Q4	1989Q4	1990Q4
Food prices	3.2	3.4	3.1	3.4	4.2
NI prices	3.6	2.3	7.2	5.7	4.5
Housing costs	7.1	7.0	10.8	14.2	8.5
Other prices					
- petrol	-12.6	1.3	2.0	3.7	2.7
- other items	3.9	4.0	3.8	4.0	2.8
Total RPI	3.4	4.1	5.0	5.6	4.1
RPI excluding Mortgage Interest payments	3.4	4.0	4.5	4.5	3.6

66. Table 20a sets out the detailed changes in nationalised industry prices assumed for domestic consumers over the year to 1987Q4 and 1988Q4, and table 20b gives real price increase over a run of financial years.

TABLE 20 NATIONALISED INDUSTRY PRICE INCREASES FOR CONSUMERS

(a) Nominal increases

(per cent)	Year to 1987 Q4	Year to 1988 Q4	Year to 1989 Q4	Year to 1990 Q4
Post	3.0	6.1	1.5	6.1
Rail	5.7	6.6	7.3	6.2
Electricity	- 0.5	8.6	5.2	4.1
Coal and coke	0.6	3.1	2.8	0.4
Bus	6.7	4.6	6.9	5.4
Water	6.9	8.1	7.6	6.2

(b) Real increases

(percent changes on previous financial year; weighted average for consumers and industry)

	Average 1983-84 to 1985-86	1986-7	1987-88	1988-89	1989-90	1990-91
British Coal	0.9	- 3.1	- 3.1	- 1.7	- 2.4	- 3.4
Electricity	- 3.1	- 2.0	- 3.8	2.9	0	0
BSC	- 1.4	- 2.0	- 2.9	- 3.2	- 2.4	- 2.4
Post Office	- 3.0	- 2.1	- 0.3	- 1.2	- 1.5	- 0.5
Water	1.9	4.5	2.3	2.7	2.0	2.0
LRT	- 6.1	2.2	2.1	4.6	2.6	1.5
British Rail	- 3.1	2.7	1.5	0.7	- 0.1	0.6

67. Increased nationalised industry prices will, by themselves, raise RPI

inflation in 1988Q4 by ¼ per cent compared with inflation in 1987Q4. Other influences underlying the RPI inflation outlook to 1988(4) are:

(i) **Gas prices** rose by 6 per cent in April after a 4½ per cent fall in 1987. (The difference is worth about ¼ per cent on total RPI inflation).

(ii) An 8½ per cent rise in average **domestic local authority rate poundage** this year, compared with 7¾ per cent last year (the difference is worth less than 0.1 per cent on inflation).

(iii) **Mortgage interest payments** add ½ per cent to inflation in 1988Q4.

68. All the above factors put upward pressure on inflation in the year to 1988Q4. They are only partially offset by a slow down in inflation in **other private sector prices**, which are projected to rise by 3¾ per cent in the year to 1988Q4, compared to 4½ per cent in the year to 1988Q2. There was a step increase in the rate in 1988Q2, mainly due to Budget measures. Other private sector price inflation edges up to 4 per cent by end-1989, largely because of rising import prices.

69. Table 21 below sets out the monthly RPI inflation path over the next twelve months, together with the path from the FSBR. Mortgage interest rate increases dominate the outlook. The profile assumes that the next rise in interest rates occurs in August, and at the beginning of each quarter up to 1989Q2. This pushes up the total from 4.7 to 5.1 per cent (excluding mortgage interest payments, inflation is constant). As in the FSBR, non-housing inflation is expected to rise to a plateau in the summer. The factors pushing it up in the short term are sharp increases in nationalised industry and gas prices, and a recovery in petrol prices. Petrol price inflation has been negative this year, but this is unlikely to last beyond June.

TABLE 21 **MONTHLY PATH OF RPI INFLATION** (annual percentage changes)

	All items RPI		RPI excluding mortgage interest payments	
	FSBR	June	FSBR	June
1988 Apr	3.6	3.9	3.9	4.2
May	3.9	_4.2_	3.9	_ 4.4_
Jun	4.2	4.5	4.1	4.7
July	4.2	4.7	4.2	4.9
Aug	4.3	5.1	4.2	4.9
Sep	4.2	5.1	4.2	4.9
Oct	4.0	5.0	3.9	4.6
Nov	3.8	4.8	3.7	4.4
Dec	4.2	5.2	3.8	4.4
1989 Jan		5.6		4.5
Feb		5.9		4.9
Mar		5.9		4.9

The GDP deflator

70. Recent revisions to the data have pushed up the **market price GDP deflator** for 1987-88 to 5.1, compared with 3.3 per cent in 1986-87. The low figure for 1986-87 was mainly accounted for by the collapse in oil prices during 1986. Latest estimates suggest a rise of 5.1 per cent in the year to 1988Q1. Given general domestic price and costs inflation prospects, it now looks as if the FSBR projections for GDP price inflation in 1988-89 are on the low side; the outturn could be over one point higher at about 5¾ per cent (6 per cent non-oil) compared with 4½ per cent in the FSBR (5 per cent non-oil). It is likely to be about 5¼ per cent in 1989-90, before moderating subsequently as demand slows down.

TABLE 22 : GDP DEFLATOR AT MARKET PRICES
(percentage change on previous year)

	1986-87	1987-88	1988-89	1989-90
MTFS				
Total	3.2	4.9	4.5	3.9
non-oil	6.0	4.3	4.9	3.6
June forecast				
Total	3.3	5.1	5.7	5.2
non-oil	5.9	4.6	6.0	5.1

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Earnings

71. **Private sector settlements** averaged 5¼ per cent in the 1986-87 round, about ½ per cent lower than the previous round. In the manufacturing sector settlements were, on average, ¼ per cent lower than in the previous round. But settlements were clearly on an upward trend through the year to August 1987, and this upward trend seems to have continued. It seems most unlikely that total private sector settlements will turn out at less than 6½ per cent in the current round (their average at the end of the previous round). That is the forecast for 1987-88. But a small fall is expected in the 1988-89 pay round.

72. Overtime in manufacturing increased steadily through 1987. By January 1988 it was at record levels, contributing some 1 per cent to the 8½ per cent growth in **private sector earnings** over the year. Since then overtime has come down as manufacturing output has slowed. But bonus payments and other drift contributed to an increase of 8¾ per cent in **manufacturing earnings** in the year to May 1988. Earnings growth should slow down towards the end of 1988 as output growth itself moderates. For 1989, the continued slow down in activity should lead to slower settlements and earnings increase.

TABLE 23 : PRIVATE SECTOR SETTLEMENTS AND EARNINGS

(Contributions to changes between third quarters of successive years)

	1986-87	1987-88	1988-89
Settlements	5¼	6½	5¾
Drift	2¼	2	2
Overtime	½	0	- ¼
Increase in average earnings	8	8½	7½

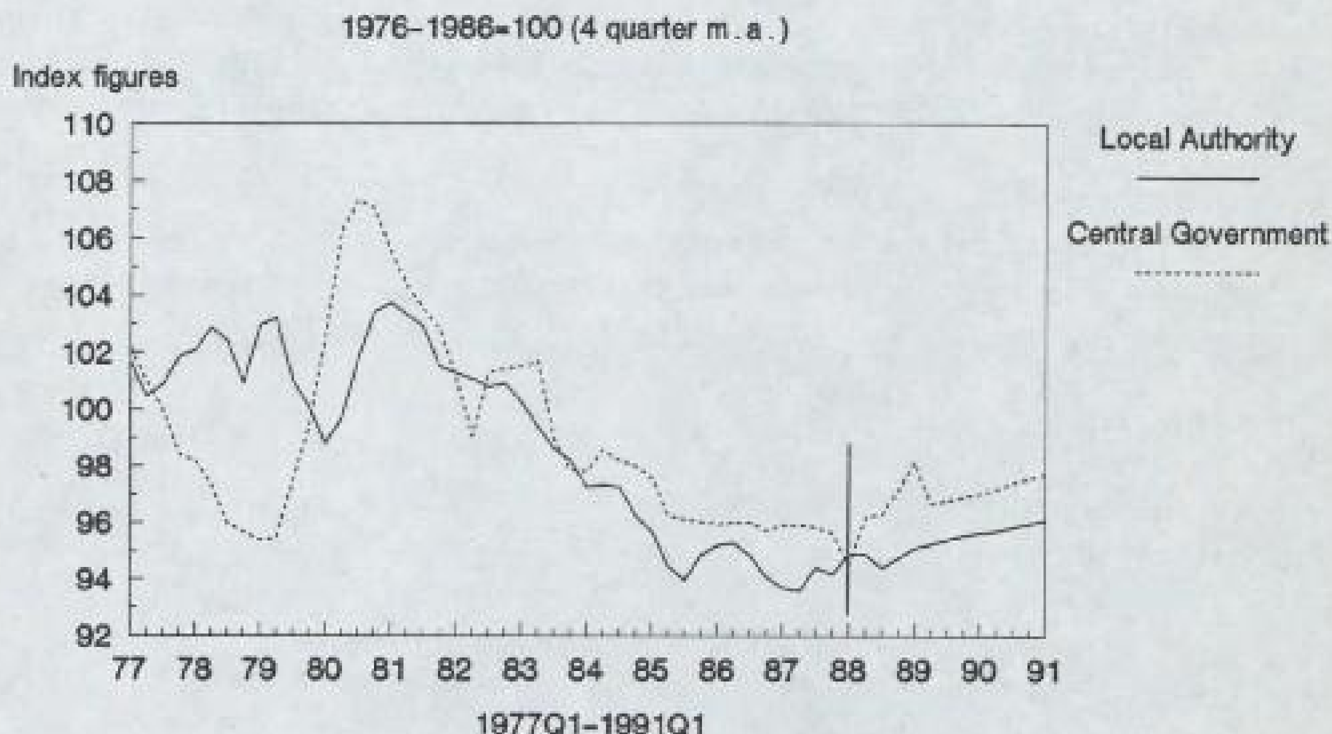
73. In the year to August 1987 **local authority earnings** grew rather more slowly than the private sector. Over the year to August 1988 they are more likely to grow a good deal faster. Teachers were paid 7½ per cent, as the second step of their 1987 settlement, from October and received another 1 per cent in April from restructuring. They received an increase of 4¼ per cent in April. Local authority manuals settled on a 10½ per cent increase. Other local authority workers face varied prospects. Overall, local authority earnings are likely to rise by 11½ per cent in the 1987-88 pay round (compared to about 8½ per cent in the private sector), and 8 per cent in the following round. They rise slightly faster than private sector settlements thereafter.

74. **Central government earnings** grew more slowly (7¼ per cent) than the private sector in the 1986-87 pay round, though nurses and some other health workers fared notably better. For central government earnings as a whole, we forecast increases of 9½ and 8 per cent for the 1987-88 and 1988-89 pay rounds, a little above the average for the private sector.

TABLE 24 : PUBLIC AND PRIVATE SECTOR UNDERLYING AVERAGE EARNINGS
(percentage changes over years to August)

Pay rounds	Central Government	Local authorities	Private sector
1986-87	7¼	7½	8
1987-88	9½	11½	8½
1988-89	8	8	7½

CHART E: RATIO OF LOCAL AUTHORITY AND CENTRAL GOVERNMENT EARNINGS TO PRIVATE SECTOR EARNINGS (FOUR QUARTERS MOVING AVERAGE)



Labour Costs

75. Manufacturers' unit labour costs are likely to rise more quickly over the next two years than in to 1987. Earnings growth picks up in the next year, and productivity growth falls back to more normal rates as output growth moderates

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TABLE 25 : LABOUR COST INCREASES IN MANUFACTURING
(percentage increases on previous year)

	UK	Major 7 (less UK)
1986	4.5	2.1
1987	0.6	0.5
1988	2.0	-0.3
1989	2.6	1.8

(6) EMPLOYMENT, UNEMPLOYMENT AND PRODUCTIVITY

76. Employment rose sharply throughout 1987; in the fourth quarter it was 500,000 higher than a year earlier. Seasonally adjusted adult unemployment has continued to fall in the first five months of 1988, though at a slower rate than in the second half of 1987. It has fallen by nearly 800,000 since the peak in July 1986. Recent developments mainly reflect strong growth in output.

TABLE 26 : CHANGES IN UK ADULT UNEMPLOYMENT
(seasonally adjusted, 000s, Q2 to Q2)

	Unemployment	Effects of employment and training measures, restart and availability testing	Underlying unemployment
1984-1985	+ 166	- 6	+ 172
1985-1986	+ 85	- 63	+ 148
1986-1987	- 242	- 162	- 80
1987-1988	- 560	- 84	- 476
1988-1989	- 158	- 53	- 105

77. Employment should continue to rise through 1988 and 1989, though more slowly than over the past year, because of the slow down in growth of output. Adult unemployment could fall to 2.32m in 1988Q4 and to 2.24m in 1989Q4. The labour supply is expected to grow by 300,000 over the three years to 1990Q4, but the working population remains broadly unchanged.

78. Manufacturing productivity rose 6.0 per cent in the year to 1988Q1. Productivity in the private non-manufacturing sector rose by 3

per cent in the year to 1987Q4. Some of the increase in productivity was undoubtedly due to the cyclical strength of output and increased overtime working. But there also seems to have been an increase in trend productivity growth and we expect this to be sustained. Actual productivity, on the other hand, slows down between 1988 and 1990 with the deceleration in activity.

TABLE 27 : LABOUR PRODUCTIVITY GROWTH
(per cent per annum)

	1964-73	1973-79	1979-87	Forecast 1987-90
Manufacturing	3¾	¾	4	4½
Private non-manufacturing	3	½	1½	2¼
Non-North Sea	2¾	½	2	2½
Whole Economy	2¾	1¼	2	2¼

79. Table 28 shows the implications of trend productivity growth and labour supply projections for productive potential.

TABLE 28 : PRODUCTIVE POTENTIAL GROWTH
(per cent per annum)

	Trend non-North Sea productivity growth	Labour Supply	Non-North Sea productive potential	Contribution to North Sea	Whole economy productive potential
1973-79	¾	½	1¼	½	1¾
1979-87	2	½	2½	¼	2½
1987-90	2½	½	3	- ½	2½

(7) FINANCIAL CONDITIONS

80. The forecast assumes that part of the recent strength of sterling is the result of temporary pressure. With a large current account deficit emerging and money GDP growing more quickly than in the 1988 MTFS, the forecast has a gradual fall in the nominal exchange rate and a rise in base rates to 10½ per cent by mid-1989. The assumed falls in the nominal exchange rate involve a small fall in the real exchange rate from its current level.

Y

TABLE 29: EXCHANGE RATES
(End year rates)

	US dollar index	Sterling index	$/£	DM/£
1984	141.7	75.1	1.22	3.72
1985	128.8	79.8	1.44	3.71
1986	110.5	68.2	1.43	2.87
1987	97.0	74.9	1.75	2.99
June 21	94.4	76.5	1.79	3.14
1988	92.7	76.6	1.89	3.05
1989	91.1	74.3	1.81	2.90
1990	89.3	72.9	1.81	2.80

81. The increases in **domestic interest rates** should widen differentials with US and average world interest rates, despite some rise in interest rates worldwide. Mortgage rates are forecast to move broadly in line with base rates, rising to 12 per cent by 1989 quarter 2. Long rates have been roughly stable since the budget, notwithstanding moves in base rates. Providing long run inflationary expectations do not change dramatically, long rates should not react much to future base rate rises. The rise in base rates is thus not accompanied by any rise in long rates and a downward sloping yield curve emerges. The level of gross gilt issues will give gilts a scarcity value that should offset any upward pressure on yields.

TABLE 30 : INTEREST RATES

End year levels	3 month rates			20 year gilt rate	Mortgage rate
	Euro-dollar	average world	sterling LIBOR		
1987	8.0	6.8	9.2	9.5	11.0
June 21	7.7	n/a	9.2	9.3	c9.8
1988	8.2	6.8	9.5	9.5	10.8
1989	9.7	7.5	10.5	9.5	12.0
1990	9.4	7.2	10.5	9.5	12.0

82. **MO** growth is currently over a point above its target range. Recent and assumed further increases in interest rates are estimated to bring MO growth within its range during the Autumn. Without these it is probable that growth would remain above 5 per cent for the rest of the year.

TABLE 31 : MONETARY AGGREGATES AND CREDIT
(per cent change on a year earlier)

	Money GDP		MO		M4	£ Lending by Banks Building Societies	House prices
	Forecast	(MTFS)	Forecast	(MTFS)			
1987-88	9.8		4.9	(2-6)	15.4	19.6	18.8
May	n/a		6.2		15.7	22.2	23.2
1988-89	10.0	(7½)	5.1	(1-5)	15.6	20.4	20.4
1989-90	7.9	(6½)	1.9	(1-5)	12.1	15.1	7.6
1990-91	6.1	(6)	0.9	(0-4)	11.1	13.1	0.4

83. **House prices** are expected to rise by around 20 per cent in 1988, while mortgage demand remains strong. Some of the higher mortgage borrowing will be for the purposes of 'equity withdrawal'. Despite rises in interest rates, there seems little prospect of significant falls in the rate of growth of consumer credit while growth of personal disposable income remains high. Household indebtedness may thus grow by as much as 20 per cent in 1988. In later years the forecast of modest growth in personal disposable income and considerably slower growth in house prices is likely to temper personal sector borrowing. The **burden of debt service** should at some stage reinforce the desire to increase borrowing less rapidly. The forecast does not envisage a major problem with debt service. If house prices were to decelerate more than forecast (after previous house price booms there have been periods of falling prices) and interest rates remained high persons could adopt a more cautious approach to additional borrowing than forecast.

84. **Lending to companies** may also increase as debt finance replaces equity finance in the wake of the stock market crash. But with industrial and commercial companies enjoying large reserves of liquidity, built up from pre-cash equity issues, this is unlikely to prove a cause for concern. Outside corporate finance the crash has had surprisingly little effect. Individuals have switched new investment away from equity linked products - notably unit trusts - to liquid assets, but there is little evidence of significant selling and, as the Treasury/Stock Exchange survey showed, the number of share owners has hardly altered. Wealth effects on spending do not seem to have materialised, probably because the crash only wiped out gains made over the first half of 1987.

85. The forecast assumes that there is a full fund of the PSBR outside banks and building societies. National savings raise around £1b. over each of the next two years. With some defensive intervention this leaves large net repayments of gilts, particularly in 1989 and 1990, which will necessitate some buying in. The resultant shortage of gilts will be a contributory factor behind the inverted yield curve discussed above, and institutions will probably turn to overseas government bonds and domestic corporate bonds to maintain desired portfolio shares.

TABLE 32 : PSBR AND FUNDING
(£ billion)

	PSBR	Gilt sales to nbnbsps*	Nat Savs	Reserves	Other overseas finances†	Other debt to nbnbsps	Overfund+	Net gilt sales to banks and b.socs	Gross gilt sales to all sectors
1985-86	5.7	3.5	2.1	-2.4	4.3	-1.6	0.2	-0.7	11.7
1986-87	3.4	3.6	3.4	-3.8	5.5	-1.7	3.6	-1.2	14.6
1987-88	-3.5	2.4	2.1	-11.1	4.3	0.2	1.3	-0.6	13.4
1988-89	-7.4	-7.4	1.0	1.0	-0.2	-1.4	0.4	-0.5	0.1
1989-90	-7.4	-9.0	1.0	2.0	-0.8	-0.7	0.0	-0.5	1.5
1990-91	-7.4	-8.6	0.5	2.0	-0.8	-0.5	0.0	-0.5	-2.6

* non-bank non-building society private sector

† includes foreign currency finance

\+ overfund on M4 definition

86. The financing of the current account deficit occurs through several channels. Direct and portfolio investment inflows are expected to increase markedly and direct investment outflows to fall back from previous high levels. Against this, the overseas sector does not continue to buy large quantities of gilts. After a large repatriation of overseas portfolio assets in 1987, outward portfolio investment is expected to resume as institutions purchase, inter alia, foreign government bonds. The resulting shortfall in financing of the current account is met by a marked increase in overseas deposits with UK banks. Clearly, for the exchange rate path assumed for the forecast, an inflow on this scale would probably require reasonably high differential between domestic and overseas interest rates.

TABLE 33 : NET EXTERNAL CAPITAL FLOWS
(£ billion)

	Direct invest -ment	Other private non bank	Banks' foreign currency	Banks' sterling	General Gov't liabi- lities	Official reserves	Balancing item	Current balance
1986	-7.3	-8.0	2.8	-0.4	3.4	-2.9	12.2	0.1
1987	-10.0	14.0	-0.9	3.9	6.3	-12.0	0.2	-1.6
1988	-5.7	-0.9	4.3	5.2	-0.2	-0.2	7.3	-9.3
1989	-6.0	1.8	3.2	5.1	-1.0	2.0	5.0	-10.1
1990	-5.9	2.4	3.2	3.3	-1.0	2.0	5.0	-9.0

(8) PUBLIC FINANCES

87. Table 34 compares the forecast with the FSBR and internal January forecast.

TABLE 34 : PUBLIC SECTOR EXPENDITURE, REVENUE, AND BORROWING
(£ billion)

	1988-89			1989-90			1990-91	
	January Fore-cast	FSBR	June Fore-cast	January Fore-cast	FSBR	June Fore-cast	FSBR	June Fore-cast
General Government Expenditure	183½	183	181	194½	193	194½	201½	205½
General Government receipts	185½*	185	187½	198*	195	204	205	216
Assumed cuts in personal taxes (cumulative)				0*	3½	2½	4½	3½
GGBR	-2½	-2	-6	-3½	1	-7	1	-7½
Public corporations' overseas and market borrowing	-1	-1	-1	-½	-1	-½	-1	0
PSBR (per cent of GDP)	-3½ (-¾)	-3 (-¾)	-7½ (-1½)	-3½ (-¾)	-3½ (0)	-7½ (-1½))	0 (0)	-7½ (-1½)

* adjusted to post-1988 budget tax rates

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1988-89

88. The PSDR in 1988-89 is forecast to be £7½ billion, compared with £3 billion in the FSBR. The more buoyant forecast for economic activity increases tax receipts and reduces some items of expenditure. On the assumption that BSC is privatised this year, privatisation proceeds are likely to be closer to £6 billion than the £5 billion assumed in the FSBR. Table 35 summarises the revisions.

TABLE 35 : MAIN CHANGES SINCE THE FSBR IN THE PSBR FORECAST FOR 1988-89

	£ billion
Higher General Government Receipts	
- higher North Sea revenues from a higher North Sea oil price;	0.3
- higher ACT reflecting higher dividend payments;	0.5
- higher stamp duty reflecting higher house prices and stock market turnover;	0.6
- higher VAT and specific duties mainly reflecting higher consumer spending;	1.0
- higher interest receipts (largely reflecting removal of presentational adjustments in Budget forecast);	0.7
- higher ECGD trading deficit on the assumption of no refinancing of loans;	-0.6
TOTAL	2.5
Lower General Government Expenditure	
- lower departmental spending	-0.3
- higher privatisation proceeds	-0.9
- lower debt interest payments	-0.2
- changes to other adjustments	-0.3
TOTAL	-1.7
TOTAL CHANGE IN PSBR FORECAST	-4.2

(b) Public Expenditure

89. With the planning total (excluding privatisation proceeds) in 1988-89 forecast to be close, in cash terms, to that in the 1988 PEWP, the higher forecast inflation squeezes expenditure in real terms (see table 36). But higher forecast real growth of expenditure in 1989-90 and 1990-91 produces a forecast level of spending in 1990-91 in real terms that is above the plans.

TABLE 36 : PLANNING TOTAL EXCLUDING PRIVATISATION PROCEEDS

	1987-88	1988-89	1989-90	1990-91
£ billion current prices				
1988 FSBR	151.0	161.8	172.1	181.1
Forecast	151.0	161.5	174.6	186.9
Real growth %				
1988 FSBR	¼	2½	2¼	1¾
Forecast	0	1	2¼	2¾

90. Table 37 compares the forecast of the planning total in cash terms with the PEWP. Local authority current spending accounts for the largest claims on the reserve. Taking defence and health together, about three-quarters of the overspend in cash terms on existing plans is attributable to pay. Forecast overspending on other central government programmes is consistent with some future increase in provision for investment in roads, prisons etc.

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TABLE 37 : FORECAST ADDITIONS TO EXPENDITURE PLANS

£ billion

	1988-89		1989-90		1990-91	
	PEWP 1988	Forecast Claims on Reserve	Survey Baseline	Forecast Claims on Reserve	Survey Baseline	Forecast Claims on Reserve
Allocated to programmes						
1. Social Security (including HB)	46.9	0.1	49.5	0.9	52.0	2.6
2. Defence	19.2	0.3	20.0	0.5	20.6	1.0
3. Health	21.8	1.0	22.9	1.9	24.0	2.8
4. Net EC	0.8	0.2	1.5	0.4	1.3	0.3
5. Other CG	29.3	0.5	31.1	1.1	32.0	1.7
6. LA current (excluding HB)	34.9	1.3	35.2	3.8	36.2	6.2
7. LA capital	4.0	-	3.9	0.4	3.8	0.7
8. Nationalised industries	0.7	-0.2	-	0.5	-0.4	1.0
9. Other PCs	0.8	-	1.0	-	1.2	-
10. Total programme	158.3	3.2	165.1	9.5	170.7	16.2
11. Privatisation proceeds	-5.0	-0.9	-5.0	0.0	-5.0	0.0
12. Expenditure met from existing reserve						
(i) allocated to programme baseline	0.0	2.3	0.0	7.0	0.0	10.5
(ii) unallocated	3.5	0.0	7.0	0.0	10.5	0.0
13. Underspend (-) Required Addition to Reserve (+)	0.0	-1.2	0.0	2.5	0.0	5.7
PLANNING TOTAL	156.8	155.6*	167.1	169.6*	176.2	181.9*

*Forecast of the planning total outcome

91. General government gross debt interest payments are forecast to be only a little lower in 1988-89 than in 1987-88 because the need to finance the rise in the foreign exchange reserves has continued to push up the <u>gross</u> stock of debt outstanding. After 1988-89, with large net repayments of debt by general government and a partial unwinding of the rise in the reserves assumed, gross interest payments fall sharply, particularly in 1990-91.

92. The ratio of GGE (excluding privatisation proceeds) to money GD[illegible]s forecast to be about one percentage point below that in the FSBR in 1988-89. It is forecast to fall further in 1989-90 and 1990-91 and to remain below the FSBR path.

TABLE 38 : RATIO OF GGE EXCLUDING PRIVATISATION PROCEEDS TO MONEY GDP (per cent)

	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91
1988 FSBR	44½	43¾	41¾	41¼	40¼	40
June forecast	44½	44	41¾	40	39¾	39½

93. Table 39 compares the forecast of GGE excluding privatisation proceeds with earlier internal forecasts, successive PEWPs and the 1988 FSBR. The forecast for 1988-89 is a little lower in both cash and real terms than in the last internal exercise in January. The forecast for 1989-90 is broadly unchanged in cash terms but lower in real terms.

TABLE 39 : PAST AND CURRENT FORECASTS OF GGE EXCLUDING PRIVATISATION PROCEEDS (£ billion)

	1987-88		1988-89		1989-90		1990-91	
Forecast	Current Prices	Real Terms*	Current Prices	Real Terms*	Current Prices	Real Terms*	Current Prices	Real Terms*
PEWP 1986	174	168	179	168	-	-		
June 1986	177	170	186	171	-	-		
PEWP 1987	179	172	185	172	193	174		
June 1987	170	170	190	171	203	174		
PEWP 1988	178	170	188	173	198	176		
Jan 1988	177	169	188	171	200	173		
FSBR 1988	177	169	188	171	198	174	207	175
June 1988	177	169	187	168	200	171	210	173

* 1986-87 prices

(c) Receipts

94. The forecast of total taxes and national insurance contributions (NICs) in 1988-89 is some £2 billion higher than in the FSBR. Even so because the level of money GDP is also higher the total and non-oil tax burdens are expected to fall in 1988-89, compared with no change in the FSBR. Before taking account of fiscal adjustments the non-oil burden is forecast to rise by about ½ percentage point in 1989-90 and to be broadly flat in 1990-91. The rise in 1989-90 is more than accounted for by a rise of over 20 per cent in non-North Sea corporation tax which in turn reflects forecast continued strong profit growth into 1988.

95. Table 40 shows that the assumed tax cuts are sufficient to hold the non-oil tax burden roughly flat.

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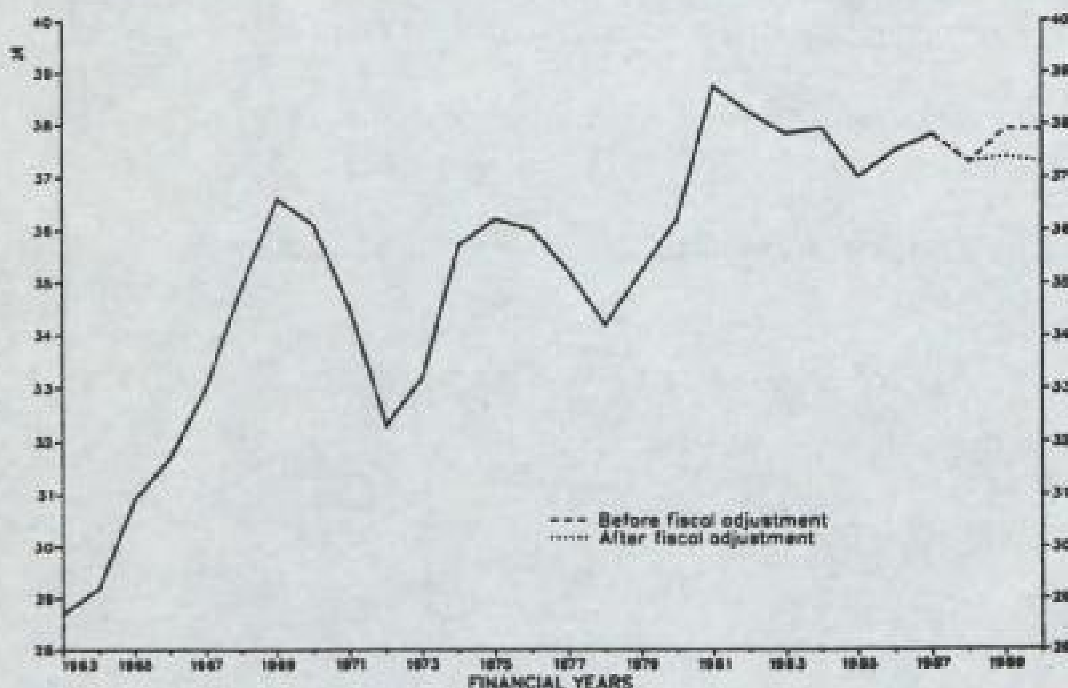
TABLE 40 : NON-OIL TAXES AND NICs AS A PERCENTAGE OF NON-OIL GDP

	1986-87	1987-88	1988-89	1989-90	1990-91
MTFS					
(a) pre-fiscal adjustment	37.5	37.7	37.7	37.7	
(b) post-fiscal adjustment	37.5	37.7	37.7	36.9	36.6
Summer Forecast					
(a) pre-fiscal adjustment	37.5	37.8	37.3	37.9	37.9
(b) post-fiscal adjustment	37.5	37.8	37.3	37.4	37.3

CHART F : THE SHARE OF NON-NORTH SEA TAXES AND NICs IN NON-NORTH SEA GDP



(d) <u>Local authority finances and the LABR</u>

96. The assessment of LA finances is particularly hazardous on this occasion because of the uncertainties associated with the introduction of the local government finance reforms, in 1989 in Scotland and 1990 in England and Wales. The forecast is crucially dependent on assumptions on:

- the growth of LA current expenditure;

- the proportion of expenditure financed by central government grant.

97. Local authorities' budgets for 1988-89 indicate that overspending (compared with PEWP provision) on current expenditure will be lower than previously forecast - current expenditure might rise by 1 per cent in real terms compared with 3½ per cent in 1987-88. Upward pressure on spending is likely to re-emerge from next year on as a result of the costs of implementing the community charge (CC) and the introduction of other initiatives such as the national curriculum. Real increases in current spending of around 4 per cent a year are forecast for 1989-90 and 1990-91.

98. The <u>outturn</u> central government grant percentage is assumed to fall slightly in 1989-90. In 1990-91, the first year of the CC in England and Wales, a one per cent rise in the outturn grant percentage is assumed (after continuous falls in the 1980s). This is equivalent to holding the percentage constant at its level in 1989-90 <u>before deduction of grant penalties for overspending</u> which will cease to exist in the new regime.

99. Against this background total income from domestic rates and the CC may fall a little in real terms in 1990-91 (see table 41).

TABLE 41 : LOCAL AUTHORITY CURRENT EXPENDITURE AND INCOME

	% increases in real terms			
	1987-88	1988-89	1989-90	1990-91
Total current expenditure	3½	1	4	4½
<u>Income from:</u>				
Central government grant	4	-2½	3	6½
Business rates	2½	3½	7	4
Domestic rates and CC	2½	3½	5½	-1

100. The LABR is forecast to be in the £1½-2 billion range throughout the forecast period. (It was £1½ billion in 1987-88.)

D2

ANNEX : COMPARISON WITH OUTSIDE FORECASTS

	JUNE FORECAST	AVERAGE OF OUTSIDE FORECASTS (JUNE)
A. ACTIVITY		
1. GDP VOLUME (per cent change on year earlier)		
1988	3.9	3.2
1989	2.9	2.2
2. UNEMPLOYMENT (UK, sa, excluding school leavers in millions)		
1988Q4	2.32	2.38
1989Q4	2.24	2.37
B. INFLATION		
3. RPI (per cent change on year earlier)		
1988Q4	5.0	3.8
1989Q4	5.6	4.7
C. PUBLIC FINANCES		
4. PSBR (£ billion)		
1988-89	-7.4	-3.0
1989-90	-7.4	-1.9
D. MONETARY CONDITIONS		
5. SHORT TERM INTEREST RATES (per cent)		
1988Q4	9.5	8.7
1989Q4	10.5	9.5
6. STERLING INDEX (1975=100)		
1988Q4	76.7	76.4
1989Q4	74.3	73.1
E. CURRENT ACCOUNT		
7. CURRENT BALANCE (£ billion)		
1988	-9.3	-5.2
1989	-10.1	-6.8

World Financial Markets

JPMorgan

1988 issue 3
July 1

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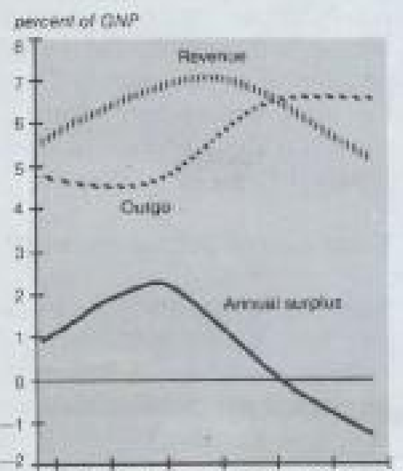
Chart 1

*The Social Security surplus**



*Projections by Social Security trustees based on current law and intermediate demographic and economic assumptions (variant IIB). Both revenue and surplus include interest earned on the trust funds.

U.S. Social Security surpluses: pitfall or opportunity?

The burgeoning surplus of the U.S. Social Security system has come to the fore this year as the latest temptation to procrastinate on decisive measures to cut the federal budget deficit. Under current law, the system surplus should rise from a projected $37 billion in the current fiscal year to almost $500 billion by 2015 — over 2% of GNP at that time (see Chart 1). More immediately, the projected $25 billion increase in the surplus between FY1987 and the new fiscal year beginning this October more than accounts for the $15 billion narrowing expected over the period in the federal budget deficit (unified basis). Further, the increase in the Social Security surplus alone should provide more than one-third of the $150 billion budget deficit reduction targeted by FY1993 under the Gramm-Rudman-Hollings (GRH) legislation.* Beyond FY1993 — assuming GRH compliance — there should be a large and growing budget surplus (see Table 1). That alluring prospect, so different from today's dreary deficit reality, already is inspiring some members of Congress to rush forward new spending schemes.

The Social Security outlook is not the only source of complacency on the budget issue. April's drop in the U.S. trade deficit, to below $10 billion CIF, plus the upgrading of mainstream forecasts for U.S. real GNP growth this year, to above 3.5%, suggest that the external imbalance is on its way to correction with no sacrifice of growth. To date, growth and trade adjustment also have been consistent with a fairly stable underlying inflation rate since the economy's resources have not been unduly pressured. Now, however, the combination of strong external and domestic demand has brought the economy close to full employment and full capacity utilization in a number of sectors. From here on, substantial further trade correction, which will have to be mainly export-driven, requires domestic demand re-

*The GRH targets are based on the "unified" budget — that is, they include the "off-budget" expenditures and receipts of the Social Security system, as well as "on-budget" items such as defense, income taxes, and Medicare.

Table 1

Social Security and the Gramm-Rudman-Hollings federal budget targets

billions of dollars

	Balances		
	Target, unified basis	Social Security	Implied on-budget
Fiscal years			
1987	—150	20	—170
1988	—144	37	—181
1989	—136	44	—180
1990	—100	54	—154
1991	—64	62	—126
1992	—20	70	—90
1993	0	78	—78
1996	120	120	0*

*Assumes the 1989-93 trend in on-budget cuts continues.

Table 2

The payoff from saving

	Net domestic saving, percent of GNP	Real GNP growth per capita, percent per annum
Actual, 1960-87	3.1	1.3
Projected, 2000-2020		
*Official projection**	6.0	1.4
*Optimal policy***	8.5	2.0

*Implied by intermediate growth assumptions of the Social Security trustees.
**GRH compliance, Medicare solvency, and productive investment of Social Security surpluses.

straint to free up resources.

The financial markets plainly crave enlightenment on just how the next Administration and Congress will seek to remedy the twin deficits within the next presidential term. The burden cannot be off-loaded onto the Federal Reserve, for while monetary restraint can in principle force down the trade deficit, it would be at the cost of economic growth and employment. Instead, as detailed in the last issue of this publication,* the constructive answer lies through resolute fiscal action, assisted if need be by easier monetary policy to keep the dollar competitive. This course would make room, and provide the incentive, for noninflationary trade correction.

In light of the twin deficit connection, the temptation to squander the looming Social Security surpluses for immediate gain must be strenuously resisted. That the temptation is strong is apparent from the pressure for increased spending, notably on "Medicare" health insurance for the elderly. Yet the federal budget already is absorbing almost half of net private savings, leaving net domestic saving at an average of just 3% of GNP in the 1980s so far, and an improvident 1.9% in 1987. To splurge on Medicare or otherwise fall short of the GRH budget targets would leave the savings shortfall unattended, plunge the nation deeper into foreign debt, heighten financial risks, and undermine U.S. standing around the world.

Longer term, the path of profligacy would defeat the whole purpose of Social Security. Spending the surplus would leave the U.S. economy underinvested and ill-prepared to face the massive retirement and health care burden that will arise in the 21st century as today's baby-boom generation exits from the workforce. Social Security would turn out to be a mere paper promise.

Instead, with careful husbandry, Social Security surpluses present an unequaled opportunity to boost the U.S. net savings and investment rates, perhaps to as much as 8% of GNP — a level not achieved since the mid-1960s but necessary to provide for the future prosperity of both retirees and the working population (see Table 2). This requires compliance with the GRH targets, effective containment of Medicare entitlements (especially for future beneficiaries), and productive investment of Social Security surpluses. A partial privatization of the Social Security system could help, lest the incipient surpluses be frittered away or mismanaged. Wisely handled, Social Security surpluses could make a dramatic difference for U.S. economic prospects. Higher domestic saving not only would help eliminate the trade and current account deficits, and the associated dependence on foreign saving, but also would build up the nation's productive capital stock. That is the only convincing assurance of retirement security.

*"Reducing the twin U.S. deficits," *World Financial Markets*, 1988 issue 2.

Evolution of Social Security

The U.S. Social Security system has had a turbulent history of changing priorities. Launched in 1935 as a narrowly defined pension and insurance plan, it was placed outside the budget and its receipts were supposed to be held in trust for future beneficiaries. Thus, like a private pen-

Chart 2

Payroll tax rates

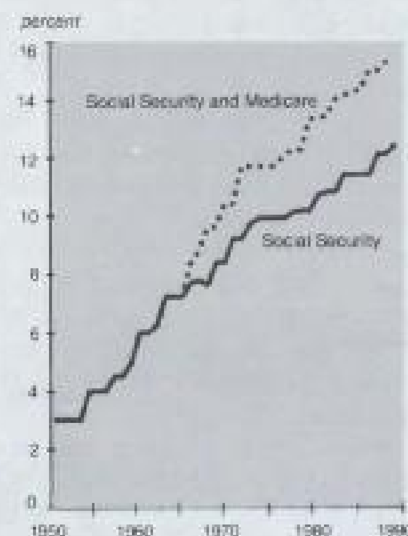
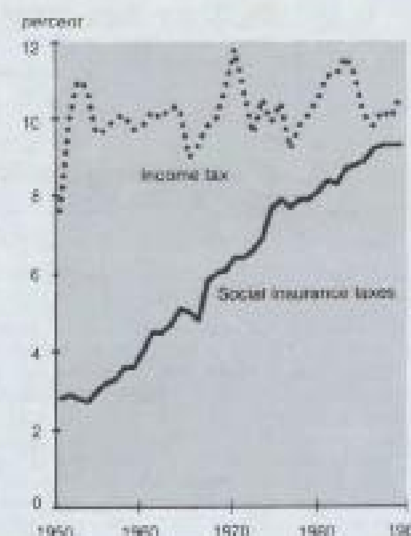


Chart 3

*Average personal tax rates**



*Collections divided by personal income. Social insurance taxes include Social Security and Medicare, as well as contributions to the federal employee retirement funds.

sion plan, the system was to pay contributors a fair rate of return and be fully funded.

Almost from its inception, however, the system was changed to a "pay-as-you-go" basis, with current workers' tax payments funding the benefits of retirees. The switch reflected broadened objectives. First, to preclude fiscal drag, it was decided that funds drawn out of the economy should be immediately returned to the spending stream. Second, benefits were extended to many who had not contributed, including the first generation of retirees who were "grandfathered" into the system. Thereafter, over time, benefits were extended to many workers not initially covered, to the disabled, and to a variety of dependents; retirement eligibility rules were loosened; and, in 1972 benefits were indexed to the cost of living. In addition, 1966 saw the introduction of "Medicare" health insurance, which is closely associated with Social Security in its means of financing and beneficiary class but is treated separately for budgetary purposes.

Social Security and Medicare payroll taxes under the Federal Insurance Contributions Act (FICA) have increased in step with benefits. The original law called for a tax on wage and salary income of 1% each on employee and employer. Today, the employee tax is made up of a 6.06% tax for Old Age Survivors and Disability Insurance (OASDI) and 1.45% for Medicare, with the employer contributing a like amount to yield a total tax rate of 15.02% (see Chart 2). Moreover, the payroll tax base has been steadily increased, with levies on labor income up to a ceiling currently set at $45,000 per annum — a near-sixfold increase since 1970. Altogether, the system's expansion has meant that the payroll tax now generates nearly as much revenue as the federal income tax (see Charts 3 and 4), while Social Security and Medicare outlays exceed the defense budget.

Amid the current reports of growing surpluses it is easy to forget that the system was close to bankruptcy five years ago. The rapid expansion of benefits and taxes proved workable as long as the labor force was growing relative to the overall population and the economy was robust. By 1981, however, the slowdown in the economy and the pickup in inflation had cut payroll tax collections sharply relative to outlays. As a result, the OASDI trust funds had fallen to the brink of insolvency.

The system was rescued in 1983 through a series of reforms proposed by a special commission headed by Alan Greenspan. The Greenspan Commission recommended a mix of benefit cuts and revenue enhancements. On the revenue side, the payroll tax was increased — it will reach 15.3% by 1990 — and half the benefits were made taxable for middle- and upper-income recipients. On the expenditure side, the annual cost-of-living increase was permanently delayed by six months and the retirement age for full benefits was set to rise to 67 by the year 2027. These adjustments have led to the current surpluses.

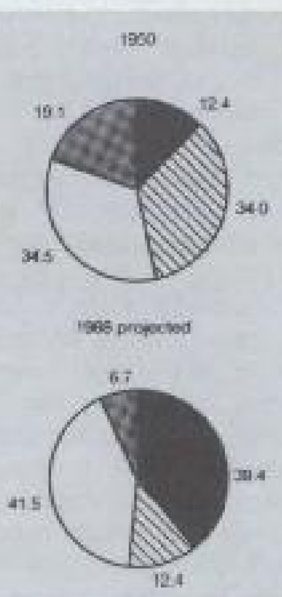
The need for surpluses

The Greenspan reform not only put the system back on its feet, but also aimed to keep it solvent for the next 75 years. The system

Chart 4

*Shares of gross federal receipts**

percent of total



■ Social insurance

▨ Corporate profits

☐ Personal income tax

▩ Other

*NIPA basis.

Table 3

Social Security surpluses

percent of GNP

	1980-86	*1986*
United States	0.1	0.5
Canada	0.8	0.8
Japan	2.8	2.8
Germany	0.2	0.5
France	0.4	—0.3
Italy	0.1	0.1
United Kingdom	0.1	0.1
Denmark	1.2	1.4
Sweden	2.9	2.5*

*1985.
Source: OECD.

has moved away from the pay-as-you-go basis on which it had previously relied and on which other industrial countries with a few exceptions continue to rely (see Table 3). While most of the U.S. payroll tax will continue to support current retirees, a growing portion will be accumulated as reserves of the Social Security trust funds. By 2030, under current law, the accumulated reserves could reach almost $12 trillion. Thereafter, they would run down to the point of exhaustion around mid-century.

The need for these reserves stems from powerful demographic forces shaping the long-term U.S. outlook. Early in the next century, the labor market will be squeezed from two directions: not only will the retired population swell as baby boomers reach retirement age, but the working population will shrink as the "baby-bust" generation begins to dominate the labor force. As a result, the ratio of retirees to working age population will almost double (see Chart 5). In the period 2010 to 2030 Social Security outlays will grow 40% faster than the payroll tax base.

Social Security may be likened to a benevolent "Ponzi" (pyramid) scheme. Each new generation pays for the older generation's retirement, relying on subsequent generations to do the same. Furthermore, each generation receives more than it pays in as long as the newer groups are willing to "up the ante." But any pyramid scheme will unravel if the pool of contributors fails to expand sufficiently fast. This could well be the case with Social Security. Chart 6 shows how the share of the adult U.S. population in various age groups is expected to evolve over time. This population pyramid shows an increasingly top-heavy structure as the prime-age population (aged 25-54) shrinks relative to the older population.*

The system differs from the classic Ponzi scheme in one important respect, the enforcement mechanism. Sheer voting power will tend to ensure that the older generation can enforce the contract implicit in Social Security. Even so, to support the top-heavy population structure in prospect, the Social Security system itself needs a credible prop. That is the essential function of the surpluses programmed by the Greenspan reform.

Policy courses to avoid

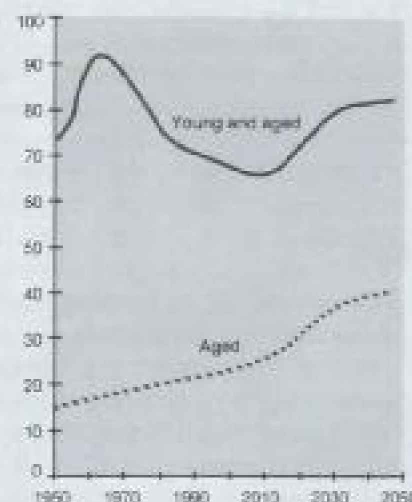
Inasmuch as Social Security surpluses are set to siphon off increasing amounts of spending power, they pose at least a theoretical risk of "fiscal drag." Critics of the surpluses go so far as to warn that the surpluses could cripple the economy, and thus be self-defeating.

In fact, the fiscal drag allegation is a red herring that can only distract policymakers from the real issues. The seemingly huge numbers involved are actually quite small when put in proper context. Although the surplus could climb as high as $500 billion in 2015, it would represent only 2.1% of that year's GNP. To be sure, if the on-line federal budget is balanced at that time, the cumulative tightening of the federal position would amount to some 5.5% of GNP relative to the current stance. In determining the possible drag on GNP growth, however, the cumulative change in the fiscal position is less important than the annual change. The annual change associated with the Social Security trend would never exceed 0.2% of GNP, far short of the approximately 0.9% annual cuts required to meet the GRH targets. Besides, any short-run difficulties in recycling the surplus can be overcome with a proper mix of monetary policy and investment incentives. Furthermore, the government still would be free to use temporary deficits in the on-line budget to counter swings in the economy.

*In principle, increased immigration could offset the decline in the prime-aged population. But unless the immigration is specially tailored to highly productive, young workers, it is unlikely to help much. Estimates in the Greenspan report suggest that an additional 100,000 immigrants per year would strengthen the long-run balance of the system by 0.1% of the taxable payroll. To make a significant dent in the Social Security problem would require more than doubling immigration — legal and otherwise — to over 1.5 million per year. At this rate most U.S. population growth would be due to immigration.

Chart 5

*Young and aged as percent of working-age population**

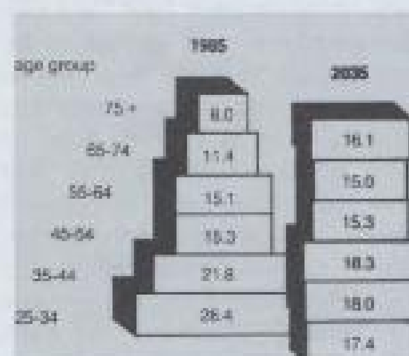


*Young, age 0-19; aged, 65+; working-age, 20-64.

Chart 6

The population "pyramid"

percent of population aged twenty-five and over



Although the fiscal drag related to Social Security poses no serious risk to the economy, it does help justify politically motivated "solutions" to the surplus. Three proposals have been made: the surplus could be used to fund higher government spending, pay for the growth in Medicare, or cut the payroll tax. These solutions would eliminate the fiscal drag problem but ultimately would jeopardize the Social Security system and the future health of the economy.

The politically tempting solution also would be the most damaging. As the surplus accumulates over the next twenty years, Congress could give in to pressure to fund new, more generous benefits. This use of the surplus could drive the average replacement rate — the ratio of benefits to previous income — almost 30% higher than under the current policy.

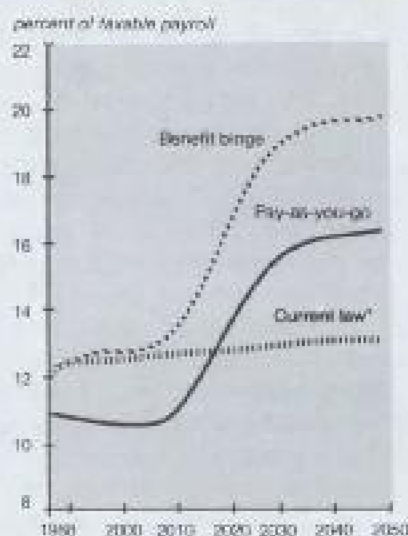
Such a benefit binge, however, would create unmanageable problems once baby boomers begin retiring around 2010. Conceivably, balance could be restored at that time by cutting outlays. This would require not only rescinding the assumed benefit increases of the next twenty years, but also lowering replacement rates below those enjoyed by the generation retired today. The sheer voting power of the baby-boom cohort makes this an unlikely outcome. The more likely policy response would be a mix of unpalatable alternatives: jacking up the payroll tax as much as eight percentage points (see Chart 7) or running outsize deficits.

At the extreme, suppose that that GRH mandate is not carried out; the Social Security surplus is used to fund a benefit binge or other programs which become built into the system; and no efforts are made to reform Medicare. The consequential rise in borrowing could absorb more than half of net private saving by 2010, with both the on-line budget and the Medicare trust fund in deficit (see Table 4). Twenty years later, the situation would be out of control: in the absence of new taxes or spending cuts the government deficit actually could exceed private saving.* With the labor force stagnant and no net investment,

*For simplicity, these projections assume that, over a long period, there are no sustained capital inflows or outflows and that net private saving continues at its historical rate of about 6%. In reality, saving patterns are sensitive to demographic changes. Baby boomers, who are now entering their thirties and forties, are prone to save more as they leave behind the initial cost of forming new households and begin to prepare for their children's education and their own retirement. Most of the increase in saving by baby boomers, however, is likely to be offset by the reduced saving of a growing number of retirees.

Chart 7

Social Security revenue requirements



*Includes a small flow of revenue from the income tax on benefits.

real GNP growth could grind to a halt.

Awareness of this long-term peril probably will keep the United States from adopting so profligate a course. Even so, the presence of a rising Social Security surplus is prone to spawn compromises falling short on the implicit GRH target for the on-line accounts. Already, Congress has been considering a number of proposals for expanding Medicare (see next article) and will be tempted to use the Social Security surplus to fund them. The outcome might leave the unified budget in deficit by $50 billion or so in FY1993, deferring elimination of the deficit till near the end of the decade and achieving at best modest surpluses during the early years of the next century.

Such a policy of borrowing from Peter's savings to pay Paul's medical bills would create almost the same financing problems as a benefit binge. Were growth in Medicare outlays to exceed current-law projections by 2.2 percentage points annually over the next fifteen years, and were such growth to be financed by the retirement fund, the combined systems would start accumulating deficits with a vengeance beyond 2010. New higher medical bills would pile on top of unfunded retirement benefits, burying the relatively small number of taxpayers. By 2020 the combined shortfall would reach 3% of GNP, rise to 4% in 2040, and further accelerate beyond (see Chart 8). Economic growth might not cease, but would provide little scope for continued improvement in living standards.

Rather than spend the Social Security surplus, a third proposal would be to return to the old pay-as-you-go system, cutting the payroll tax to avoid accumulating a surplus. By 2010, when the demands on the system begin to escalate, the payroll tax could be increased step-for-step. The cumulative increase to cover retirement benefits could be as much as 6 percentage points. Were the tax also increased to expand Medicare entitlements, the tolerance of the working population would be sorely strained.

It would be a serious mistake to defer until the next century the hard budget choices necessary to deal with the retirement and health care burden. Spending cuts or tax increases then would have to be undertaken amid slowing economic growth, thanks to drastically reduced labor force growth (see Table 5). Middle-of-the-road estimates by the Social Security Administration show labor force growth declining from a current rate of 1.5% to about 0.5% in 2010. That could depress real GNP growth below 2% annually. Even that figure could be optimistic, given that the official projections assume significant rebounds in both the fertility rate and real wage growth relative to the experience of the last twenty years (see Table 6). Neither rebound can be taken for granted.

Table 4

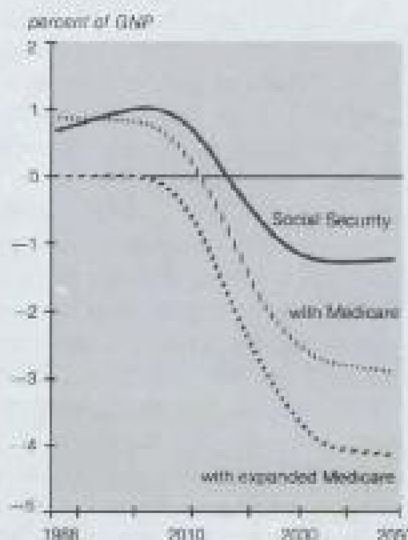
*Sources of net U.S. saving**
percent of GNP

	Private	Federal government: On-budget	Federal government: Social Security	Federal government: Medicare	Total
Actual 1980-87	7.1	—4.2	0.1	0.1	3.1
Policy choices					
Benefit binge					
2010	6.0	—3.0	0.0	—1.0	2.0
2030	6.0	—3.0	—4.0	—2.5	—3.0
Compromise					
2010	6.0	—2.0	2.0	—2.0	4.0
2030	6.0	—2.0	—2.0	—4.0	—2.0
Optimal					
2010	6.0	0.0	2.5	0.0	8.5
2030	6.0	0.0	0.5	0.0	6.5

*Social Security and Medicare projections account for feedback between the budget and the economy. "Private" includes state and local government surpluses.

Chart 8

*Combined operating surpluses**



*Tax revenue minus outgo; excludes interest paid on trust fund assets and liabilities.

Table 5

*Official U.S. economic assumptions**
percent change

	1990	2010	2030	2050
Working-age population	0.9	0.6	0.2	0.0
Real GNP	2.9	1.9	1.7	1.6
Consumer prices	4.3	4.0	4.0	4.0
*Interest rate*** *(percent per annum)*	8.9	6.0	6.0	6.0

*Projections of the Social Security trustees under current law with intermediate assumptions ("II B").
**Rate earned on assets of the Social Security trust funds.

Saving for investment: the bottom line

The prospective growth shortfall highlights the fundamental problem with most "solutions" for the Social Security problem: their implications for saving, investment, and GNP growth. When the economy is operating at or near full employment, government deficits draw savings out of the private sector, either "crowding out" private investment or requiring that it be financed by net capital inflows from abroad. U.S. net private saving was 4.3% of GNP last year, but government borrowing of 2.4% cut the net domestic savings rate to only 1.9%. Net domestic investment was considerably higher, at 5.3% of GNP, thanks to the capital inflows that covered the nation's $154 billion external deficit on current acount. It is unlikely, for both economic and political reasons, that this high pace of net foreign inflows could be sustained through coming decades. In any case, foreign inflows increase foreign claims on future U.S. output. Inadequate domestic saving therefore would hurt future U.S. generations by reducing the stock of productive assets they inherit.

For that reason, the ultimate objective of a well-conceived Social Security policy is not merely to provide for retirement financing, but also to set aside real resources for the future. After all, the larger the economic pie as a whole, the easier it should be to assure the next century's retirees the increasing slice that their numbers and intergenerational equity will demand.

More than anything, a larger pie requires higher investment. The dramatic improvement that an effective domestic saving and investment effort can make is evident in the "optimal" policy scenario (see Tables 4 and 7). This would avoid all the mistakes of the "benefit binge" or "compromise" scenarios: GRH targets would be met on schedule, reforms in Social Security and Medicare would be implemented keeping the combined system solvent, and an overall budget surplus equal to the Social Security surplus would be productively invested.

With this optimal policy the unified budget would swing from a deficit of 3.4% of GNP in FY1987 to a peak surplus of 2.4% in 2010, pushing up the overall net domestic savings rate to over 8% of GNP in 2000-2020. Thereafter, saving would decline upon the reemergence of Social Security deficits. Nevertheless, with the budget under control, the net savings rate would remain above its 1987 level, in turn engendering a "virtuous circle." Increased investment would lift real GNP and tax revenues, making a still larger surplus available for investment. Conservative estimates show that GNP growth would be boosted an average of 0.6 percentage points annually relative to the official projection of the Social Security trustees. Taxable incomes would be higher in consequence, increasing the assets of the trust funds and making possible, if so desired, higher benefits to retirees. Altogether, there would be a larger economic pie to share among growing demands — provided the Social Security surplus is productively invested.

Table 6

Sensitivity of Social Security tax to assumptions

percent per annum

	Fertility rate*	Real wage growth	Inflation-adjusted interest rate
Actual			
1960-73	2.8	1.5	1.7
1974-79	1.8	0.3	—0.2
1980-87	1.8	0.9	5.3
Long-term projections			
Official	1.9	1.4	2.0
Alternative	1.6	0.9	3.0
*Impact on payroll tax rate in 2010***	1.0	0.5	—0.5

*Average number of children born to women who reach reproductive age.

**Percentage point change to yield same revenue as projected on the middle-of-the-road official assumptions.

Table 7

Policy payoffs

	Year in which Social Security	
	Goes into deficit	Runs out of money
Policy choices		
Official projection	2030	2048
Benefit binge	2008	2013
Compromise	2010	2015
Optimal	2038	2051

	Annual average real GNP growth	
	Rate	Per capita
Actual, 1980-87	2.3	1.3
Projected, 2000-2020		
Official projection	1.9	1.4
Benefit binge	1.0	0.5
Compromise	1.5	1.0
Optimal	2.5	2.0

Investing the surplus

How to assure productive investment of the U.S. Social Security surplus has received scant attention in the popular debate, yet is an issue crucial to the viability of the system.

The simplest investment options carry the greatest risk. Under current law, the surplus must be invested in government securities. However, this does not constitute productive investment if it merely encourages the government to "borrow" from Social Security to cover on-line budget outlays, except to the extent that these outlays themselves constitute productive investment. Obviously, with a change in the law, the U.S. surplus could be used to fund public investment directly. This would parallel practice in Japan, whose sizable and long-standing social security surpluses finance investments by public corporations. Going one step further, the U.S. surplus might even be used to support an expanded "industrial policy," targeting loans for investment by deserving private businesses.

Would such public or publicly directed investment be productive? The federal government already engages in a host of lending activities. Certainly too, the United States could use more infrastructure such as better roads and bridges as well as nursing homes and hospitals. The risk in such projects, however, is that the funds may be used inefficiently, either poorly managed or diverted to current spending. Any shortfall in the return on these projects would have to be made up in the future through higher taxes.

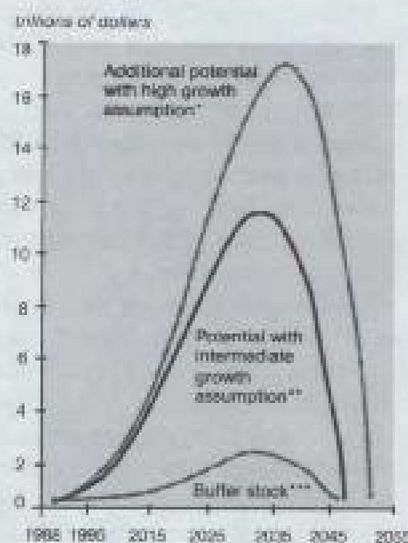
These risks, which apply to all public capital programs, cast doubt on current proposals to divide all federal government accounts into distinct capital and operating budgets. This is the practice of private business, lower levels of government in the United States, and most foreign governments. Typically, borrowing is considered permissible to cover part of the capital budget, but not the operating budget. The problem is that there is an ever-present temptation to hide maintenance and consumption outlays in the capital budget. Furthermore, the aura of virtue surrounding "capital" outlays shields them from rigorous scrutiny, resulting in a poor rate of return in many instances. In sum, earmarking the Social Security surplus to finance public capital items would do little to ensure its productive investment.

The danger that the surplus will be dissipated bolsters the case for removing all or part from the political arena through some form of privatization. Of course, purely voluntary, private provision for retirement is a political nonstarter. It would require an enormous "buy-out," running to several trillions of dollars, to preserve benefits to current retirees. Besides, unlike a private pension, Social Security provides an income maintenance system for low-income retirees. Much of the payroll tax constitutes a form of forced saving for people who otherwise would make inadequate individual provision for retirement. Plainly, private saving alone cannot meet the objectives of Social Security.

The best solution could be to privatize just the surplus portion of Social Security revenues, perhaps along the following lines. Until 1990 the surplus would continue to be invested solely in government securities, building up a buffer stock holding of about $300 billion. Starting in 1990 Social Security contributors would be allowed to divert, say, 2 percentage points of their payroll tax to individual investment accounts. The percentage point diversion would be redetermined periodically in light of experience with the take-up rate; the intent would be to maintain the official buffer stock holding at a level on the order of one year's outgo, enough to cover any unanticipated shortfall in the system. This partial privatization would continue until the system stops running large surpluses, which is projected to occur around 2020.

Chart 9

Privatization potential of Social Security assets



* With optimal saving, investment, and growth performance as projected in Tables 4 and 7.

** Under assumptions of the Social Security trustees.

*** Prudent minimum to be retained in official fund, set at one year's system outgo through 2030, thereafter drawn down in step with total assets.

For the typical taxpayer the diversion would amount to about $500 to $1000 per year, measured in 1987 dollars. The funds would be restricted to pre-approved investment accounts, similar to today's Individual Retirement Accounts (IRAs) but subject to tougher tests of investment suitability and tighter restraints on early withdrawals. Upon retirement, the individual would receive public benefits lower than under current law but would supplement them by drawing on the private accounts.*

This privatization scheme would ensure that most of the Social Security reserve is productively invested. For example, based on official projections the total reserve should reach about $9 trillion in 2020. Under privatization about 80% of the total would be diverted to private accounts. And a substantially greater sum would be held in the private accounts were the high-growth "optimal" policy scenario also to be followed (see Chart 9). By taking most of the assets out of government hands, this scheme would help depoliticize Social Security. It would not only reduce the risk that the funds would be diverted to other uses, but also help assure future retirees that some of the benefits the system promises today will be forthcoming at their time of need.

Financial market implications

Beyond their consequences for U.S. economic growth and living standards, the budget decisions made — or not made — in the years ahead will have profound implications for both domestic and international capital markets.

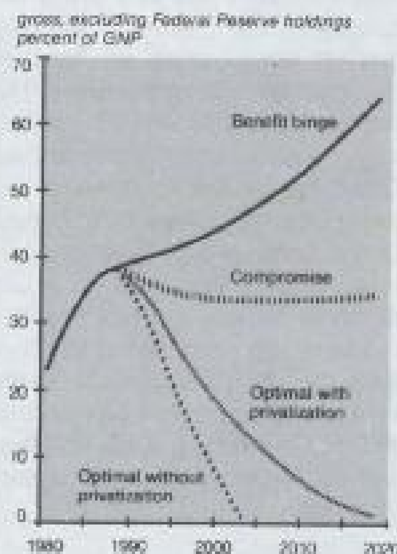
If the federal government adheres to the Gramm-Rudman-Hollings deficit targets, holds the line on new programs, and invests the Social Security surplus as current law requires, the ramifications are startling.

For example, the trust funds could absorb all outstanding federal debt by the year 2005. That would force a change in the way U.S. monetary policy is conducted. With few or even no government bonds available to buy on the open market, the Federal Reserve could not maintain its present operating procedure. This need be no calamity, since the authorities have other means to exercise monetary control. Among them are changing reserve requirements and discount window policy. Both these tech-

*Each individual's public benefit would be lowered by an actuarially determined figure based on the amount of payroll tax diversion plus interest this would have earned had it remained in the trust fund. To the extent that the private accounts earn a higher yield, the individual would receive greater benefits through privatization. For an individual contributing regularly and earning one percentage point additional yield, the value of a private account after thirty years would be about 10% higher than that of the government alternative.

Chart 10

Publicly held federal debt



niques have the disadvantage of rather limited flexibility. Instead, there should in principle be no objection to conducting open market operations through purchase or sale of liquid commercial paper and other private debt instruments. The Federal Reserve did this earlier in its history and it is today a normal practice on the part of the Bank of England, the Bank of Japan, and the Bundesbank.

Of course, sustained fiscal discipline is hardly certain. More likely, political compromise will eventually yield something approaching a balanced federal budget on a unified basis. In that event the government securities market will shrink in relation to both the private capital market and U.S. GNP (see Chart 10) — the more so if foreign official reserve policies effectively lock up U.S. Treasury issues.*

The relative decline in the market for government obligations would be matched by growth in the private capital markets. The increased availability of funds for private investment would place downward pressure on real interest rates. How far rates might fall is a matter of controversy. The highest estimates offered in the literature on the "crowding out" of investment by government borrowing suggest that full implementation of the GRH budget targets would cut long-bond rates by more than 100 basis points, with another 100-point cut possible if the Social Security surplus develops as projected. To take the place of the reduced stock of government securities, there also may be increased demand for relatively low-risk private-sector securities. The yield curve for such securities could steepen in consequence insofar as short-term assets are perceived as less risky. Rates on high quality private securities also could fall relative to lower quality issues.

Lower interest rates and higher domestic saving would have profound effects on the external balance. In particular, the United States could again become a net lender, pushing the current account toward surplus. The most noticeable change could be in U.S. trade with Japan. Demographically, Japan is about twenty years ahead of the United States. Whereas the ratio of the over-65 population to the workforce will remain roughly constant in the United States until 2010, it will more than double in Japan; the working-age population in Japan will be in outright decline, as already is the case in Germany. Therefore, during this period when the U.S. population would be well advised to step up capital formation, the Japanese may begin drawing on their accumulated capital. Reflecting the shift in relative savings behavior, net capital flows between the two nations, and the associated trade and current account imbalances, could reverse by the turn of the century, completing the adjustment already under way.

Do the demographic forces portend a higher or a lower real exchange market value of the dollar over the long term? Conflicting forces will be at work. If U.S. labor productivity growth matches that of other industrial countries, the relatively fast increase of the labor force points to higher growth in economic activity in the United States than elsewhere. In itself, the correspondingly higher U.S. import demand at any given level of the exchange rate would suggest difficulties in achieving balance, let alone surplus, in the external accounts.

Yet a strong dollar often is inspired by a strong U.S. economy, particularly if productivity- and competitiveness-boosting investment can become the engine of U.S. growth as a result of budget surplus. By contrast, during the next twenty years the faster-aging populations of Japan and Germany may become much more consumption-oriented.

This strong dollar environment, however, is a long way off. The dollar's recent run-up, seemingly in response to U.S. monetary tightening and somewhat better trade results, still should be viewed as temporary. The dollar will hold firm on a permanent basis only when much more progress on the twin deficits has been achieved. Yet, for the time being the dollar's present level substantially eliminates the relative cost handicap borne by U.S. industry during the first half of the 1980s. Industry now has the opportunity to compete on price to recapture domestic and global market share. With its resources almost fully stretched, the open and growing U.S. economy is unlikely to see an absolute rollback in imports. Instead, decisive narrowing of the trade and current account deficits will depend on boosting exports 15%-20% annually for several years ahead.

To that end there is pressing need to expand the nation's productive capacity. This is a matter of raising and sustaining the U.S. net savings rate well above its average of the past twenty years. Higher saving is the fundamental rationale for steadfast implementation of the Gramm-Rudman-Hollings budget targets and for the productive investment of the Social Security surplus. By these means, domestic saving and investment should rise strongly enough to put the economy in good shape to carry the demographic burden of the next century.

Controlling Social Security and Medicare

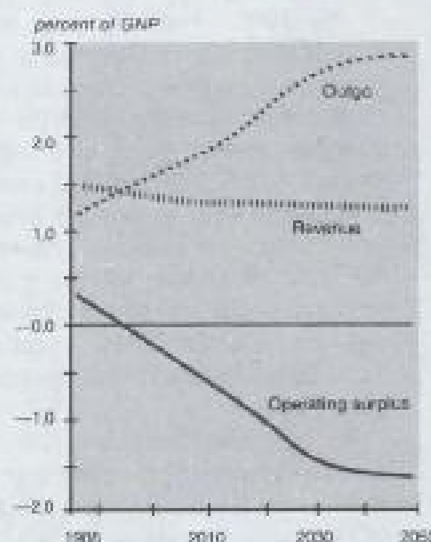
Barring unforeseen misfortune, the accumulation and investment of the Social Security surplus should keep the system on its feet for the next 75 years. Nonetheless, there are considerable downside risks to this promising outlook, risks that warrant further streamlining of the Social Security retirement system. In addition, projections show Medicare going into the red in 1998, exhausting its trust fund by 2005, and incurring a deficit of 3% of taxable payroll by 2030. Reforms to Medicare therefore are needed if it is to meet its current obligations, let alone incorporate the host of new programs being debated in Congress. So long as current retirees and the elderly poor are protected, Social Security and Medicare should not be immune to cutback.

The Social Security system is intended to provide adequate protection for the elderly and disabled. With the growth of both

*Speculation has arisen that, given the shrinkage of the deficit, the government soon will stop issuing new 30-year bonds. This speculation has little logic as a matter of sound debt management. As long as the market demand is there, and the government has to refinance the federal debt, issues spanning the whole range of maturities should continue to be sold for the foreseeable future.

Chart 11

*The Medicare outlook**



*Projections by Hospital Insurance trustees based on current law and intermediate assumptions (variant IIB).

Table 8

Health care spending

1984, percent of GNP

	Public	*Total*
United States	4.4	10.7
Canada	6.2	8.4
Japan	4.8	6.6
Germany	6.4	8.1
France	6.5	9.1
Italy	6.1	7.2
United Kingdom	5.3	5.9
Denmark	5.3	6.3
Sweden	8.8	9.4

Source: OECD.

public and private pension plans, however, the elderly no longer are poor relative to the population as a whole.* Furthermore, in the future, as current public and private plans take full effect, the position of the elderly is likely to continue to improve. Admittedly, the elderly are particularly vulnerable to economic and health problems, so that holes in the Social Security and Medicare safety net need repair. It does not follow, however, that the elderly as a group deserve a larger slice of the economic pie than their numbers warrant.

Two reforms of future retirement benefits would significantly alleviate the potential burden on contributors and, by lowering expected benefits, would encourage higher private saving. The first reform would reduce future benefits to middle- and upper-income recipients. The formula for calculating benefits could be made more progressive. Alternatively, with appropriate protection for the low-income elderly, benefits could be fully taxed as ordinary income, raising revenue by about 1% of taxable payroll per year.

The second reform would be to increase further the retirement age at which full benefits are paid. Under the current law that age is to rise gradually to 67 by the year 2027. Instead, the phase-in could be accelerated and the age pushed up to 68 or 69, for a saving in outlays of 1%-1.5% of taxable payroll per year. Later retirement would be consistent with demographic trends toward longer and healthier lives, such that many people likely will wish to work longer, although not necessarily in their primary working-life occupation. Besides, faced with the likely labor shortage of the next century, firms will be less keen to encourage the early retirement of seasoned employees. This would reverse the tendency of the last two decades when slower economic growth and a rapid increase in the labor force have made early retirement attractive.

*In 1967 30% of people over 65 had incomes below the poverty line, more than double the rate for the rest of the population. Today the opposite is true: average incomes and wealth of the elderly exceed those of the population as a whole. Furthermore, the poverty rate among the elderly is below 15%, a lower incidence than among the rest of the population.

Medicare warrants urgent attention. Under current law, Medicare outlays are projected to rise an average 10% annually over the next 40 years, even using assumptions on health-cost inflation that are optimistic relative to recent experience. The Medicare trust funds are projected to run deficits reaching 1.5% of GNP by the end of the same period (see Chart 11) and will be prime suitors for "borrowing" from the Social Security surplus. Such borrowing would not be a permanent solution; taken together, the Medicare and Social Security trust funds could be exhausted by 2030.

Regaining Medicare solvency will require a combination of creativity, realism, and restraint to address both financing arrangements and the costs of care. Ideally, Congress and the Administration would address the long-run funding problems of the current system before succumbing to pressures for expanded benefits. Recent bills before Congress have sought coverage for long hospital stays, large doctors' bills, prescription drugs, and both nursing and private home care.

Most of the proposed bills have been advertised as "self-financing," relying primarily on insurance premiums and taxes levied on the elderly. These are favored over payroll tax financing, since the group receiving the increased benefits pays the associated costs. Initially the costs would be fairly modest. For example, the Congressional Budget Office estimates the price tag on the catastrophic health costs bill at $7-$11 billion in 1992. By itself this would represent no more than a 12% increase in Medicare outlays over the next four years. More ominous would be the accelerating growth in the covered catastrophic costs — to above 10% per annum in 1992 and still faster thereafter. There is a limit to how high taxes on the elderly can go before pressure mounts to shift the burden onto the general population. Were the costs of the more generous new health care proposals to be assumed by the payroll tax, the Medicare portion, now 2.9%, could triple by the time the baby boomers retire.

Before this happens, it would make sense to reconsider the potential role of private sources of funds. With about $2 trillion in assets, the elderly as a group can afford to continue paying substantial medical bills, given well-conceived private financing options. For example, at individual premiums of some $350 annually, the more comprehensive "Medigap" insurance policies, which fill gaps in Medicare coverage, protect against catastrophic costs much better than any of the proposals considered by Congress. For nursing home care, by contrast, the private insurance market leaves much to be desired. Nor have the private markets yet evolved widely available and appropriate mechanisms to mobilize the near-50% of the elderly's assets that are tied up in home equity. One attempt is seen in the "reverse annuity" mortgage instruments that some banks now offer, whereby the bank pays the retiree homeowner a lifetime income in exchange for a full or partial equity claim following the homeowner's death. Unfortunately, wider use of such instruments is inhibited by their unfamiliarity, illiquidity, and, in some states, unacceptability to regulators.

Value for money should be the other priority concern in health care. In 1984 the U.S. health industry consumed 10.7% of GNP, a higher percentage than anywhere else in the industrial world (see Table 8). U.S. spending was significantly above that of the next highest spender, Sweden, and double that of the United Kingdom. At present, the preponderance of passive, third-party financing in the U.S. health care system militates against cost-consciousness. This failing can never be adequately addressed by ever-increasing regulation. Getting more care for less money is a matter of creating effective incentives to both patients and providers to choose and develop cost-sparing solutions. Strengthening the role of provider competition is crucial for a more satisfactory outcome. So too is acceptance of the hard reality that, one way or another, health care cannot be exempt from demand restraint.

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Statistical appendix

For key to data in tables see pages 22 and 23.

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Effective exchange rates — industrial countries

Index numbers, 1980-82 average=100.

	United States	Canada	Japan	Australia	France	Germany	Italy	United Kingdom	Austria	Belgium	Neth-erlands	Spain	Swit-zerland	Den-mark	Norway	Swe-den
Nominal against 15 other industrial-country currencies																
1983	114.2	100.8	107.8	92.0	87.3	107.5	90.3	91.6	103.6	90.0	105.0	78.4	111.5	96.4	99.5	82.2
1984	122.3	97.3	112.9	94.2	84.4	107.3	86.7	88.1	103.6	88.6	103.9	77.4	110.5	93.9	97.8	84.3
1985	127.0	92.8	115.9	76.3	85.5	107.8	82.1	88.2	104.2	89.6	104.0	75.6	109.5	95.1	95.6	83.9
1986	106.0	87.6	150.1	61.4	87.4	116.1	82.9	80.7	107.8	92.9	110.3	73.4	118.1	99.7	89.2	81.6
1987	94.1	89.6	164.4	58.3	87.1	122.0	82.3	79.0	110.8	95.6	114.6	73.1	123.1	102.8	85.7	80.1
1987																
June	94.8	88.8	164.7	59.9	87.1	121.6	81.8	79.1	110.2	95.6	114.3	71.9	122.7	103.4	86.5	80.5
July	96.0	90.0	159.1	60.0	87.2	121.4	81.6	79.2	110.2	95.4	114.2	72.5	122.2	102.4	87.2	80.4
August	95.7	90.0	162.7	59.8	86.8	121.3	81.5	78.9	110.1	95.2	114.1	73.6	122.6	101.3	87.3	80.2
September	93.9	90.3	165.4	60.5	86.9	121.5	81.8	79.6	110.1	95.3	114.4	74.6	122.7	101.0	87.4	79.7
October	93.4	90.7	165.1	58.9	86.7	121.3	81.7	80.0	115.7	96.1	114.6	75.9	122.3	101.3	87.0	79.6
November	90.0	89.3	171.2	54.3	86.7	123.6	81.2	81.5	110.9	95.6	115.9	75.6	125.4	102.5	85.2	79.2
December	87.4	89.4	178.6	55.1	87.0	123.8	81.4	81.9	110.8	95.8	115.9	75.2	126.9	103.0	83.5	78.9
1988																
January	87.4	91.0	179.8	55.1	87.2	123.4	81.3	81.2	110.7	95.6	115.8	74.8	126.5	103.0	84.6	79.1
February	88.2	92.6	179.3	56.0	86.8	122.9	81.0	80.8	110.7	95.4	115.6	75.0	125.1	102.8	85.4	79.7
March	86.8	93.7	180.7	57.0	86.3	122.8	80.5	83.5	110.7	95.2	115.4	75.5	123.9	102.3	86.1	79.9
April	85.8	94.6	183.2	57.5	85.9	122.6	80.1	85.2	110.6	94.9	115.3	76.2	123.6	101.5	86.1	80.1
May	86.1	94.5	183.7	60.0	86.1	122.1	79.7	85.4	110.4	94.8	115.0	76.0	122.2	101.2	87.1	80.4
May 6	85.9	94.7	183.4	59.0	86.0	122.6	79.8	84.9	110.6	95.0	115.2	76.2	122.6	100.9	87.0	80.4
13	85.8	94.6	183.7	59.3	86.1	122.3	79.8	85.7	110.4	94.8	115.0	75.9	122.6	101.0	87.1	80.3
20	86.3	94.5	183.4	59.9	86.0	121.9	79.7	85.7	110.3	94.8	114.9	75.9	122.0	101.2	87.2	80.4
27	86.3	94.3	184.3	61.3	86.2	121.7	79.6	85.5	110.2	94.8	114.8	75.9	121.6	101.4	87.3	80.4
June 3	86.9	95.1	183.4	62.0	86.2	121.8	79.5	84.1	110.2	94.7	114.7	75.8	121.8	101.6	87.2	80.3
10	86.6	95.7	183.5	62.6	86.2	122.0	79.6	83.6	110.3	94.8	114.8	76.0	121.9	101.9	87.2	80.2
17	87.0	96.5	183.0	63.2	86.1	121.6	79.5	83.6	110.1	94.5	114.5	75.7	121.4	101.7	87.1	80.2
Real against 15 other industrial-country currencies																
1983	112.7	102.6	96.8	101.8	94.7	101.0	101.1	93.1	102.0	88.6	100.8	88.8	105.1	100.4	102.0	90.8
1984	119.6	101.2	97.8	106.4	97.0	98.0	101.8	90.2	103.0	85.9	97.8	91.0	100.1	99.2	100.5	96.0
1985	121.7	96.3	99.0	88.9	100.4	96.6	100.2	92.8	103.2	85.2	96.5	92.3	97.9	101.2	99.3	96.8
1986	100.8	93.3	122.1	78.3	103.6	104.1	102.3	87.2	106.1	84.4	101.1	93.7	105.2	107.2	96.8	95.8
1987	90.1	96.4	127.8	80.3	105.0	107.2	103.3	87.3	109.6	84.1	104.1	95.6	109.1	111.4	100.2	95.1
1987																
December	84.2	97.0	136.7	77.8	104.3	108.5	103.7	90.9	109.5	83.0	104.3	100.2	112.0	112.2	98.8	94.6
1988																
January	84.5	99.1	137.0	78.0	104.3	108.1	104.1	90.7	109.3	82.8	102.0	100.3	111.1	112.0	100.5	95.5
February	85.3	100.2	136.0	79.8	103.7	107.5	104.6	90.5	109.1	82.2	102.1	101.0	109.7	112.4	101.7	96.5
March	84.1	101.5	136.6	81.8	103.4	107.3	103.3	93.8	109.2	81.7	102.4	99.8	108.9	112.2	101.3	97.1
April	83.4	102.7	137.5	82.7	102.8	107.2	103.2	96.1	108.7	81.3	101.6	100.7	108.1	111.4	103.0	97.2
May	83.8	102.7	137.4	86.7	103.0	106.6	103.1	96.5	108.6	81.0	101.0	101.0	107.0	112.2	104.8	97.0
Real against 18 other industrial-country and 22 LDC currencies																
1983	114.9	104.6	100.4	102.0	94.4	100.6	100.8	93.1	102.1	88.2	99.5	89.2	105.1	100.3	101.9	91.0
1984	120.8	102.6	102.4	108.7	98.4	98.8	101.0	89.7	102.6	85.0	95.9	91.2	99.8	99.0	100.5	95.8
1985	123.3	99.0	104.2	89.8	99.9	95.6	99.7	92.2	102.8	84.5	94.7	93.0	97.7	101.1	99.7	96.7
1986	105.3	94.3	126.7	80.2	104.1	105.2	103.7	87.8	106.9	84.9	101.0	96.2	107.1	107.7	97.6	96.5
1987	96.2	96.5	131.5	81.8	106.1	109.5	105.8	88.8	111.3	85.3	105.0	99.1	112.1	112.2	101.1	96.4
1987																
December	90.2	96.3	139.5	79.4	105.5	111.0	106.5	92.7	111.3	84.4	105.4	104.1	115.1	113.0	99.8	95.9
1988																
January	90.4	98.4	139.8	79.5	105.3	110.4	106.7	92.4	110.9	84.0	103.0	104.0	114.1	112.8	101.5	96.7
February	90.6	99.5	138.7	81.1	104.5	109.4	105.9	92.0	110.6	83.2	102.9	104.4	112.4	113.1	102.7	97.6
March	89.5	100.7	139.2	83.0	104.1	109.2	105.8	95.3	110.6	82.7	103.1	103.0	111.4	113.0	102.3	98.2
April	88.7	101.8	140.0	84.2	103.5	108.8	105.3	97.5	110.0	82.2	102.2	103.9	110.5	112.2	104.0	98.3
May	89.1	101.9	139.9	87.9	103.5	108.1	105.1	97.8	109.7	81.8	101.4	104.0	109.1	112.9	105.7	98.1

Real effective exchange rates — developing countries

Index numbers, 1980-82 average=100.

	Argentina	Brazil	Chile	Colom-bia	Mexico	Peru	Vene-zuela	Hong Kong	Indo-nesia	Korea	Malaysia	Philip-pines	Singa-pore	Taiwan	Israel	Turkey
1983	71.6	86.0	89.3	104.9	79.0	98.5	117.3	95.0	96.2	97.0	113.9	96.1	101.8	94.6	120.8	94.2
1984	80.2	85.7	90.1	99.6	91.9	105.8	85.9	99.5	96.0	96.5	119.7	107.9	102.5	97.1	119.5	89.6
1985	71.0	84.8	79.5	86.3	90.4	96.5	92.7	103.3	93.7	88.7	115.7	114.1	95.2	94.3	106.5	88.8
1986	60.8	74.2	68.4	67.4	65.0	96.3	85.4	93.2	70.6	82.0	94.0	89.7	79.8	88.3	100.7	70.5
1987	53.3	73.5	65.1	63.0	66.7	107.6	60.1	89.2	53.9	83.9	87.9	86.4	73.3	93.4	97.1	62.5
1987																
June	53.5	75.2	65.4	62.7	64.9	109.2	61.7	90.4	53.9	84.8	88.7	86.0	73.3	94.6	96.7	62.8
July	53.3	72.9	65.6	63.9	68.2	115.0	63.6	89.3	55.2	86.4	88.6	86.4	73.9	95.8	98.5	62.9
August	54.8	71.1	66.1	63.5	69.6	119.9	64.3	89.4	55.1	86.0	88.4	88.2	74.2	97.4	99.6	63.1
September	53.5	71.0	65.3	62.7	71.5	121.1	64.5	90.2	54.0	85.0	88.3	87.0	73.5	97.4	99.7	61.6
October	53.6	73.3	64.2	62.1	73.6	119.9	64.9	89.9	54.3	85.7	87.0	89.1	73.0	98.1	100.4	60.7
November	49.2	73.9	61.6	60.4	73.5	104.6	64.2	89.0	52.6	85.3	84.8	87.3	72.0	94.8	99.2	58.6
December	49.0	74.7	61.3	60.0	67.2	80.1	63.3	87.1	51.1	84.3	82.7	87.8	70.1	95.9	99.9	62.3
1988																
January	49.3	75.9	59.1	61.6	72.6	76.5	62.9	85.7	51.0	85.3	81.4	87.5	70.0	95.5	100.1	62.8
February	50.9	78.0	60.7	62.7	79.1	86.0	63.8	86.0	51.7	88.1	81.1	87.6	70.8	96.3	101.3	63.5
March	51.6	76.7	62.4	61.4	80.1	104.1	63.6	86.6	50.9	89.0	80.4	85.4	68.9	95.0	101.8	64.2
April	52.2	78.1	63.0	60.1	79.7	121.4	63.3	86.6	50.6	89.2	79.9	85.3	69.0	94.6	102.4	65.0
May	55.1	78.0	59.5	59.7	80.4	131.8	63.7	86.5	51.1	90.3	79.8	87.3	69.4	93.1	103.8	64.7

International banking market size

at end of period, billions of dollars

	1982	1983	1984	1985	1986 Dec	1987 Mar	Jun	Sep	Dec
Gross claims									
Eurocurrencies, on residents and nonresidents	**2 146**	**2 253**	**2 359**	**2 833**	**3 560**	**3 811**	**3 942**	**4 147**	**4 405**
On nonbanks	634	665	694	822	938	995	1 175	1 215	1 284
On banks	1 512	1 588	1 665	2 011	2 622	2 817	2 767	2 932	3 121
In dollars	1 694	1 797	1 894	2 101	2 534	2 602	2 753	2 882	2 891
In other currencies	452	456	465	732	1 025	1 209	1 189	1 265	1 515
Domestic currencies, on nonresidents	**398**	**402**	**402**	**506**	**672**	**721**	**757**	**801**	**915**
On nonbanks	132	140	142	187	209	229	236	230	222
On banks	266	262	260	319	463	492	521	571	693
In dollars	211	221	215	215	227	206	215	220	221
In other currencies	187	181	187	291	445	515	542	581	694
Total	**2 544**	**2 655**	**2 761**	**3 339**	**4 232**	**4 532**	**4 699**	**4 948**	**5 320**
On nonbanks	766	805	836	1 009	1 147	1 224	1 411	1 445	1 506
On banks	1 778	1 850	1 925	2 330	3 085	3 309	3 288	3 503	3 814
In dollars	1 905	2 018	2 109	2 316	2 761	2 808	2 968	3 102	3 112
In other currencies	639	637	652	1 023	1 470	1 724	1 731	1 846	2 209
Gross liabilities									
Eurocurrencies, to residents and nonresidents	**2 168**	**2 278**	**2 386**	**2 846**	**3 579**	**3 851**	**3 999**	**4 205**	**4 461**
To nonbanks	432	479	497	585	685	740	768	791	808
To official monetary institutions	91	88	96	112	109	125	139	151	151
To other banks	1 645	1 711	1 793	2 149	2 786	2 986	3 085	3 263	3 502
In dollars	1 741	1 846	1 950	2 147	2 553	2 648	2 785	2 936	2 924
In other currencies	427	432	436	699	1 026	1 203	1 214	1 269	1 537
Domestic currencies, to nonresidents	**250**	**260**	**280**	**377**	**494**	**556**	**580**	**638**	**782**
To nonbanks	70	73	80	114	116	134	144	176	191
To banks	180	187	200	263	377	422	436	462	591
In dollars	116	135	146	169	192	192	197	212	262
In other currencies	134	125	134	208	302	364	383	427	520
Total	**2 418**	**2 538**	**2 666**	**3 223**	**4 073**	**4 407**	**4 579**	**4 843**	**5 243**
To nonbanks	502	552	577	699	801	874	912	967	999
To banks and official institutions	1 916	1 986	2 089	2 524	3 272	3 533	3 660	3 876	4 244
In dollars	1 857	1 981	2 096	2 316	2 745	2 840	2 982	3 148	3 186
In other currencies	561	557	570	907	1 328	1 567	1 597	1 696	2 057
Net market size	**1 285**	**1 362**	**1 430**	**1 676**	**1 979**	**2 083**	**2 170**	**2 231**	**2 377**

International bond issues and bank credits

millions of dollars

	1985	1986	1987	1988 Mar	1988 Apr	1988 May	Jan-May 1987	Jan-May 1988
By country of borrower								
Industrial countries	**225 885**	**273 683**	**248 758**	**30 424**	**27 440**	**24 754**	**105 035**	**141 921**
Australia	14 407	19 251	11 349	1 824	1 535	1 552	4 845	6 167
Austria	2 435	3 821	4 695	569	991	180	1 674	4 069
Belgium	3 289	5 042	4 443	525	81	161	2 054	1 708
Canada	17 184	23 752	10 161	2 198	1 570	1 229	4 373	7 425
Denmark	3 589	9 613	4 774	359	691	325	3 502	2 297
Finland	1 846	3 678	3 517	779	190	880	1 967	2 581
France	18 773	20 027	16 022	2 981	2 284	2 069	7 243	13 188
Germany	3 452	12 589	10 922	1 338	729	290	5 836	4 080
Greece	1 587	1 361	1 462	350	—	119	510	469
Ireland	1 881	3 281	2 195	331	150	123	939	835
Italy	11 033	12 723	13 421	1 499	707	613	3 337	3 892
Japan	21 269	35 283	45 591	2 016	4 070	2 570	17 606	16 488
Netherlands	2 299	3 215	5 089	610	383	645	2 158	2 744
New Zealand	2 707	7 818	5 942	437	402	1 936	2 608	3 086
Norway	3 905	6 750	5 917	478	888	544	3 355	3 789
Portugal	2 382	2 503	2 159	—	362	—	1 010	1 051
Spain	3 913	7 083	1 794	434	250	82	767	1 275
Sweden	9 890	8 000	5 766	1 683	1 889	985	2 914	6 528
Switzerland	864	2 247	1 201	—	664	250	635	915
United Kingdom	25 424	24 109	33 225	5 446	4 638	5 582	15 867	26 056
United States	69 193	55 703	45 412	6 129	2 887	3 978	19 971	24 513
*Other**	4 582	5 703	13 719	440	2 099	750	1 385	8 784
Developing countries	**32 964**	**23 884**	**28 070**	**5 372**	**925**	**1 635**	**15 062**	**10 922**
Latin American countries	**8 115**	**3 395**	**10 729**	**2 635**	**94**	**130**	**8 097**	**3 988**
Argentina	3 700	17	2 110	—	—	—	—	—
Brazil	—	350	—	—	—	—	—	—
Chile	1 085	—	—	—	—	—	—	—
Colombia	1 052	240	137	—	—	—	50	1 000
Mexico	109	313	7 700	2 556	—	—	7 700	2 556
Venezuela	48	—	30	—	34	—	—	134
*Other***	2 121	2 475	753	79	60	130	347	298
Asian countries	**18 410**	**14 444**	**13 219**	**1 935**	**565**	**488**	**5 422**	**4 440**
China	3 192	3 336	4 338	515	300	192	1 676	1 252
India	810	1 796	2 156	546	82	120	905	1 133
Indonesia	451	1 343	1 745	174	—	30	620	330
Hong Kong	2 516	846	640	79	—	61	206	159
Korea	5 898	3 251	2 522	345	98	—	1 322	602
Malaysia	2 219	1 204	584	276	60	—	167	568
Thailand	1 497	1 676	463	—	—	—	169	300
Other	1 619	990	792	—	25	63	276	95
Middle Eastern and African countries	**6 439**	**6 044**	**4 122**	**802**	**266**	**1 019**	**1 543**	**2 493**
Algeria	1 450	1 344	344	153	—	—	154	333
Turkey	1 203	2 754	2 831	434	266	790	969	1 705
Other	3 786	1 946	947	215	—	228	420	455
Eastern European countries	**5 236**	**3 941**	**3 584**	**317**	**150**	**150**	**1 657**	**690**
Hungary	1 577	1 315	1 951	317	—	—	714	317
Soviet Union	1 489	1 821	884	—	50	150	662	273
*Other****	2 169	805	749	—	100	—	280	100
International organizations****	**20 635**	**19 896**	**20 013**	**3 034**	**1 624**	**1 072**	**8 051**	**8 896**
By type of instrument and currency								
International bond issues	**167 756**	**228 106**	**177 291**	**21 552**	**19 548**	**19 055**	**86 646**	**95 311**
Eurobonds	136 731	186 747	140 481	15 620	16 249	15 476	73 214	74 725
U.S. dollar	97 782	119 096	56 727	5 551	4 805	4 656	26 131	27 529
Japanese yen	6 539	18 516	23 116	694	3 096	1 961	14 562	8 058
German mark	9 491	17 127	15 518	3 256	1 413	1 873	8 645	10 693
British pound	5 766	10 585	14 997	2 713	3 184	3 215	8 006	12 622
Australian dollar	3 118	3 381	9 041	488	1 111	989	5 211	3 590
European composite units	7 038	7 057	7 423	1 163	755	927	4 669	3 621
Canadian dollar	2 822	5 067	5 691	1 224	1 196	1 306	2 620	5 751
Other	4 174	7 918	7 766	531	679	347	3 271	2 862
Foreign bonds	31 025	39 359	36 811	5 932	3 299	3 579	13 432	20 587
Swiss franc	14 954	23 213	23 976	3 048	2 148	2 118	8 789	13 329
U.S. dollar	4 655	6 782	5 911	979	356	550	1 750	2 585
Japanese yen	6 379	5 223	3 068	1 286	484	481	1 517	2 482
Other	5 037	4 141	3 856	620	311	429	1 375	2 190
International bank credits	**116 964**	**93 269**	**123 115**	**17 595**	**10 591**	**8 557**	**43 160**	**67 089**
Eurocurrency credits	110 317	84 208	112 104	16 700	10 156	8 193	39 919	65 132
Foreign credits	6 647	9 061	11 012	895	435	364	3 241	1 957
Total	**284 720**	**321 375**	**300 406**	**39 148**	**30 140**	**27 611**	**129 806**	**162 400**

*Includes multinational organizations. **Includes unallocated. ***Includes COMECON institutions. ****Includes regional development organizations.

Eurocurrency deposit rates

prime banks' bid rates, at or near end of month

	1984 Dec	1985 Dec	1986 Dec	1987 Nov	1987 Dec	1988 Jan	1988 Feb	1988 Mar	1988 Apr	1988 May
Eurodollar										
overnight	8.63	12.25	22.00	6.62	6.75	6.69	6.69	6.75	6.88	7.31
one month	8.38	8.00	6.50	8.25	7.06	6.69	6.69	6.69	7.00	7.44
three months	8.63	7.88	6.25	7.94	7.37	6.81	6.69	6.81	7.19	7.63
six months	9.13	7.88	6.12	7.94	7.50	6.87	6.75	7.06	7.44	7.81
twelve months	9.81	7.94	6.12	8.19	7.81	7.25	7.12	7.44	7.88	8.31
Euro-Canadian dollar										
one month	9.88	9.00	8.00	8.56	8.00	8.50	8.25	8.25	8.44	8.81
three months	10.81	9.00	8.12	9.00	8.12	8.37	8.37	8.37	8.75	8.94
six months	10.06	9.00	8.19	9.12	8.44	8.50	8.37	8.62	8.88	9.19
twelve months	10.44	9.00	8.31	9.44	8.87	8.75	8.75	9.00	9.25	9.63
Euro-French franc										
one month	10.69	12.50	10.12	9.37	8.75	7.50	7.25	7.81	8.00	7.31
three months	10.69	13.00	10.37	9.37	9.00	8.00	7.75	8.31	8.25	7.50
six months	11.00	13.13	9.75	9.37	9.25	8.25	8.19	8.44	8.38	7.63
twelve months	11.38	12.25	8.75	9.37	9.25	8.50	8.50	8.56	8.50	8.00
Euromark										
one month	5.50	4.75	6.12	3.94	3.25	3.19	3.31	3.25	3.31	3.31
three months	5.50	4.75	4.87	3.94	3.37	3.25	3.31	3.31	3.44	3.56
six months	5.56	4.75	4.81	4.06	3.50	3.31	3.37	3.37	3.63	3.81
twelve months	5.56	4.81	4.81	4.12	3.75	3.56	3.50	3.56	3.81	4.19
Euro-Dutch guilder										
one month	5.69	5.75	6.31	4.81	4.50	3.94	3.94	3.87	3.88	3.81
three months	5.75	5.75	6.00	4.94	4.62	4.00	4.00	3.87	3.94	3.94
six months	5.81	5.81	5.87	5.00	4.69	4.12	4.06	4.06	4.06	4.13
twelve months	5.94	5.88	5.81	5.12	4.81	4.37	4.12	4.19	4.19	4.44
Euro-Swiss franc										
one month	4.44	3.88	3.94	4.94	2.50	1.25	1.37	1.62	2.06	2.81
three months	4.56	4.00	3.94	4.06	3.00	1.81	1.69	1.87	2.25	2.88
six months	4.63	4.00	3.87	4.06	3.19	2.37	2.12	2.19	2.44	2.94
twelve months	4.69	4.06	3.87	4.06	3.25	2.67	2.69	2.62	2.75	3.13
Eurosterling										
one month	9.50	11.69	11.12	9.00	8.56	8.44	9.00	8.44	8.06	7.38
three months	9.88	11.81	11.12	8.94	8.81	8.69	9.31	8.56	8.31	7.75
six months	10.00	11.81	11.06	9.00	9.00	8.87	9.50	8.69	8.69	8.25
twelve months	10.19	11.69	11.06	9.12	9.31	9.25	9.75	9.00	9.06	8.81
Euroyen										
one month	6.19	7.13	4.56	4.75	4.00	4.06	4.37	4.00	3.81	4.06
three months	6.19	6.56	4.50	4.44	4.12	4.12	4.19	4.00	3.94	4.06
six months	6.13	6.50	4.37	4.37	4.12	4.12	4.19	4.12	4.13	4.25
twelve months	6.13	6.38	4.31	4.44	4.12	4.19	4.19	4.19	4.25	4.31
European currency unit										
one month	9.25	9.63	8.56	6.94	6.62	5.87	6.12	6.19	6.13	5.63
three months	9.38	9.63	8.44	7.00	6.75	6.19	6.31	6.37	6.38	6.00
six months	9.50	9.63	8.06	6.94	6.87	6.37	6.44	6.44	6.50	6.31
twelve months	9.63	9.63	7.31	7.06	7.00	6.62	6.62	6.62	6.69	6.56

International bond yields

average yield of several actively traded, high quality issues with a maturity of 7 to 12 years at or near end of month

	1985 Dec	1986 Dec	1987 Aug	1987 Sep	1987 Oct	1987 Nov	1987 Dec	1988 Jan	1988 Feb	1988 Mar
United States companies										
Eurodollar	9.68	8.67	9.99	10.95	10.41	10.21	10.31	10.24	9.79	9.78
Euromark	6.73	6.62	6.82	6.87	7.04	6.74	6.69	6.54	6.27	6.33
Swiss franc	5.49	5.70	5.43	5.60	5.83	5.56	5.71	5.57	5.66	5.61
European governments										
Eurodollar	10.52	9.91	11.41	11.61	11.63	11.63	11.64	11.48	11.38	11.50
Euromark	7.03	6.77	6.65	6.76	6.81	6.61	6.21	6.23	6.07	6.06
Swiss franc	4.91	4.51	4.38	4.39	4.54	4.15	4.11	4.05	3.71	3.88
European currency unit	10.23	10.20	10.43	10.46	11.10	11.06	10.84	10.85	10.56	10.35

Central bank discount rates

at or near end of month

	1985	1986	1987	1988					Current	
	Dec	Dec	Dec	Jan	Feb	Mar	Apr	May	Jun 29 1988	effective since
United States	7.50	5.50	6.00	6.00	6.00	6.00	6.00	6.00	6.00	Sep 24, 87
Canada	9.49	8.47	8.66	8.62	8.67	8.78	9.12	9.17	9.39	Jun 23, 88
Austria	4.00	4.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	Dec 3, 87
Belgium	9.75	8.00	7.00	6.75	6.75	6.50	6.50	6.50	6.50	Mar 3, 88
Denmark	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	Oct 27, 83
Finland	9.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	May 19, 86
France	9.50	9.50	9.50	9.50	9.50	9.50	9.50	9.50	9.50	Aug 31, 77
Germany	4.00	3.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	Dec 3, 87
Ireland	10.25	13.25	9.25	9.25	9.25	9.25	8.50	8.00	8.00	May 30, 88
Italy	15.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	Aug 28, 87
Netherlands	5.00	4.50	3.75	3.75	3.25	3.25	3.25	3.25	3.25	Feb 5, 88
Portugal	19.00	16.00	14.50	14.50	14.00	14.00	14.00	14.00	14.00	Feb 5, 88
Spain	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	Jul 26, 77
Sweden	10.50	7.50	7.50	7.50	7.50	7.50	8.50	8.50	8.50	Apr 29, 88
Switzerland	4.00	4.00	2.50	2.50	2.50	2.50	2.50	2.50	2.50	Dec 4, 87
United Kingdom	11.31	10.81	8.37	8.37	8.87	8.37	7.88	7.38	8.88	Jun 24, 88
Japan	5.00	3.00	2.50	2.50	2.50	2.50	2.50	2.50	2.50	Feb 23, 87
New Zealand	19.80	24.60	18.55	18.05	18.20	17.80	19.70	17.15	16.90	Jun 29, 88
South Africa	13.50	10.00	9.80	9.80	9.80	10.80	10.80	11.80	11.80	May 5, 88
Argentina*	5.00	11.19	17.59	15.71	16.71	18.38	19.10	21.58	21.58	May, 88
Korea	5.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	Jul 10, 86
Philippines	11.50	9.64	9.25	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	
Singapore	5.00	5.00	5.00	5.00	3.50	3.50	3.50	3.50	3.50	Feb, 88
Thailand	11.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	Sep 1, 86
Venezuela	12.94	12.79	12.49	12.89	12.93	n.a.	n.a.	n.a.	12.93	Feb, 88

*Percent per month.

Day-to-day money rates

monthly averages

	1984	1985	1986	1987			1988				
	Dec	Dec	Dec	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May
United States	8.38	8.27	6.91	7.29	6.69	6.77	6.83	6.58	6.58	6.87	7.09
Canada	10.50	9.23	8.28	8.41	8.16	8.40	8.44	8.41	8.45	8.28	8.69
Austria	7.63	7.25	7.62	4.60	4.20	4.10	4.50	3.50	3.50	3.65	3.60
Belgium	9.12	6.60	5.09	4.34	5.44	5.09	5.02	4.16	5.10	5.05	4.28
Finland	15.07	11.96	11.97	11.00	11.00	11.00	11.00	11.00	11.00	11.00	11.00
France	10.95	9.02	7.80	7.69	8.67	8.23	7.80	7.26	7.54	7.55	7.34
Germany	5.62	4.64	5.00	3.74	3.66	3.19	3.13	3.32	3.24	3.25	3.30
Ireland	14.50	9.62	13.00	6.50	6.50	7.50	6.00	6.50	6.25	8.00	7.38
Italy	17.25	14.75	11.42	10.90	10.26	10.25	10.60	9.87	10.14	9.96	11.41
Netherlands	5.60	5.75	6.19	5.19	4.44	4.25	4.12	3.87	3.94	4.00	3.94
Norway	12.50	12.50	14.00	13.80	13.68	14.02	13.88	13.87	13.91	14.03	13.51
Spain	12.18	9.92	11.76	16.22	14.60	14.02	13.20	12.13	11.40	11.01	10.81
Sweden	11.88	11.83	8.89	8.42	8.07	8.43	8.75	9.37	9.61	9.71	9.75
Switzerland	1.50	2.00	1.12	1.25	1.50	0.50	0.50	1.00	1.25	2.13	2.25
United Kingdom	6.31	9.72	9.19	9.68	9.13	7.60	8.26	8.28	8.55	8.13	7.51
Australia	10.98	18.37	15.40	10.77	10.90	10.37	10.23	10.25	10.33	10.35	11.20
Japan	6.41	8.02	4.18	3.37	3.39	3.81	3.54	3.39	3.53	3.28	3.18
South Africa	21.13	12.50	8.50	8.64	8.45	9.76	9.75	9.25	9.85	10.00	10.90
Argentina*	17.75	4.50	7.00	9.00	9.80	14.90	16.40	14.90	17.60	18.18	19.70
Brazil	272.02	352.23	83.05	150.10	329.33	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Hong Kong	6.80	6.10	3.90	4.92	1.90	0.56	0.58	1.83	2.84	3.64	6.02
Korea	10.00	8.60	9.00	10.00	8.70	9.20	9.30	9.20	9.40	n.a.	n.a.
Philippines	15.22	15.03	9.92	12.94	14.35	22.53	n.a.	n.a.	n.a.	n.a.	n.a.
Singapore	6.01	4.53	3.51	3.55	3.40	2.57	2.73	2.93	3.01	3.08	3.56
Taiwan	8.07	4.50	4.00	3.67	3.57	4.56	5.11	5.52	5.37	5.23	n.a.

*Percent per month.

Treasury bill rates

bond equivalent yields, at or near end of month

	1984	1985	1986	1987			1988				
	Dec	Dec	Dec	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May
United States	8.12	7.28	5.83	5.41	5.79	5.84	5.80	5.78	5.87	6.15	6.67
Canada	9.84	9.24	8.24	7.84	8.31	8.41	8.37	8.32	8.53	8.87	8.92
Belgium	10.90	9.89	7.50	7.26	6.95	6.84	6.44	6.24	6.18	6.18	6.18
Ireland	15.10	11.15	13.60	8.80	9.10	8.69	8.34	8.76	8.33	7.83	7.17
Italy	14.69	13.10	10.00	11.98	12.06	11.66	11.37	10.78	10.78	10.81	10.82
Netherlands	6.88	5.69	6.37	5.50	5.25	4.95	4.75	4.25	4.12	4.38	4.25
Spain	12.27	9.52	8.37	8.23	6.78	6.67	5.56	5.83	10.17	n.a.	10.25
Sweden	11.83	12.49	9.20	9.49	9.20	9.05	9.20	9.32	9.58	10.70	10.29
United Kingdom	9.33	11.49	10.79	9.07	8.87	8.38	8.38	9.01	8.26	7.88	7.28
Australia	12.27	19.40	14.91	10.47	10.34	10.06	9.92	10.44	9.83	10.40	11.80
Japan	4.91	4.91	2.89	2.38	2.38	2.38	2.38	2.38	2.38	2.38	2.38
New Zealand	13.50	17.62	19.69	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
South Africa	21.94	12.99	8.84	8.88	8.54	8.85	9.49	9.55	10.51	10.97	11.61
Brazil	273.03	379.77	149.00	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Mexico	48.67	72.98	104.03	96.43	110.67	133.04	155.67	153.86	75.16	54.51	50.04
Philippines	47.14	16.45	9.55	12.97	13.18	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Singapore	2.91	2.94	2.10	3.57	3.69	3.23	2.92	2.97	2.97	3.02	n.a.

Representative money market rates

bond-equivalent yields on major short-term (mostly 3-4 month) money market instruments other than Treasury bills, at or near end of month

	1984	1985	1986	1987			1988				
	Dec	Dec	Dec	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May
United States	8.49	8.02	6.64	7.58	7.80	7.21	6.90	6.77	6.90	7.20	7.75
Canada	10.00	9.40	8.35	8.50	8.70	8.90	8.85	8.55	8.65	8.94	9.32
Belgium	10.65	9.89	7.60	7.35	7.15	6.95	6.54	6.34	6.24	6.24	6.24
France	10.69	9.12	8.37	8.25	8.62	8.56	8.06	7.44	8.25	7.88	n.a.
Germany	5.75	4.80	4.85	4.10	3.80	3.85	3.23	3.28	3.40	3.55	3.60
Ireland	15.13	12.00	14.06	9.25	9.19	8.81	8.62	8.94	8.38	8.13	7.38
Italy	16.88	15.13	11.37	12.00	11.62	11.50	10.75	11.13	11.13	10.38	11.00
Netherlands	5.75	5.75	6.19	5.25	4.94	4.56	4.32	4.06	4.06	4.13	4.19
Portugal	24.57	20.71	16.07	14.66	14.30	14.34	13.97	13.43	13.03	n.a.	n.a.
Spain	12.21	10.51	11.79	15.84	14.44	13.59	12.30	12.01	11.06	10.90	11.11
Switzerland	5.00	4.75	4.50	4.06	4.06	3.56	1.69	1.81	1.88	2.13	2.75
United Kingdom	9.88	12.75	11.25	9.19	8.87	8.94	9.31	9.38	8.56	8.31	7.81
Australia	12.90	19.75	15.10	13.65	12.15	11.25	10.85	10.90	11.50	11.55	12.87
Japan	6.33	7.03	4.34	3.88	3.90	3.90	3.85	3.90	3.80	3.75	3.80
New Zealand	15.00	20.00	24.25	20.30	16.90	17.70	17.00	17.35	n.a.	17.20	15.75
South Africa	22.78	13.35	8.55	8.90	8.50	8.90	9.60	10.25	10.90	11.85	12.65
Chile	20.68	22.42	19.56	31.37	34.49	15.25	11.35	10.69	21.41	20.84	11.09
Hong Kong	8.25	6.50	4.62	6.19	4.06	1.50	3.00	3.87	4.12	5.13	7.31
Indonesia	19.00	15.00	19.50	17.37	17.50	17.50	17.00	18.50	22.50	18.50	19.00
Korea	8.00	8.00	8.00	7.50	7.50	7.50	n.a.	n.a.	n.a.	n.a.	n.a.
Malaysia	10.30	8.20	6.00	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	3.70	3.85
Philippines	33.21	14.61	8.31	11.81	n.a.	10.55	13.80	n.a.	n.a.	n.a.	n.a.
Singapore	7.00	5.88	3.94	4.50	4.00	3.25	3.13	3.13	3.19	n.a.	n.a.
Taiwan	7.65	4.10	3.87	3.23	3.13	3.09	4.12	4.47	4.23	4.48	n.a.

Commercial bank deposit rates

at or near end of month

	1984	1985	1986	1987			1988				
	Dec	Dec	Dec	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May
United States	8.34	7.72	6.26	7.40	7.72	7.10	6.67	6.57	6.69	7.05	7.54
Canada	10.05	9.40	8.15	8.45	8.57	8.40	8.50	8.45	8.60	9.00	9.30
Austria	7.50	6.50	5.50	4.75	4.45	4.25	4.40	4.05	3.90	3.90	3.95
Belgium	10.63	9.63	7.44	6.60	6.66	6.69	6.31	6.25	6.19	6.00	6.06
Denmark	6.00	7.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Finland	5.25	4.75	2.75	2.75	2.75	2.75	2.75	2.75	2.75	2.75	2.75
France	7.04	6.12	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Germany	5.25	4.40	4.80	3.90	3.70	3.50	3.20	3.20	3.25	3.40	3.40
Ireland	14.63	11.87	13.75	8.62	9.12	8.62	8.50	8.75	8.25	7.75	7.25
Italy	11.64	13.21	10.69	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	9.50	9.50
Netherlands	5.69	5.81	6.06	5.12	4.81	4.59	4.21	3.94	4.00	4.06	4.05
Norway	12.75	12.00	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Portugal	28.00	20.00	15.00	14.00	14.00	14.00	14.00	13.50	13.50	13.50	n.a.
Spain	11.64	9.64	8.67	9.11	9.32	9.48	9.39	9.30	9.17	9.05	n.a.
Sweden	11.45	12.18	9.83	9.70	9.70	9.45	9.55	9.55	9.95	10.95	10.60
Switzerland	4.50	4.50	4.25	3.81	3.81	3.37	1.44	1.56	1.63	1.88	2.50
United Kingdom	9.88	11.75	11.19	9.12	8.81	8.81	8.75	9.25	8.37	8.13	7.63
Australia	12.75	16.60	15.56	11.25	12.28	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Japan	6.36	7.04	4.55	4.63	4.46	4.42	4.33	4.41	4.38	4.25	4.30
New Zealand	15.25	19.98	23.50	19.85	16.65	16.85	16.00	n.a.	14.60	15.50	15.50
South Africa	22.88	13.20	8.65	9.35	9.30	10.25	11.20	11.90	11.90	12.70	14.00
Argentina*	31.23	5.40	8.41	9.10	8.92	14.00	15.12	14.30	17.10	18.10	18.70
Brazil	27.00	18.00	220.00	14.00	15.00	17.50	n.a.	n.a.	n.a.	n.a.	n.a.
Chile	20.88	23.60	20.98	30.30	31.53	14.84	11.75	9.25	19.84	17.73	9.77
Hong Kong	8.25	6.50	4.62	6.19	4.06	1.50	3.00	3.87	4.12	5.13	7.31
Korea	6.00	6.00	6.00	6.00	6.00	6.00	n.a.	n.a.	n.a.	n.a.	n.a.
Malaysia	9.58	7.00	6.33	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Mexico	47.45	72.90	94.30	94.20	103.74	120.35	118.99	118.80	75.97	53.01	49.38
Philippines	31.01	12.34	7.75	8.56	9.50	11.19	9.65	9.27	10.09	n.a.	n.a.
Singapore	6.13	5.26	4.00	4.31	3.69	3.13	3.06	n.a.	n.a.	n.a.	n.a.
Taiwan	6.50	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25
Venezuela	12.50	8.00	8.00	8.92	8.95	8.95	8.97	8.94	8.85	8.96	n.a.

*Percent per month.

Domestic government bond yields

long-term issues, at or near end of month

	1984	1985	1986	1987			1988				
	Dec	Dec	Dec	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May
United States	11.61	9.49	7.79	9.04	9.10	8.95	8.42	8.39	8.82	9.07	9.31
Canada	11.66	10.04	9.23	10.21	10.50	10.34	9.74	9.61	10.13	10.36	10.38
Austria	8.03	7.61	7.33	7.26	7.13	6.89	6.83	6.80	6.71	6.62	6.61
Belgium	11.56	9.60	7.70	8.32	7.98	8.04	7.58	7.38	7.65	7.62	7.89
Denmark	14.60	9.67	11.70	12.56	11.84	12.05	11.18	10.91	11.22	11.44	n.a.
Finland	10.73	10.58	7.83	7.77	7.64	7.67	7.40	7.40	7.41	7.41	n.a.
France	12.70	11.33	9.89	10.95	10.46	10.57	9.73	9.33	9.61	9.42	9.38
Germany	7.17	6.57	6.25	6.62	6.46	6.51	6.50	6.28	6.30	6.47	6.68
Ireland	14.90	11.84	12.97	11.05	10.23	10.45	10.61	10.41	10.12	9.74	9.80
Italy	14.52	13.66	10.05	11.41	11.25	10.50	10.29	10.30	10.29	10.39	10.49
Netherlands	7.72	6.96	6.40	7.05	6.37	6.32	6.17	5.99	6.01	6.21	6.36
Norway	12.00	13.00	13.24	13.10	13.25	13.29	13.35	13.16	13.24	13.24	n.a.
Portugal	22.23	16.64	14.49	15.30	15.60	14.80	14.70	14.50	n.a.	n.a.	n.a.
Spain	13.83	12.52	10.36	14.24	13.34	13.14	12.48	11.91	11.82	11.35	11.63
Sweden	12.04	12.11	10.66	11.42	11.51	11.39	11.30	10.96	11.05	11.41	11.21
Switzerland	4.60	4.42	4.05	4.12	3.86	3.95	3.94	3.93	3.92	3.77	3.38
United Kingdom	10.25	10.35	10.17	9.22	9.23	9.47	9.26	9.10	8.96	9.14	9.17
Australia	13.50	14.85	13.40	13.65	13.30	12.85	12.40	12.30	11.90	11.50	12.30
Japan	6.47	5.92	4.61	4.58	5.00	4.88	4.23	4.36	4.43	4.45	4.60
New Zealand	16.90	17.00	16.00	15.70	14.90	14.30	14.00	13.30	13.08	13.15	13.05
South Africa	16.55	18.09	15.06	15.44	15.30	15.70	16.80	16.52	16.60	16.48	16.40
Philippines	18.54	n.t.	n.t.	n.t.	n.t.	n.t.	n.t.	n.t.	n.t.	n.t.	n.t.
Venezuela	14.00	12.00	12.00	12.50	12.50	12.50	n.a.	n.a.	n.a.	n.a.	n.a.

Commercial bank lending rates to prime borrowers

at or near end of month

	1984	1985	1986	1987			1988				
	Dec	Dec	Dec	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May
United States	10.75	9.50	7.50	9.00	8.75	8.75	8.50	8.50	8.50	8.50	9.00
Canada	11.25	10.00	9.75	9.75	9.75	9.75	9.75	9.75	9.75	10.25	10.25
Austria	9.25	9.00	9.00	8.50	8.50	8.25	8.25	8.25	8.25	8.25	8.25
Belgium	14.00	11.50	9.75	8.75	8.75	8.75	8.75	8.50	8.50	8.50	8.50
Denmark	10.50	8.50	8.00	9.50	9.50	9.50	9.50	9.50	9.50	9.50	n.a.
Finland	10.68	10.37	8.81	8.97	9.02	8.99	9.03	9.05	9.07	n.a.	n.a.
France	12.00	10.60	9.45	9.45	9.45	9.45	9.45	9.45	9.45	9.45	9.45
Germany	7.75	7.25	6.75	6.25	6.25	6.25	6.00	6.00	6.00	6.00	6.00
Ireland	15.75	12.50	15.75	12.00	12.00	11.50	11.50	11.50	11.50	11.25	11.25
Italy	18.00	15.88	13.00	13.00	13.00	13.00	12.50	12.62	12.62	12.63	12.63
Netherlands	6.25	6.25	7.12	5.50	5.25	4.87	4.62	4.06	4.12	4.19	4.25
Norway	13.00	12.40	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Portugal	29.00	22.50	17.50	18.50	18.50	18.50	18.50	18.00	18.00	18.00	n.a.
Spain	15.84	14.75	14.22	16.40	16.36	16.34	16.10	15.76	15.42	15.23	14.79
Sweden	14.50	15.05	11.50	11.50	11.50	11.50	11.50	11.50	11.50	11.50	12.00
Switzerland	6.00	6.00	5.75	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00
United Kingdom	9.50	11.50	11.00	9.50	9.00	8.50	8.50	9.00	8.50	8.00	7.50
Australia	14.00	21.00	18.50	14.00	14.00	14.00	13.50	13.50	13.50	n.a.	n.a.
Japan	5.50	5.50	3.75	3.37	3.37	3.37	3.37	3.37	3.37	3.38	3.38
New Zealand	14.00	21.00	23.00	22.50	19.75	18.75	18.75	n.a.	n.a.	n.a.	n.a.
South Africa	24.00	16.50	12.00	12.50	12.50	12.50	13.00	13.00	14.00	14.00	15.00
Argentina*	32.05	7.30	11.30	9.80	9.98	14.80	15.80	15.00	17.60	17.92	19.50
Brazil**	31.00	18.00	250.00	18.00	18.00	19.50	n.a.	n.a.	n.a.	n.a.	n.a.
Chile	60.62	33.34	29.13	37.33	40.20	30.99	21.22	20.51	25.49	31.64	21.88
Hong Kong	11.00	7.00	6.50	6.50	6.00	5.50	5.25	6.00	6.00	6.50	7.50
Indonesia	23.50	18.75	19.75	21.00	20.50	20.50	20.50	20.50	20.50	21.00	22.00
Korea	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00
Malaysia	12.00	10.50	10.00	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Mexico	47.54	65.66	95.33	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Philippines	44.00	15.00	10.50	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Singapore	9.40	7.20	6.10	6.10	6.10	6.10	5.96	5.93	5.85	5.85	5.65
Taiwan	10.00	9.50	9.00	9.00	9.00	9.00	9.00	9.00	9.00	9.00	9.00
Venezuela	16.00	13.00	13.00	13.00	13.00	13.00	13.00	13.00	13.00	13.00	n.a.

*Percent per month.

**Spread above monetary correction until Feb 86; nominal rate of interest until Jan 87; spread above LBC rate thereafter.

Domestic corporate bond yields

long-term issues, at or near end of month

	1984	1985	1986	1987			1988				
	Dec	Dec	Dec	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May
United States	12.25	10.15	8.88	10.25	10.30	9.90	9.38	9.45	9.85	10.25	10.38
Canada	12.42	10.74	10.18	11.22	11.32	10.95	10.37	9.96	n.a.	10.97	10.86
France	12.94	11.76	10.18	11.28	10.96	10.92	10.38	9.91	10.03	9.78	9.77
Germany	7.20	6.90	6.50	7.00	6.70	6.70	6.70	6.70	6.60	6.60	6.80
Netherlands	7.61	n.t.	n.t.	n.t.	n.t.	n.t.	n.t.	n.t.	n.t.	n.t.	n.t.
Spain	18.32	14.92	13.40	17.39	17.08	16.15	15.79	14.88	14.78	12.89	12.89
Sweden	12.33	13.25	11.99	12.78	12.36	12.31	12.20	11.83	11.94	12.20	12.16
Switzerland	5.09	4.93	4.72	4.87	4.65	4.60	4.50	4.39	4.39	4.29	4.36
United Kingdom	11.64	11.47	11.71	10.75	10.59	11.11	10.76	10.82	10.66	10.55	10.89
Japan	7.10	6.79	5.93	5.95	5.59	5.32	5.08	5.03	4.99	4.93	4.95
Korea	15.00	13.60	12.80	12.50	12.90	12.80	12.80	13.20	13.70	13.00	n.a.
Venezuela	18.00	17.00	17.00	18.00	18.00	18.00	n.a.	n.a.	n.a.	n.a.	n.a.

Key to data in tables

I. International markets

Data on the *international banking market size* are based on resident and nonresident Eurocurrency (i.e., foreign currency) assets and liabilities and on nonresident domestic currency assets and liabilities of banks in nearly all European countries, the Bahamas, Bahrain, Canada, Cayman Islands, Hong Kong, Japan, Netherlands Antilles, Panama, Singapore, and the United States. All assets and liabilities of international banking facilities (IBFs) of banks in the United States are treated as Eurocurrencies.

An *international bond issue* may be either a Eurobond issue or a foreign bond issue. A *Eurobond issue* is one placed principally in countries other than that of the currency in which the bond is denominated, usually through an international syndicate. A *foreign bond issue* is one issued by a nonresident borrower on the market of a single country and denominated in that country's currency. Data on new international bond issue volume include all publicly announced issues of straight bonds, convertibles, bonds with warrants, floating rate notes, and certificates of deposit with an original maturity of three years or more (one year or more beginning in 1985), whether publicly or privately placed.

An *international bank credit* may be either a Eurocurrency credit or a foreign credit. A *Eurocurrency credit* is one denominated in a currency that is foreign to the country of the bank office extending the credit. A *foreign credit* is one extended to a nonresident borrower and denominated in the domestic currency of the country in which the bank office extending the credit is located. Data on new international bank credit volume include all publicly announced bank credits with an original maturity of one year or more (term loans, revolving lines of credit, and facilities to back up the issuance of other financial instruments such as commercial paper, short-term notes, certificates of deposit and banker's acceptances).

Data on international bond issues and bank credits through 1984 were compiled by Morgan Guaranty Trust Company. Beginning in January 1985 these data are based on figures published in the OECD's *Financial Statistics Monthly*.

II. Domestic markets

Central bank discount rates

Rates shown are the official discount rates with the exception of:
Ireland — Short Term Facility rate.
South Africa — discount rate for 90-day banker's acceptances.
United Kingdom — rate of discount for outright purchases of 15- to 33-day bank bills.

Day-to-day money rates

Argentina—7-day interbank money regulated by the central bank.
Austria — day-to-day interbank rate.
Australia — effective interest rate in the official short-term money market.
Belgium — day-to-day loan rate in the call money market.
Brazil — interbank overnight money.
Canada—chartered banks' day-to-day loans.
Finland — Bank of Finland call money.
France — interbank call money against private paper.
Germany — interbank call money.
Hong Kong — interbank 24-hour call rate.
Ireland — interbank call money.
Italy — interbank 48-hour call money.
Japan—Tokyo interbank call money, unconditional lenders rate.
Korea — overnight interbank call money.
Netherlands — open-market call money.
Norway — day-to-day interbank rate.
Philippines — interbank call loan rate.
Singapore — interbank overnight money.
South Africa — discount houses basic call rate.
Spain — day-to-day interbank rate.
Sweden — interbank call money.
Switzerland — call money.
Taiwan — private interbank overnight loan rate.
United Kingdom — call money.
United States — federal funds rate.

Treasury bill rates

Australia — 13-week Treasury notes at tender.
Belgium — new issue of 3-month Treasury certificates.
Brazil — 3-month Treasury bills.
Canada — 3-month Treasury bills at tender.
Ireland — 3-month central bank exchequer bills at tender.
Italy — 6-month Treasury bills.
Japan — 60- to 62-day noninterest-bearing discount government bills.
Mexico — 3-month Federal Treasury bills.
Netherlands — 3-month Treasury bills.
New Zealand — tap issue rate for 3-month Treasury bills until December 1984. As of January 1985, 3-month Treasury bills at tender.
Philippines — simple average of 91-day Treasury bills at tender until June 1984. Beginning July 1984 rates refer to the weighted average interest rate on 91- to 183-day Treasury bills sold to banks under negotiated basis.
Singapore — 91-day Treasury bills at tender.
South Africa — 3-month Treasury bills at tender.
Spain — 3-month Treasury bill repos reported by the Bank of Spain until January 1988. As of February 1988 secondary market yield on 3-month Treasury notes (average of quotations during the month).
Sweden — new issues of 3-month Treasury bills until June 1982. New series as of July 1982, 6-month Treasury discount notes, market rate.
United Kingdom — 91-day Treasury bills at tender.
United States — 3-month Treasury bills.

Representative money-market rates

Australia — buying rate for 90-day bank accepted commercial bills.
Belgium — 4-month Fonds des Rentes certificates.
Canada — 3-month prime finance company paper.
Chile — central bank 60-day fixed rate promissory notes (PDBC) at tender.
France — 3-month interbank money against private paper.
Germany — 3-month interbank deposits.
Hong Kong — 3-month interbank deposits.
Indonesia — 1-month interbank deposits.
Ireland — 3-month interbank deposits.
Italy — 3-month interbank deposits.
Japan — 3-month "gensaki" rate.
Korea — 3-month financial bill.
Malaysia — 3-month interbank deposits.
Netherlands — 3-month interbank deposits.
New Zealand — 90-day commercial bills.
Philippines—weighted average interest rate for 90-day promissory rates.
Portugal — average of 30- to 90-day interbank deposits.
Singapore — 3-month banker's acceptances until July 1987. As of August 1987 3-month commercial bills.
South Africa—90-day banker's acceptances.
Spain — 3-month interbank rate reported by the Bank of Spain (average of quotations during the month).
Switzerland — 3-month interbank deposits.
Taiwan — 90-day banker's acceptances.
Thailand — interbank call money.
United Kingdom — 3-month interbank deposits.
United States — 3-month prime industrial paper.

Commercial bank deposit rates

Argentina — nominal 30-day time deposits. Average of bank rates published by the central bank until August 1984. New series as of September 1984, 30-day acceptances maximum interest rate.
Austria — 3-month time deposits.
Australia — 3-month certificates of deposit.
Belgium — special maximum rate for 3-month time deposits in large amounts.
Brazil — 6-month certificates of deposit with prefixed yields until July 1982. New series as of August 1982, 6-month certificates of deposit reported as a spread above monetary correction which is set every month in relationship to inflation.
Canada — 3-month time deposits.
Chile — 30-day time deposits.
Denmark — time deposits of 3-months' notice.
Finland — time deposits of six-month notice.
France — 3-month time deposits of FF. 1,000,000.
Germany — 3-month time deposits in large amounts.
Hong Kong — negotiable 3-month time deposits of more than HK$500,000.
Ireland — 3-month deposits.
Italy — 3-month time deposits of Lit. 100 million or more.
Japan — 90-day negotiable certificates of deposit issued by the Tokyo office of Morgan Guaranty Trust Company.
Korea — 3-month time deposits.
Malaysia — 3-month time deposits.
Mexico — 3-month certificates of deposit until September 1983. New series as of October 1983, 3-month promissory notes.
Netherlands — 3-month time deposits in large amounts.
New Zealand — 6-month transferable certificates of deposit.
Norway — 3-month special term deposits.
Philippines — weighted average interest rates on 60- to 90-day time deposits of sample commercial banks.
Portugal — 90- to 180-day time deposits until May 1984. New series as of June 1984, 180-day to one-year time deposits.

Singapore — 3-month certificates of deposit.
South Africa — 3-month negotiable certificates of deposit.
Spain — deposits over 6 months and less than 1 year for Pts. 1 million or more reported by the Bank of Spain.
Sweden — 3-month certificates of deposit.
Switzerland — 3-month time deposits.
Taiwan — maximum rate for 3-month time deposits.
Thailand — 3-month time deposits.
United Kingdom — 3-month time deposits.
United States — 3-month negotiable certificates of deposit issued by Morgan Guaranty Trust Company.
Venezuela — 6-month negotiable certificates of deposit for domestic depositors only.

Domestic government bond yields

Austria — Austrian National Bank average yield on all outstanding government bonds.
Australia — secondary market yield for 10-year Treasury bonds.
Belgium — Belgium National Bank secondary market average yield on central government bonds of more than 5 years' maturity quoted on Brussels Stock Exchange.
Canada — Bank of Canada average yield on all direct government bonds due or callable in 10 years or more.
Denmark — 12% serial bonds maturing 2001 until April 1983. New series as of May 1983, 10% serial bonds maturing 2004.
Finland — rate of interest at issue on central government bonds intended for public subscription, weighted by sales of bonds in the latter half of each month.
France — INSEE secondary market weighted average yield of public sector bonds with a remaining maturity of 10 years or more.
Germany — Frankfurter Allgemeine Zeitung 10-year public authority bond average.
Ireland — 15-year government bonds.
Italy — average yield on fixed-interest government bonds, not including irredeemable bonds, weighted by the amounts in circulation, for maturities of 9 years or more.
Japan — secondary market average yield on Central government bonds with a maturity of 5 years or more.
Netherlands — Central Bureau of Statistics (CBS) average yield on three latest government bonds.
New Zealand — average yield on government bonds maturing after 5 years.
Norway — 5% government bond of 1996 until December 1982. New series as of January 1983, average yield of long-term government bonds.
Philippines — weighted average interest rate of outright sales on secondary transactions for central bank certificates of indebtedness.
Portugal — yield of 4% Centenary Loan of 1940.
South Africa — 25-year government bonds until August 1983; 20-year Republic of South Africa bonds until April 1984; new series as of May 1984, secondary market yield for the 13% due 2005 Republic of South Africa bond.
Spain — Bank of Spain secondary market weighted average yield of several central government issues with more than 2 years' maturity (average of quotations during the month).
Sweden — 15-year government bonds until October 1983. New series as of November 1983, 5-year government bond yield index, market rate.
Switzerland — Swiss Confederation bond average.
United Kingdom — F.T. (*Financial Times*) Actuaries 25-year government stock.
United States — Morgan Guaranty 20-year U.S. Government Bond Index until December 1986. As of January 1987 U.S. Treasury 30-year constant maturity index.
Venezuela — Banco Central average yield on public-sector bond issues.

Commercial bank lending rates to prime borrowers

Argentina — average rate on 30-day loans.
Austria — overdraft rate for prime borrowers, including commission.
Australia — overdraft rate. Maximum indicator rate applying to loans of A$100,000 or more for major trading banks.
Belgium — prime overdraft rate.
Brazil — prefixed rate applied to working capital loans until July 1982; monetary-corrected free rate applied to working capital loans from August 1982 to July 1983. New series as of August 1983, maximum legal rate reported as a spread above monetary correction which is set every month in relationship to inflation. Charges for fees and commissions are often added.
Canada — prime rate.
Chile — average prime rate of six major commercial banks.
Denmark — approximate rate for loans and advances to prime borrowers.
Finland — average rates on total commercial bank lending.
France — base lending rate, excluding a commission of .05% per month on highest debit balance during the month. A spread above base rate is often added.
Germany — approximate effective overdraft rate for prime borrowers.
Hong Kong — prime lending rate set by the Hong Kong Association of Banks.
Indonesia — prime rate for domestic affiliates of foreign companies.
Ireland — AA corporate borrowing rate.
Italy — unsecured overdraft rate for prime borrowers.
Japan — standard rate of interest on short-term loans of especially high credit standing.
Korea — prime rate.
Malaysia — Bank of Commerce Berhad base lending rate.
Mexico — base rate or average cost of money for banks determined monthly by the Banco de Mexico S.A.
Netherlands — overdraft rate for prime borrowers, including commission.
New Zealand — overdraft rate for prime borrowers.
Norway — overdraft rate, including a commission of .25% per quarter on the total line of credit until January 1983. New series as of February 1983, special rate of first class, large borrowers.
Philippines — prescribed administrative ceiling for unsecured loans with maturities of 365 days and below, including charges until December 1982. New series as of January 1983, modal rate to prime borrowers.
Portugal — maximum rate for 90- to 180-day loans.
Singapore — most common overdraft rate, major banks.
South Africa — unsecured overdraft rate for prime borrowers.
Spain — private banks' average interest rate for 1-year loans reported by the Bank of Spain.
Sweden — overdraft rate for prime industrial borrowers, commission not included.
Switzerland — unsecured overdraft rate for prime borrowers, excluding commission of .25% per quarter on average or highest outstanding debit balance in quarter.
Taiwan — maximum rate for 3- to 12-month secured loans. Rate is an indication only and may vary from actual bank lending rate which is subject to volatile interbank rates.
Thailand — prime rate.
United Kingdom — clearing bank base lending rate. A spread above base rate is often added.
United States — prime rate of Morgan Guaranty Trust Company.
Venezuela — representative rate for domestic prime borrowers only.

Domestic corporate bond yields

Canada — McLeod, Young, Weir Co. Ltd., weighted long-term bond yield index for AA corporates.
France — INSEE secondary market weighted average yield of private company bonds with a remaining maturity of 10 years or more.
Germany — Bundesbank secondary market weighted average yield of industrial bonds with a remaining maturity of more than 3 years.
Japan — secondary market yield for industrial bonds.
Korea — average of yields on corporate bonds guaranteed by local banks, with an original maturity of 3- 2- 5-years.
Netherlands — CBS average yield on three 6%-6.5% corporate bonds until December 1981. As of January 1982, CBS secondary market weighted average yield on all commercial bank issues with a quotation between 92% and 103%.
Norway — 5.75% Dalen Portland-Cement bond of 1969-1984 until December 1982. New series as of January 1983 average yield of long-term industrial bonds.
Spain — Bank of Spain seconary market weighted average yield of several corporate issues with more than 3 years' maturity (average of quotations during the month).
Sweden — Central Satistical Bureau average yield on industrial bonds.
Switzerland — average yield on outstanding bonds of four leading Swiss companies. Mixture changed as of January 1982.
United Kingdom — *Financial Times* secondary market average yield of industrial and financial company debentures and loan stocks with an average of 25 years to maturity.
United States — Salomon Brothers index of new issues yields for Aa industrial bonds with five-year call protection.
Venezuela — average of yields on 15-year bond issues of Electricidad de Caracas.

World Financial Markets

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary 12 July 1988

NATIONAL SAVINGS

Thank you for your letter of 11 July. The Prime Minister is content with the proposed announcement of the 34th savings certificate issue today.

PAUL GRAY

Guy Westhead, Esq.,
Economic Secretary's Office,
H M Treasury

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53/2/LPD/3757/043

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Treasury Chambers, Parliament Street, SWIP 3AG

Prime Minister!
X is the main reason why the Chancellor wants to announce this issue now. 7.5% is also consistent with some future increase in market rates.

PRCG 11/7

Paul Gray Esq
Private Secretary to the Prime Minister
10 Downing Street
LONDON
SW1

11 July 1988

Dear Paul,

NATIONAL SAVINGS

This is to let you know that the Department for National Savings will be announcing at noon tomorrow the issue of a new fixed interest savings certificate, the 34th Issue, which will go on sale on 22 July.

The new certificate will offer 7.5 per cent a year over five years, compared with the 7 per cent currently on offer. Although we shall not make the point explicitly, we hope the announcement of a new issue will give the building societies an additional stimulus to raise their mortgage rates on 1 August and so help to restore the traditional relationship between mortgage rates and bank base rates.

As you know our current strategy is to secure more good quality funding and so to encourage holders of matured certificates to reinvest in the current issues of index-linked and fixed interest certificates. The new issue fits in well with this too. During August and September a number of investors will be considering a move out of the first and second issue index-linked savings certificates having earned their annual supplement on 1 August. There are also heavy maturities on 26th Issue.

Like the current issue, the investment limit on the 34th will be £1,000 for new purchases with an additional entitlement of £5,000 for holders of matured certificates who wish to reinvest the new issue.

DNS will announce at the same time a corresponding rise in the rate offered on the Yearly Plan. The current monthly investment limit of £200 remains unchanged.

Yours sincerely,

Guy R. Westhead.

GUY WESTHEAD
Assistant Private Secretary

PRIME MINISTER

MEETING WITH ALAN WALTERS

You are seeing Alan at 1445. I imagine you will want to have a general chat with him about recent economic developments and prospects.

Nigel will be seeing Alan beforehand to discuss the issue you talked to him about yesterday. If Alan wishes to talk to you about that, Nigel will come in for the start of the meeting.

PRCG

(PAUL GRAY)

30 June 1988

PRIME MINISTER

Alan Walters will be over here from the afternoon of 30 June to the evening of 1 July and would very much like an hour with you. He would probably be at his best on Friday 1 July. You could see him then if you came back to No.10 after seeing the Chiefs of Defence Staff and before going on to Chequers.

Do you wish to? If so, I will fix a slot early on the afternoon of Friday 1 July.

Dominic

DOMINIC MORRIS

6 June 1988

PRIME MINISTER

Sir Peter Middleton has suggested to me, privately, that it would be helpful to have before too long another Seminar with the Treasury about economic policy. I agree with his suggestion. There is a lot to be said for putting a Seminar in the diary at a time when there is no pressing economic issue, so that there can be no suggestion that it is a "crisis" meeting.

I think that the next Seminar ought to range more widely than market management issues. It should deal with the recent development of, and the prospects for, the economy as a whole, perhaps based on a presentation from Terry Burns. If the Seminar is to deal with the economy widely, there is less case for including the Bank. But that is something to be discussed with the Treasury.

Agree to arrange a Seminar, on these lines, at a convenient time (followed by a small lunch)?

N.L.W.

N. L. Wicks

25 May 1988

Economic Briefing

Prime Minister

An interesting piece which, though possibly overstated, demonstrates the difficulties of assessing where we are now, let alone where we're going. PRCG 8/3

Saving slump — Shome mishtake shurely?

According to official statistics, personal saving slumped to a 30-year low at 5% of disposable income in the third quarter of last year. After deducting the cash flow of pension funds, the figure implied **negative** saving, 3½% of income.

But the official statistics are of doubtful quality. **Thanks to a huge blackhole in personal sector figures, the saving ratio might have been 10 percentage points higher: 15% rather than 5%.**

In 1987 as a whole, the official saving ratio could have been biased down by ½-1% on account of under-recorded interest and dividend receipts from overseas investments and by 2-2½% because of concealed incomes in the black economy. Mismeasurement of taxed income might have pushed the official saving ratio down by up to 1%.

Saving trends are better measured by an average of the official measure and an alternative based on identified financial investments and borrowing. Although trending down, the average measure does not register the alarming drop in saving shown by the official measure after 1984.

Saving ratios compared

	1979	1980	1981	1982	1983	1984	1985	1986	1987*
Official	13	14½	13	12	10½	10¼	9	7½	6½
Average	14½	15½	14	12½	12	11¼	11	10	10

* First three-quarters only. Figures rounded to nearest ¼%.

It is quite possible that the consumer boom of 1987 was due to buoyant incomes growing 1% faster than officially measured. **But without a firm set of historical statistics, forecasters attempts to project consumers' spending can be little more than stabs in the dark.**

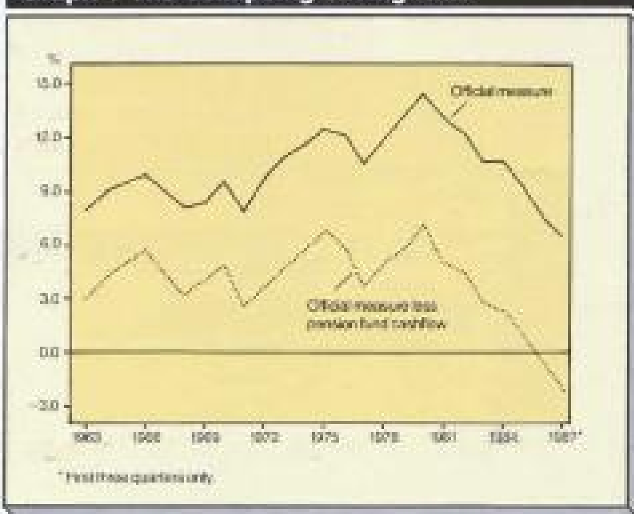
Consequently, Mr Lawson cannot confidently assume that the British consumer will exercise the restraint necessary if the economy is to slow down gracefully this year. His policies should reflect this deep uncertainty and put safety first. **It is the extent of forecasters' current ignorance about the economy rather than their knowledge which reinforces the case for a tight Budget on 15 March.**

PHILLIPS&DREW

What is it that causes hand-wringing at the Bank of England, finger-wagging by apocalyptic, apoplectic monetarists and head-scratching by stupefied Keynesians? The answer is the collapse of the saving ratio which, according to official figures, fell to all-time lows last year. In the third quarter personal sector saving as a proportion of disposable income dropped to a mere 5%, the lowest level seen since the late 1950s. Even if it perked up in the final quarter, it is likely that the saving ratio in 1987 as a whole was less than half the peak rate of over 14% registered in 1980.

Revealed in the official statistics, then, we have the dramatic vision of British households becoming increasingly less provident and living instead on tick. The drama can be heightened further by deducting from personal saving the cash flow of life assurance and pension funds which the official statistics lump in with the personal sector. After this deduction, it appears that households were actually **dis-saving** – a negative saving ratio – to the tune of 2% of their incomes in 1987. On this definition, the saving ratio has fallen a full 9 percentage points since 1980. This compares with a drop of a mere 8 percentage points in the official personal sector measure (Table 1, Graph 1).

Graph 1 The collapsing saving ratio



Surveying the scene of booming credit growth and pounding activity the Bank of England warned darkly in its latest bulletin that 'The sharpness and extent of the recent fall in savings raises questions about the appropriate response of monetary and fiscal policy'. And it added: 'the latest economic and monetary indicators depict a still buoyant economy amply provided with credit, giving little sign so far that the pressures from domestic demand will abate soon'. The Bank's nightmare is that the glacier of liquidity, represented by the overhang of over-fast money supply growth, is at last melting. **Households' collective attempt to offload excess money balances could be driving saving down, pushing consumption up and sending the economy into overdrive.**

D FOR ACCURACY

Fears about overheating are quite justified in our judgement. The economy's true growth rate in the second half of last year at around 7% (ex-oil) was well in excess of most estimates of the rate of expansion compatible with stable and low inflation. But the monetarist interpretation of events and of consumer behaviour in particular is far more open to question.

The problem is one of simple fact. Official statistics on personal sector savings are dreadfully inaccurate. They are derived as the difference between two large numbers – for personal disposable income and consumption. So comparatively small errors in estimating either of these magnitudes can have a disproportionate impact on the measure of saving. On 1986 figures, a 1% under-estimate of disposable income combined with a 1% over-estimate of consumption would have generated a 26% under-statement of total saving and a 1¾% percentage point understatement of the saving ratio.

In terms of reliability, the statisticians award their estimates of saving the wooden spoon: a D rating. This makes saving numbers amongst the least reliable of all national account statistics, fluctuating between plus or minus 20% of the true figure 90% of the time. The latest provisional figures are naturally even more suspect. **Indeed, there are good reasons for believing that the recent plunge in savings is grossly over-stated. A measure of saving inferred from the personal sector's investment and borrowing activities suggests that the saving ratio may even have risen last year, with savings in the third quarter 240% higher than the official measure!**

The alternative measure is derived from the identity which links the sources and uses of funds in the personal sector. The sources of its funds are saving, as officially defined, and new borrowing. The uses to which these funds can be put include physical investment, purchasing homes for example, and all forms of financial investments – ranging from simple deposits with banks and building societies to investments in stocks and shares.

In theory, the total use of funds should just exhaust the sum raised from the various sources. By implication, the official measure of saving should equal the value of physical investment by the personal sector plus its acquisition of financial assets, net of new borrowing.[1] But in practice, there is an awfully large gap between these two definitions of saving, thanks to measurement errors in various parts of the accounts.

[1] Denote S = officially-defined saving, B = new borrowing, I = physical investment, D = deposits and acquisition of other financial assets. Sources of funds = S+B. Uses of funds = I+D. In the absence of measurement errors, S+B = I+D. It follows that S = I+D−B where D−B is the net acquisition of financial assets.

Table 1 The collapsing saving ratio (saving as % of disposable income)

	1963	1973	1980	1983	1984	1985	1986	1987†
Official measure	8	11	14½	10½	10½	9	7½	6½
Less pension fund flows	3	4½	7	2½	2½	1	−½	−2

† First three-quarters only. Figures rounded to nearest ½%.

Personal sector figures are particularly prone to error since a number of items are obtained only as a residual after all the transactions of the other sectors in the economy have been taken into account. Estimates obtained this way include those for dividend and net interest receipts and for transactions in financial assets like gilt-edged and company securities. As a result the personal sector ends up as a dustbin for the errors and omissions in the statistics for other parts of the economy.

Table 2 How much saving in 1987 Q3?

£m	
Official measure	
Personal disposable income	69,679
Less: consumers' expenditure	66,132
Equals: saving	3,547
Alternative measure	
Acquisition of financial assets	15,948
Less: borrowing	10,103
Plus: investment*	6,176
Equals: 'saving'	12,021
Plus: consumers' expenditure	66,132
Equals: 'personal disposable income'	78,153
Plus: balancing item	−8,474
Equals: official personal disposable income	69,679
Memo: saving ratio (%) official	5.1
alternative	15.4

* Includes net capital transfers. Figures are not seasonally adjusted.

Table 2 shows the derivation of the alternative measure of saving in the third quarter of 1987. Instead of £3½bn of saving and a saving ratio of 5%, the alternative measure gives £12bn of saving and a saving ratio in excess of 15%. The balancing item, the gap between the two measures, was a cool (negative) £8½bn, 12% of measured income.

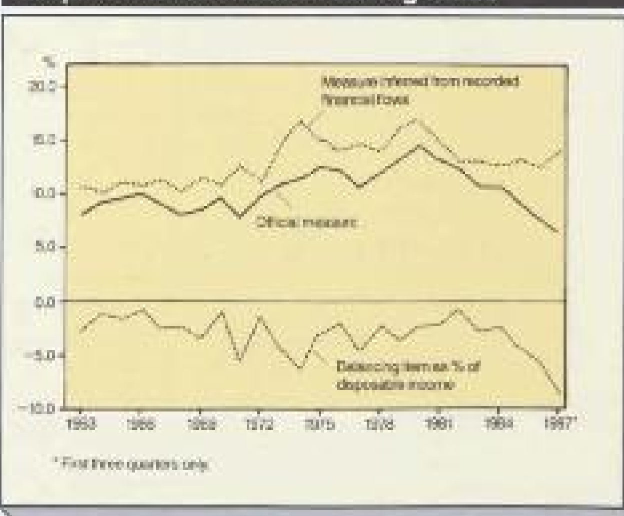
Graph 2 and Table 3 show longer-term comparisons of the two saving measures. Three features stand out:

- **The saving ratio inferred from financial flows is generally in excess of the official definition.** Between 1963 and 1985, the average excess each year was around 2½ percentage points. The gap varied considerably, though most of the variation was contained within a range of ½ to 4½ percentage points.

- **The saving ratio on the alternative measure stays broadly stable after 1981 at around 13% sharply in contrast to the precipitous fall in the official measure.**

- **The gap between the two measures widened dramatically in 1986 and 1987: first to 5 and then to 7 percentage points.** The balancing item, meanwhile, plumbed new depths.

Graph 2 Personal sector saving ratios



UNDERSTATED INCOMES?

Although errors in a number of items will have contributed to the growing balancing item, the most interesting possibility is that the official statistics may have progressively understated incomes and therefore saving. A likely culprit is the estimate of personal sector **rent, dividend and net interest payments.** As one of the items in the personal sector which is inferred by residual, it is rightly regarded as pretty unreliable. It scores a possibly generous C rating in the national accounts; that is, accurate within plus or minus 10 to 20%.

Table 4 shows the latest available official figures split between the receipts of life assurance and pension schemes and those of households, unincorporated businesses and non-profit making bodies which comprise the rest of the personal sector. A surprising feature is the collapse in the net receipts of this latter group after 1983. Recorded net receipts dropped to minus £1bn by 1986 having run at a positive £2½-3bn pa in the second half of the 1970s and early 1980s.

Table 4 Rent, dividend and interest receipts*

£bn	1981	1982	1983	1984	1985	1986
Receipts by						
Funds etc	8.8	10.5	11.8	14.0	15.9	17.4
Other	2.9	2.8	2.4	0.6	−0.6	−0.9
Total	11.7	13.3	14.2	14.6	15.3	16.5

* Excluding imputed rent of owner-occupied dwellings.

One explanation of this decline is the surge in mortgage interest payments as households took on ever-more home loans. The movement in the stock of the personal sector's net financial assets on which interest is likely to be payable provides mild support for this view. The approximate measure given in Table 5 shows net assets in this sense falling after 1984, while mortgage payments were boosted in 1985 by the rise in mortgage rates. The sharp fall in net receipts in 1984 is less easy to explain in these terms, however.

Table 3 Alternative measure of saving § (% of disposable income)

	1963	1973	1980	1983	1984	1985	1986	1987*
Saving ratio	10½	14½	16½	13	12½	13	12½	13½
Memo								
Balancing item §§	−3	−4½	−2½	−3	−2½	−4½	−5½	−8½
Saving gap ††	2½	4	2	2½	2	4	5	7

* First three quarters only. Figures rounded to nearest ½%.
§ Saving ratio inferred from investment and identified net financial flows.
§§ As a % of disposable income.
†† Differences in percentage points between official and inferred saving ratios.

Table 5 Assets and liabilities*

£bn	1982	1983	1984	1985	1986	1987H1
Assets†	186.0	210.8	236.4	262.8	289.5	326.3
Liabilities	116.6	138.3	162.1	189.0	220.9	257.8
Net assets	69.4	72.5	74.3	73.8	68.6	68.5
Memo						
Building society:						
share rate %	8.8	7.3	7.7	8.7	7.9	8.0
mortgage rate %	13.3	11.0	11.8	13.5	11.9	12.0

* Personal sector excluding insurance and pension funds, average year estimates.
† Excluding direct equity holdings.

Further doubts are raised by the behaviour of balancing items in the other sectors of the economy. The outstanding feature of these black holes in the official statistics is the large and offsetting movements for the personal and overseas sectors (Table 6). Between 1982 and 1986, the negative personal sector balancing item worsened by £12½bn while the positive overseas sector balancing item rose by £13bn. In 1987, however, this inverse relationship broke down. On provisional numbers, the personal sector's balancing item finds a counterpart in the company and monetary sectors, not in the overseas sector. The offsetting movements in balancing items of personal and overseas sectors in the earlier period nevertheless provides an important clue to the behaviour of true saving.

Table 6 Sector balancing items

£bn	1982	1983	1984	1985	1986	1987*	Change 1982-86
Sector							
Public	−0.8	1.3	0.2	0.2	0.7	0.3	1.5
Company†	7.0	5.0	2.3	6.4	4.6	20.8	−2.4
Personal	−1.8	−5.9	−5.3	−10.4	−14.4	−15.9	−12.6
Overseas	−1.1	1.7	5.8	4.9	11.9	1.3	13.0
Total **	3.3	2.1	2.9	1.0	2.9	6.5	−0.5

* First three-quarters, not seasonally adjusted.
† Includes monetary sector and other financial institutions.
** Equals the income measure of GDP (£323.8bn in 1986) less the expenditure measure of GDP (£321bn in 1986). Figures subject to rounding error.

The large statistical hole in the overseas accounts arises from the gap between the recorded balance of payments on current account and net recorded financial flows across the exchanges. In 1986, for example, the current account was in deficit to the tune of £1bn. In theory, this should have been financed by a net capital inflow of similar size. But in fact recorded financial outflows across the exchanges exceeded inflows by £11bn. The overseas balancing item was therefore a huge £12bn.

Conventional wisdom has it that most of the errors in the overseas account occur in the measurement of capital flows. But there are good grounds for believing that part of the problem stems from an under-recording of net invisible earnings, especially on portfolio income (see Economic Briefing note No 154). On present methods of estimation, under-recording of the UK's invisible earnings would feed through one-for-one into an underestimate of personal sector incomes and saving. Table 7 shows how the saving ratio looks after adjustment for our conservative guesstimates for under-recorded invisibles. On these tentative numbers, the adjusted saving ratio falls less sharply than the official measure between 1980 and 1984. But the fall thereafter is more pronounced.

In more recent years, then, other factors may have been at work depressing measured incomes. An increase in **black economy** activity is one possibility. Official figures on incomes are based largely on returns to the Inland Revenue whereas spending figures are derived from surveys which guarantee anonymity from the tax man. If tax evasion increases, official statistics will tend to understate income in relation to spending, biasing down measured saving.

To cope with this problem, the official statisticians make a rough allowance for evasion, incrementing their initial estimates of income especially of the self-employed. The total allowance has been fixed at 1½% of the expenditure measure of GDP from 1981 onwards, an addition currently worth about £4½bn pa. Despite the allowance, the error-prone estimates of self-employment income rate only a C for reliability in the national accounts.

The suspicion is that the evasion allowance is too small. The official allowance does not purport to be a measure of the black economy in total; it is just a device for reducing the gap between **initial** estimates of income and expenditure in the economy as a whole. The trend in that gap largely determines the size of the official allowance. Unfortunately, this procedure cannot detect certain types of concealed income (like transfers) or concealed expenditure. Moreover, there is a whole host of measurement difficulties, like sampling and timing errors, which contribute to the difference between income and expenditure estimates of GDP. Consequently, the official procedure does not provide a particularly reliable basis for measuring black economy activity.

More reliable estimates have been compiled by Stephen Smith at the Institute for Fiscal Studies. After a

Table 7 Personal saving — invisible adjustment

	1979	1980	1981	1982	1983	1984	1985	1986
Invisibles adjustment £bn	0	+½	+1	+1½	+2	+3	+2½	+2
Saving ratio %:								
official	13	14½	13	12	10½	10½	9	7½
adjusted	13	14½	13½	13	11½	11½	10	8

comprehensive review of the evidence, he put the size of the black economy at 3-5% of GDP. Even allowing for some differences of definition, this range is well above the official guesstimate and suggests the need for a larger evasion increment to official estimates of income.

Taking the mid-point of Smith's range, we would raise current official estimates of personal pre-tax incomes by over £9bn pa. The increment to measured saving would be less because the official figures miss out taxes payable on black economy earnings. Yet even if the addition were only two-thirds of that to income, current estimates of saving would have to be raised by some 40%, boosting the saving ratio by over 2 percentage points.

Regrettably, an addition of this sort would create another headache for official statisticians. It would increase the amount by which published estimates of GDP based on income statistics already exceed those based on expenditure statistics (Table 6). Official statisticians are naturally very keen to keep this important overall residual error in the nation's statistics as small as possible. **Yet the truth may well be that personal sector incomes and saving are billions of pounds greater than estimated, thanks to the black economy. At the same time and for other reasons, there could be large-scale under-recording of expenditure outside of the personal sector — company investment, for example, or exports.**

Important though they are, black economy considerations do not necessarily explain the downward trend in the measured saving ratio. The trend would have been depressed only if the black economy were expanding in relation to the white economy. For this, Smith says there is no evidence. Nor can the black economy explain another puzzling feature of personal sector statistics — the remarkable strength of tax payments in relation to measured pre-tax incomes. Underlying tax payments, adjusted for changes in tax rates and allowances, were growing twice as fast as pre-tax incomes in the first half of fiscal 1987, implying a tax elasticity of 2 (Table 8). In 1983 and 1984, the elasticity was just 1.4 but has since shown a very pronounced upward trend. Although changes in income distribution may be partly responsible for tax buoyancy, tax experts admit to being stumped for a satisfactory explanation. So the suspicion arises that the official figures may have understated taxed income in more recent years.

Table 8 Taxes and personal incomes

FY	1983	1984	1985	1986	1987H1*
% growth, year-on-year					
Pre-tax income	8.0	6.8	8.0	7.9	7.2
Tax payments †	11.2	9.6	13.3	14.0	14.7
Tax elasticity§	1.40	1.42	1.66	1.77	2.04

* Based on non seasonally adjusted figures. † At given 1982/83 tax structure. § Growth in tax payments divided by growth in pre-tax personal income.

A possible culprit is the estimate **of wage and salary income** though this is not an explanation which would find great favour in official circles. The statisticians regard their estimates of wages and salaries as the bee's knees. Based on a 1% sample of tax deduction documents, the estimates are given the accolade of an A rating — reliable to within plus or minus 3% of the truth. But these high-quality sample estimates are currently available only up to and including the 1985 tax year. For most of 1986 and for all of 1987, wages and salaries are derived more uncertainly from an annual survey of average earnings, the Department of Employment's monthly and quarterly numbers on employees in employment and on earnings and from some limited evidence on income tax flows. In the past, it was discovered that estimates based on earnings and employment figures understated the growth in wage and salary incomes. Although a corrective for understatement is now applied, the chances are that it is too small.

TRUE SAVING?

It would be wrong to leave the impression that errors in personal sector statistics arise exclusively in the measurement of income. Estimates of financial transactions are also unreliable and prone to large revisions. Our preference is to take a simple average of alternative measures to get a better guide to saving trends. In 1987, the average of the official measure of saving and the alternative measure based on financial flows suggests a 'true' saving ratio of around 10-3½ percentage points above the official number. As Table 9 shows, this gap can be explained reasonably well in terms of under-recorded invisible receipts of dividends and interest and concealed domestic incomes in the black economy. These two factors would leave less than 1 percentage point to be explained by downward bias in the measurement of taxed incomes — well within the bounds of possibility.

Table 9 Saving breakdown in 1987 %

Average measure	10	
Official measure	6½	
Difference	3½	
Of which		
Under-recording of invisibles		½-1
Black economy under-recording		2-2½
Residual		0-1

Table 10 and Graph 3 overleaf compare the recent history of the official and average measures of the saving ratio. Two features stand out.

- Both measures indicate a marked fall in saving in the personal sector since the 1980 peak. Lower inflation and easier access to credit probably explain much of this change in behaviour.

- The fall in the saving ratio on the average measure is much less pronounced especially for years after 1984. Between 1984 and 1987, the average measure falls only 1½ percentage points. In contrast, the official measure dives 4 percentage points.

The conclusion is that the monetarist interpretation of recent consumer behaviour is probably misplaced. The boom in consumers' spending in 1987 was probably due to fast growth in incomes rather than to a collapse in saving. If the true saving ratio remained unchanged, disposable incomes probably rose by 8½% last year —

about 1 percentage point above the likely outturn on official figures.

All this is frankly cold comfort for the forecaster and policy maker. If the economy is to make a smooth and painless transition from excessive election year growth to more sustainable growth in 1988 and 1989, consumers' spending must slow down. **But sucked into the mire of unreliable statistics, forecasters' projections of consumption can be little more than stabs in the dark. The policy implication is that the Chancellor should play it safe, tightening his Budgetary policy while standing ready to cut interest rates should activity take an unexpected dive. The economy does not warrant tax cuts. But the Chancellor could with advantage spend a little more money to improve the quality of the nation's economic statistics.**

Graph 3 The truth about personal saving?

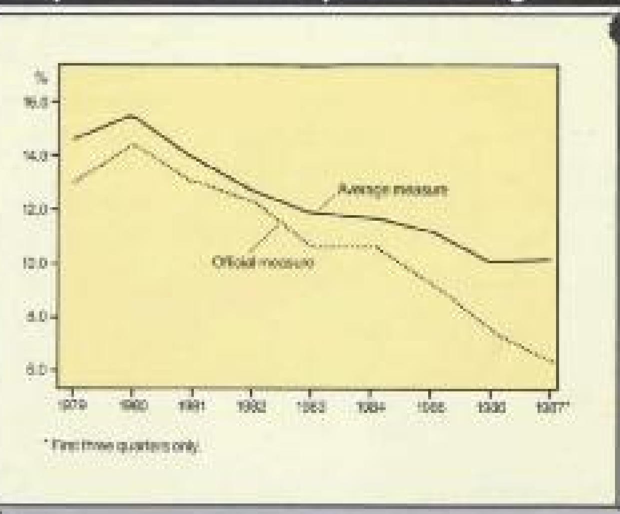


Table 10 Saving ratios compared

	1979	1980	1981	1982	1983	1984	1985	1986	1987*
Official	13	14½	13	12	10½	10½	9	7½	6½
Average	14½	15½	14	12½	12	11½	11	10	10

* First three-quarters only. Figures rounded to nearest ½%.

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From the Private Secretary

20 January 1988

Dear Alex,

The Prime Minister and the Chancellor this morning had a general discussion about economic policy against the background of Sir Terence Burns' note of 18 January. Sir Peter Middleton, Sir Terence Burns and Professor Brian Griffiths were also present.

The Prime Minister said there were a number of features of the economic scene that caused her concern. Inflation remained stubbornly high, particularly in relation to key competitors, and latest figures on earnings and unit labour costs pointed to the dangers of inflation accelerating. Allied to this, the personal savings ratio had fallen to very low levels. The trend of the balance of payments current account was adverse with a significant deficit now emerging; it was essential the UK did not take the place of the United States as a major deficit country. Action to sterilise the large increase in foreign currency reserves had led to large overfunding during 1987. The public finances were at risk if oil prices fell. And the ratio of net public sector debt to GDP remained at very high levels compared with other countries.

In discussion the following points were raised:

(i) The political difficulties of the trend in the current account should not be underestimated, and would be exacerbated if there were downward adjustments to the figures for invisibles. On the other hand, recent balance of payments figures had been marked by a large positive balancing item which could lead to favourable corrections. In addition the current size of the deficit was only around half a percent of GDP and, unlike the balance of payments crises of the 1960s and early 1970s, it was associated with a strong underlying economic performance.

(ii) The interpretation of the current account deficit (equivalent to a surplus for the overseas sector) also had to take account of the position in other sectors of the economy. Historically, whenever the public sector had been in the broad balance, there had been no sustained overseas sector surplus. But

the present position of the private sector was also unusual, with a move into deficit. To the extent that this private sector deficit reflected strong investment growth, a relatively relaxed view could be taken of its being financed from overseas - in effect the current account deficit had been privatised.

(iii) There had been a small public sector surplus in 1970 but the opportunity that presented had then been wasted by allowing public expenditure to run out of control. It was therefore important to ensure that the present position of broad public sector balance was sustained against a background of rising public expenditure commitments, particularly on the pay front.

(iv) Interpretation of the present low savings ratio was particularly difficult. The statistics were bedevilled by a large residual error. It had to be remembered that the savings ratio was measured net and that the reduction in recent years in large part reflected the build up of mortgage borrowing. This was associated with heavy consumer expenditure on items such as kitchens and white goods. One view of the prospect for 1988 was for a substantial slowdown in this type of consumer expenditure, a view supported by recent discussions with the Retail Consortium. On this view it was reasonable to expect some increase in the savings ratio during 1988 which would provide an automatic correction of the pressures on inflation and the trade balance. GDP growth during the course of 1988 might slow to say 2 - 2.5 per cent.

(v) An alternative scenario was one in which consumption-led growth continued at a high rate with no recovery in the savings ratio. On this basis the case for a restrictive fiscal stance was even stronger and would need to be coupled with some tightening of monetary policy.

(vi) There were indeed substantial grounds for considering an early move to raise interest rates by half a percent to tighten the monetary stance. If the circumstances and timing were right this need not necessarily mean upward pressure on the exchange rate. On the other hand, if the exchange rate was pushed up and unsterilised intervention was carried out to hold sterling below DM 3 that would simply offset the desired monetary effect. In those circumstances a tighter monetary stance could only be achieved by allowing the exchange rate to rise.

(vii) Table 6 of Sir Terence Burns' paper pointed to the broadly unchanged ratio of taxes and NICs to GDP in recent years. This single aggregate figure was

difficult to interpret as there were different trends for some of the component elements. But a major factor in the continuing strong tax take was the buoyancy of corporation tax as profits rose. In addition, although income tax allowances were indexed for price movements, there was still fiscal drag in the system resulting from real growth. One view of this phenomenon was that 'tax cuts' were no more than returning to taxpayers the additional tax burden generated by growth. There was a related point that, in terms of presentation, the single banner of 'tax cuts' should not be applied to a position in which, although marginal tax rates might be reduced for many taxpayers, the overall tax burden was little changed and was financing a continuing high level of public expenditure.

Summing up the discussion the Prime Minister said it was essential not to take a complacent view of current economic prospects and she felt it was important she should use Question Time and other opportunities to damp down the recent public mood of euphoria about the Budget prospects. She invited the Chancellor to propose some suitable forms of words for this purpose. It would also be helpful if the Treasury could provide a breakdown of the aggregate figures for the ratio of taxes and NICs to GDP.

Yours,
Paul

PAUL GRAY

Alex Allan, Esq.,
H.M. Treasury

PRIME MINISTER

ECONOMIC POLICY DISCUSSION WITH THE TREASURY

This note draws heavily on comments from Brian Griffiths. Sir Terry Burns has tabled the paper at Flag A for tomorrow's meeting. It is more sketchy than we might have hoped. But I think we can take it as the starting point for discussion.

Objectives for the Meeting

You are dining with the Chancellor next Sunday when he will reveal his Budget thinking to you. I suggest you keep off possible Budget details tomorrow but one of the key elements for discussion must be the appropriate broad fiscal stance.

Additional Material

I attach at Flag B some further tables breaking down the figures for GDP and inflation for the G7 countries - this supplements the summary table 1 in the Treasury paper. There are also two tables showing current account balances for the same countries both in absolute terms and as percentages of GDP. You might also like to refer back to the summary forecast published in the 1987 Autumn Statement (but N.B. these published figures are not necessarily the same as the Treasury's internal Autumn forecasts).

I hope the Treasury will also bring with them some figures on net debt and net debt interest as a percentage of GDP for other countries to supplement the figures in table 3 of the Treasury paper.

Background

The starting point is:

(i) considerable success in UK performance over the last four years in terms of growth, productivity, investment, employment and profitability;

(ii) a less good result in terms of inflation and more rapid growth of money GDP than expected;

(iii) cause for concern over the trend in the balance of payments current account - a surplus of £2.8 billion in 1985 to a prospective deficit in 1987 of £2.5 billion possibly rising from now on;

(iv) much more rapid than expected growth in tax receipts, leading to a large fiscal adjustment for 1988/89. Recent City estimates if anything understate this; I gather the Treasury's latest figure is for a PSBR surplus of £9 billion if there were no tax cuts (not to be revealed tomorrow).

Where is the economy now and where is it heading?
Before moving to the Treasury's suggested issues for discussion you might press them a lot further for their forecast for the next 18 months. Terry Burns' paper is particularly thin on this. Questions could include:

Growth 1988-9?

(i) prospects for real growth following the stock market collapse. Do the latest business surveys, retail sales figures, etc. suggest a significant impact on growth? N.B. paragraph 6 of Terry's paper says the 1988 year on year growth of GDP could be above 2.5 per cent but with a slow down during the year.

BoP?

(ii) What do they expect the current account balance to be in 1988?

Inflation

(iii) What is likely to happen to the underlying rate of inflation, eg. after ignoring mortgage effects and bearing in mind the likely slow down in productivity growth?

Savings ratio.

(iv) Will the savings ratio recover at all?

(v) Is the buoyancy of tax revenue expected to continue?

Wage increases?

Issues for discussion

The order suggested at the end of the Treasury paper seems sensible.

(a) Output growth, market uncertainties and monetary and fiscal policies.

(i) What are the chances of a recession in the US economy?

(ii) What are the Treasury's views of the prospects for the dollar (assuming it was allowed to find its own level)

Oil prices

(iii) How sensitive is UK growth to oil prices and any delayed effects of the stock market crash?

(iv) What exactly do the Treasury mean by 'a cautious fiscal and monetary policy'?

(b) Taxes and the fiscal stance.

Table of the Treasury paper shows that total taxes plus NICs as a proportion of GDP have changed little; and the proposal is to continue this broadly unchanged ratio. But what exactly would that imply for the size of tax cuts/PSBR in the Budget?

(c) Balance of Payments and Exchange Rates

This is probably the most difficult set of questions. The Treasury paper is very relaxed about running a current account deficit (i.e. an overseas sector surplus) of some one per cent of GDP (£4 billion), when the public sector is in broad balance and the private

sector is in deficit (reflecting a strong growth of private investment). You may like to probe this carefully. The danger is that an over-relaxed fiscal stance which allowed consumer spending to continue to grow rapidly could substantially worsen the current account deficit. Might not a tight budget act to curb consumption, help restore the savings ratio and simultaneously both ease inflationary pressures and help the current account deficit?

(d) Inflation and Monetary Policy

(i) what is "adequate downward pressure on inflation"? Does this need to be given higher priority?

(ii) what does avoiding "excessive upward pressure on the exchange rate" mean? If it means holding to something like the DM3 cap this could mean putting the weight of monetary adjustment on interest rates And if there is still market pressure to push up the exchange rate we will add further to the reserves and loosen the monetary stance. (But NB the comments in paragraph 11 of the Treasury paper that nearly three-quarters of this year's intervention has been sterilised.)

PRCG.

(PAUL GRAY)
19 January 1988

FIGURES PROVIDED BY
TREASURY AT 20/1/88 MEETING

Net Public Debt as a Percentage of GNP/GDP in the Major Countries

Net General Government Debt

(Net General Government Interest payments as a Percentage of GNP/GDP in brackets*)
- Source OECD

	1980	1986(1985)
US	19.5(2.0)	28.8(3.7)
Japan	17.3(1.2)	26.2(1.7)
Germany	14.3(0.9)	22.2(1.7)
France	9.1(1.0)	18.5(2.0)
Italy	61.8(5.4)	99.2(8.7)
Canada	11.5(2.0)	34.0(4.4)
G7 Average	21.8	32.2

*Estimated from OECD National Accounts data. Figures are not entirely consistent between countries but they illustrate the broad pattern of change.

B

Real GDP/GNP

Percentage growth rates

	1983	1984	1985	1986	1987	Average 1983-1987
UK	**3.3**	**2.4**	**3.6**	**3.0**	**4**	**3.3**
US	3.6	6.8	3.0	2.9	2¾	3.8
Japan	3.3	5.0	4.8	2.5	3½	3.8
Germany	1.9	3.3	2.0	2.5	1½	2.2
France	0.7	1.4	1.7	2.0	1½	1.5
Italy	0.5	3.5	2.7	2.7	2¾	2.4
Canada	3.2	6.3	4.3	3.3	3¾	4.2
Major 7	2.8	4.9	3.1	2.7	2¾	3.2

Source: OECD, CSO, Autumn Statement

Consumer Price Inflation

Annual percentage changes

	1983	1984	1985	1986	1987*	Average 1983-1987
UK	**4.6**	**5.0**	**6.1**	**3.4**	**4.2**	**4.7**
US	3.2	4.2	3.6	1.9	3.6	3.3
Japan	1.8	2.3	2.0	0.4	0.2	1.3
Germany	3.3	2.4	2.2	0.2	0.2	1.6
France	9.4	7.7	5.8	2.5	3.3	5.7
Italy	14.6	10.8	9.2	5.8	4.7	9.0
Canada	5.8	4.3	3.9	4.2	4.4	4.5
Major 7	4.6	4.5	3.9	1.9	2.7	3.5

Source: OECD, CSO

* US,UK, Germany and Italy: January to November
Japan, France and Canada: January to October

Current Account Balances $ billion

	1983	1984	1985	1986	1987	Average 1983-1987
UK	**5**	**2**	**4**	**- 1**	**- 4***	**1**
US	- 46	- 107	- 116	- 141	- 156	- 113
Japan	21	35	49	86	86	55
Germany	4	8	15	37	44	22
France	- 5	- 1	0	3	- 3	- 1
Italy	2	- 2	- 4	4	- 2	0
Canada	2	3	- 1	- 7	- 7	- 2
Major 7	- 17	- 62	- 53	- 20	- 42	- 39

* Autumn Statement forecast

Source: OECD

Current Account Balances

Percentage of GNP/GDP

	1983	1984	1985	1986	1987	1983-1987 Average
UK	**1.1**	**0.5**	**0.8**	**- 0.3**	**- 0.6***	**0.5**
US	- 1.4	- 2.8	- 2.9	- 3.4	- 3.5	- 2.8
Japan	1.8	2.8	3.7	4.4	3.6	3.3
Germany	0.6	1.3	2.4	4.1	3.9	2.5
France	- 0.9	- 0.2	0.0	0.4	- 0.3	- 0.2
Italy	0.4	- 0.5	- 0.8	0.7	- 0.3	- 0.1
Canada	0.8	0.8	- 0.3	- 1.9	- 1.7	- 0.5
G7 total	- 0.2	- 0.8	- 0.7	- 0.2	- 0.4	- 0.5

* Autumn Statement forecast

Source: OECD

1987 AUTUMN STATEMENT

Table 1.12 Economic prospects: summary

	Forecast 1986 to 1987	Forecast 1987 to 1988	Average errors from past forecasts[1]
	per cent changes		percentage points
Output and expenditure at constant 1980 prices			
Domestic demand	4	3½	1
of which:			
Consumers' expenditure	5	4	1¼
General government consumption	½	½	1
Fixed investment	5½	4½	2¼
Change in stockbuilding (as per cent of level of GDP)	0	0	½
Exports of goods and services	5½	2	2½
Imports of goods and services	6½	5	2¾
Gross domestic product: total	4	2½	¾
manufacturing	5	3½	2¼
Inflation			
Retail prices index	per cent changes		
1986 Q4 to 1987 Q4	4		¼
1987 Q4 to 1988 Q4	4½		2
Deflator for GDP at market prices	per cent changes on a year earlier		
Financial year 1987–88	4¼		1
Financial year 1988–89	4½		2
Money GDP at market prices	£ billion[2]		
Financial year 1987–88	418 (8½)		1
Financial year 1988–89	448 (7¼)		1½
Balance of payments on current account			
1987	−2½		1½
1988	−3½		3

[1] The errors relate to the average differences (on either side of the central figure) between forecast and outturn; the errors given for constant price output and expenditure are relevant to the forecast for next calendar or financial year. The method of calculating these errors has been explained in earlier publications and Government forecasts (see Economic Progress Report June 1981). The calculations of average errors are based on forecasts made between 1975 and 1985.

[2] Per cent change on previous financial year in brackets; average error shown relates to the forecast of the percentage change.

psl/29A Covering CONFIDENTIAL

A

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

18 January 1988

P R C Gray Esq
10 Downing Street
LONDON SW1

Dear Paul,

THE ECONOMIC SITUATION

... I attach a note by Sir Terence Burns for discussion at the Prime Minister's meeting on Wednesday, 20 January.

Yours
Alex

A C S ALLAN

CONFIDENTIAL

THE ECONOMIC SITUATION - JANUARY 1988

A note by the Chief Economic Adviser

All the major economies have now been expanding for five years since the recession - some, among them the UK, for rather longer. Growth weakened a little after the strong recovery of 1984, but remained in the 2½-3½ per cent range. Recent evidence suggests that activity was picking up again in 1987 particularly in the US and Japan, although it remained weak in Continental Europe. Consumer price inflation in the main industrial countries rose during 1987 as the impact of the earlier fall in the oil price diminished.

2. Growth in the main industrial countries is expected to remain buoyant in the first half of 1988. The stock market collapse may have a perceptible effect on demand in the US though there are few signs of it yet. Only weak effects are expected elsewhere.

Table 1

World Growth and Inflation

Percentage changes

	Major 7 GNP	Major 7 CPI
1983	2.8	5.0
1984	4.9	4.3
1985	3.1	3.9
1986	2.7	2.1
1987E	2.9	2.9

E: Treasury estimate

3. The UK economy is performing well. Growth and inflation in recent years have been much the same as in the 1950s and 1960s in contrast to the major industrial countries where growth has been less and inflation no better.

Table 2

UK Economic Indicators

Percentage changes

	GDP	Retail prices index	Manufacturing Productivity	Profitability* (level)
1983	3.3	4.6	8.6	4.8
1984	2.4	5.0	5.6	5.6
1985	3.6	6.1	3.3	7.2
1986	3.0	3.4	2.8	8.9
1987E	4.2	4.1	7.2	10.4

*Net return on capital employed by non-North Sea industrial and commercial companies

E: Treasury estimate

4. There are increasing signs of a real supply side improvement - faster growth of productivity, better profitability, improved rates of return on investment and much better than expected trade (especially export) performance.

5. The Government's own accounts are in good order - for the current financial year the PSBR is likely to be negative.

6. The increase in GDP in 1988 over 1987 could be higher than the 2½ per cent envisaged in the Autumn Statement. But the rate of growth is expected to slow down through the year following the very sharp rise in output through 1987. This would imply no further rise in the pressure of demand at home this year.

7. Money GDP has been growing faster than envisaged in successive editions of the MTFS: most of this excess has been due to faster growth of output. Inflation has been fairly steady, averaging around 4½ per cent over the past five years, with most of the fluctuations in the RPI due to mortgage rates and oil prices. The combination of rapid growth and low inflation is further evidence of the improvement in overall economic performance and the efficacy of the Government's stance against inflation. In the past, periods of rapid growth have habitually led to a pronounced rise in inflation.

8. Commodity prices rose during 1987 and recently pay settlements have been drifting up following an earlier decline; but unit costs have grown very little because of the rapid growth of productivity. CBI surveys show no substantial rise in the proportion of firms expected to raise prices in the next few months.

Table 3

Net Debt and Net Debt Interest as a Percentage of GDP

	1983-84	1984-85	1985-86	1986-87	Latest Estimate 1987-88
Ratio of net public sector debt* to GDP, end year	46.5	46.6	44.9	42.6	38.4
Public sector net debt interest payments as a percentage of GDP	3.1	3.3	3.1	3.0	2.7

*Bank of England definition

9. Fiscal policy has been tighter than originally intended for the past two years. Even allowing for faster growth of output and for higher privatisation proceeds the PSBR has turned out below expectations. The ratio of public sector debt to national income has been falling, contributing to a declining ratio of interest

payments to GDP unlike most other major countries where the interest burden is rising. Estimates for 1987 show a tighter fiscal stance in the UK than in any of the other G7 countries except Japan.

Table 4

General Government Financial Balances*

(as per cent of GDP/GNP)

	United States	Japan	Germany	France	United Kingdom	Italy	Canada
1979	0.5	-4.7	-2.5	-0.7	-3.3	-10.1	-2.0
1985	-3.3	-0.8	-1.1	-2.9	-2.9	-12.3	-7.0
1986	-3.5	-0.9	-1.2	-2.9	-2.6	-11.2	-5.5
1987	-2.4	-1.2	-1.7	-2.8	-1.5 (-1.1)**	-10.3	-4.4

*These figures do not take credit for privatisation proceeds

**Financial year 1987-88

Source: OECD Economic Outlook, except for the 1987 UK figure which is the latest Treasury estimate

10. The evidence on monetary conditions is more difficult to assess. MO remains within the target range, though in the upper half of it. It may temporarily move outside the range in the next few months but is expected to come back in the first half of the next financial year. Measures of broad money continue to grow rapidly, reflecting the strength of bank and building society lending.

Table 5

Indicators of Monetary Conditions

	M0[1] Growth (%)	M4[1] Growth (%)	Exchange Rate Index (1975=100)	Short-term Interest Rates (%)	Long-term Interest Rates (%)
1980-81	7.1	15.9	98.2	15.5	13.6
1981-82	5.3	18.1	92.3	14.2	15.0
1982-83	3.2	16.3	88.0	11.5	12.1
1983-84	6.0	13.3	83.5	9.7	10.5
1984-85	5.5	13.2	76.2	10.9	10.9
1985-86	4.3	13.6	79.0	12.1	10.4
1986-87	4.3	15.2	71.5	10.5	9.7
Latest Observation	4.3[2]	15.2[3]	74.7[4]	9.0[4]	9.7[5]

[1]Percentage change of average level outstanding during year

[2]12 months to December 1987, seasonally adjusted

[3]12 months to November 1987, not seasonally adjusted

[4]Close 15 January 1988

[5]Close 14 January 1988

11. The exchange rate has risen over the past 12 months and the sterling index is about 8 per cent higher than a year ago. Only part of this rise is due to the fall in the dollar; the £ has also risen 6 per cent against the deutschemark over the year. Net funding over the first 9 months of the year was around £7½ billion compared with a PSBR of minus £½ billion. We have thus already sterilised three-quarters of this year's foreign exchange intervention, and at the present rate of funding it should all have been sterilised by the end of the financial year.

Not Int. Fund

Table 6

Expenditure, Taxation and Borrowing
(percentage of GDP)

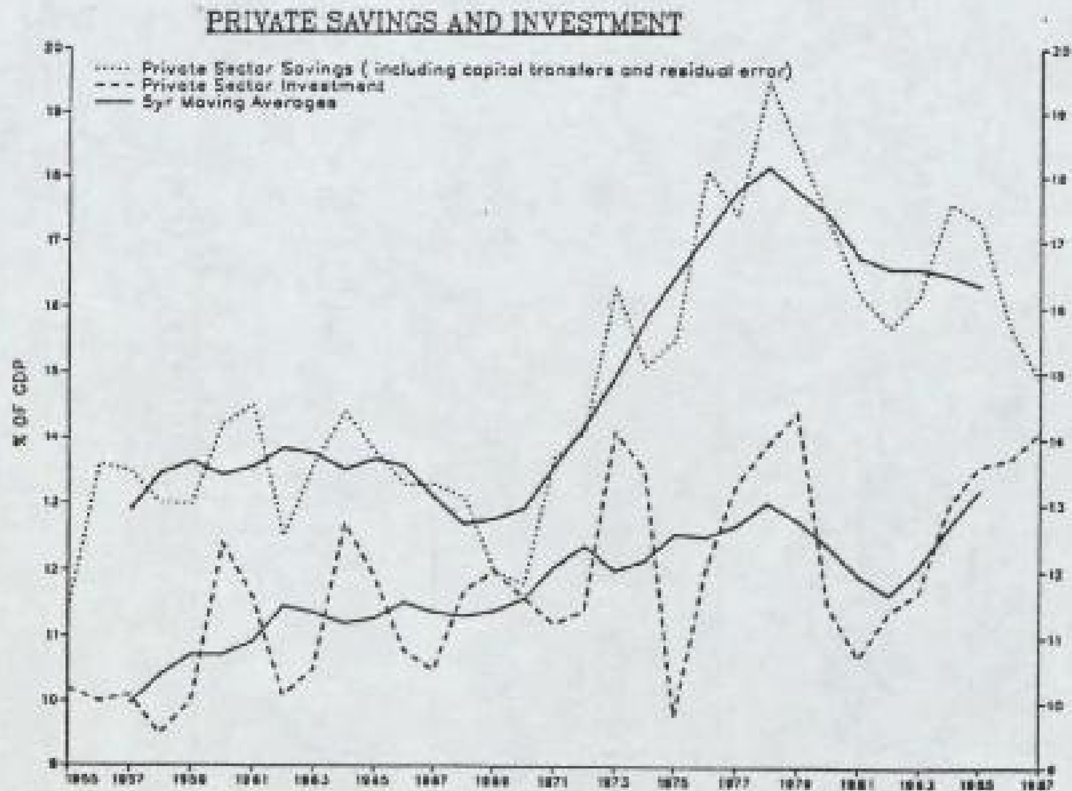
	General Government Expenditure (excluding privatisation proceeds)	Non-North Sea Taxes plus NICs (as % of non-North Sea GDP)	Total Taxes plus NICs	PSBR
1973-74	42.6	33.1	33.2	5.8
1974-75	48.0	35.7	35.7	9.0
1975-76	48.5	36.1	36.2	9.4
1976-77	45.9	36.0	35.8	6.4
1977-78	42.6	35.0	34.7	3.6
1978-79	43.2	34.1	33.8	5.3
1979-80	43.4	35.2	35.1	4.8
1980-81	46.0	36.1	36.3	5.4
1981-82	46.5	38.9	39.3	3.3
1982-83	46.8	38.2	38.9	3.1
1983-84	45.9	37.8	38.5	3.2
1984-85	46.2	37.8	39.1	3.1
1985-86	44.5	37.0	38.5	1.6
1986-87	43.9	37.4	37.9	0.9
Latest Estimate				
1987-88	41.7	37.8	38.1	-0.7

12. The ratio of public expenditure to GDP has fallen sharply since 1982-3 whether privatisation proceeds are included or excluded. The ratio of non-North Sea taxes to non-North Sea GDP fell between 1981-82 and 1985-6 but has risen over the past two years. As a result the PSBR has been falling sharply as a share of GDP.

13. The Public Expenditure White Paper shows the public expenditure ratio continuing to fall. Inevitably there is some uncertainty about the projections for tax receipts. But with unchanged tax rates the non-North Sea tax ratio is expected to rise further.

14. Looking ahead, the fiscal position is likely to continue to be very strong, implying little or no public sector borrowing.

15. The flow of private savings is projected to be below the level of private sector investment. This is an unusual situation (see Chart). Net private sector savings have been falling as a share of GDP largely because of lower inflation and improved confidence about the economic prospect; but there may be other, temporary, factors at work. Mortgage lending growth in particular has been very rapid. Private sector investment is rising because of higher profitability, the higher levels of capacity utilisation, and some transfer of investment from the public sector (particularly housing and the privatisation programme).



16. There may be a current account deficit of about 1 per cent of GDP. But this should not pose a problem given its size in relation to the stock of net overseas assets, the availability of world financial capital, the improved rate of return and the possibly temporary nature of the fall in private sector savings.

Issues for Discussion

(a) Is it agreed that while world activity may continue to grow in 1988 at not much less than its recent rate, there are likely to be continued market uncertainties, particularly with respect to the dollar? Is it agreed that this points to a cautious fiscal and monetary policy in the UK?

(b) Is it agreed that it would be undesirable to see a further rise in non-North Sea taxes as a proportion of GDP although there may not be much immediate scope for a reduction?

(c) Is it agreed that a current account deficit does not pose a serious problem when the Government's budget is in balance and private investment is growing rapidly? Is it agreed that we should not seek to eliminate the current account deficit through a lower exchange rate?

(d) Is it agreed that, in order to maintain adequate downward pressure on inflation, we should take any opportunity that becomes available to tighten monetary policy without producing excessive upward pressure on the exchange rate?

18 January 1988

PRIME MINISTER

MEETING WITH SIR ALAN WALTERS: 9 JANUARY

The meeting has been arranged for 0930. I gather from Sir Alan today that in order to catch his plane he would like to leave No. 10 by 1015. He (and I) will be here from 0900, so if you wish to have more than 45 minutes you might want to consider starting the meeting a bit earlier.

PAUL GRAY

8 January 1988

P.G.

D

You are coming in.

N.W.
5.1

MR. WICKS

The Prime Minister has agreed to see Professor Alan Walters at 0930 on Saturday, 9 January, immediately after her return from Africa. He has been informed. You will no doubt want to sit in on the meeting or arrange for Mr. Gray to do so.

C.D.P.

Tessa told.

CDP

31 December, 1987.

PART 27 ends:-

Ch Ex to PM 24.7.87

PART 28 begins:-

CDP to NLW 31.12.87

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